Creditreform Sovereign Rating

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Rating Object	Rating Information	
ITALIAN REPUBLIC Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Assigned Ratings/Outlook: **BBB- /stable**	Type: Follow-up Rating, unsolicited
	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	28-10-2016 29-09-2017 “Sovereign Ratings”

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Rating Action

Neuss, 29 September 2017

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of “BBB-” for the Italian Republic. Creditreform Rating has also affirmed Italy’s unsolicited ratings for foreign and local currency senior unsecured long-term debt of “BBB-”. The outlook is stable.

Key Rating Drivers

1. Large and diversified domestic economy, as well as high net wealth of households providing some buffer against external shocks
2. Economic recovery set to strengthen in 2017-18, but medium-term growth prospects remain modest against the backdrop of unfavorable TFP and labor productivity trends over the recent years
3. High debt levels and moderate progress on deficit adjustment, complemented by uncertainty related to fiscal policy after the 2018 elections and persisting weaknesses in the banking sector
4. Reforms aimed at improving the efficiency of public administration and reducing the regulatory burden have been initiated; while the 2015 Jobs Act appears to be bearing fruit, limited progress regarding the Annual Competition Law and Public Administration Reform
5. External position has somewhat strengthened; though still in a net debtor position, NIIP improved in 2016 as government and deposit-taking corporations continued to reduce external liabilities

Reasons for the Rating Decision

Our assessment of the Italian Republic’s highly satisfactory creditworthiness continues to be backed by its large and diversified economy. With nominal GDP reported at USD 1.85tr in 2016, Italy was the third-largest economy in the euro area and 8th in the world. The country features a diversified economy, with services contributing 73.8% to gross value added in Q2-17. Furthermore, Italy’s economic resilience is backed by high net wealth of private households, amounting to 190.9% of GDP in Q1-17, as well as high per

capita income levels. According to the IMF, Italian GDP per capita stood at USD 36,833 (PPP) last year – in line with the euro area median.

By contrast, Italy's ratings remain constrained by institutional inefficiencies, persisting problems in the banking sector, heightened uncertainty related to the fiscal outlook, as well as the sovereign's large debt stock.

Although we expect Italy's debt-to-GDP ratio (2016: 132.6%) to peak this year and stabilize thereafter, public debt levels will remain high in the medium term. Currently, Italy's debt sustainability benefits from the ECB's Public Sector Purchase Program. Since March 2015, the volume of the ECB's net purchases of Italian government debt has mounted to EUR 291.4bn (Aug-17), with positive repercussions on the sovereign's funding costs. In September 2017 Italian 10y government bonds yielded at about 1.8%. However, sharply rising interest rates or slower-than-projected GDP growth could pose a risk to Italy's medium-term debt sustainability. Although from low levels, bond yields have trended upward since Sep-16 (1.1%). As the government has to refinance about one third of its outstanding marketable debt in 2018-20, significantly higher rates could put debt consolidation at risk. To be sure, this is not our baseline scenario, as we expect a very gradual tightening of the monetary policy stance in the euro area. Moreover, interest risks should be somewhat mitigated by the structure of the government debt stock. Throughout the last year, Italy continued to capitalize on favorable financing conditions and extended its maturity profile. As indicated by Banca d'Italia data, the average residual maturity of the sovereign's gross debt increased from 7.1y in Jul-16 to 7.3y in Jul-17.

Regarding its fiscal framework, Italy adopted a comprehensive reform of the budgetary process in 2016, which we view as positive. Going forward, spending reviews and targets for each ministry are foreseen to be integrated in the government budget in order to improve the reliability of medium-term fiscal planning. Furthermore, public procurement was streamlined, which should yield some efficiency gains in the future.

Turning to Italy's budgetary performance in 2016, some improvement was observed as the budget deficit narrowed from 2.7 (2015) to 2.4% of GDP, broadly in line with the government's 2016 stability program target (2.3% of GDP). While lower interest payments accounted for half of this improvement, primary expenditures stalled (+0.1%). Meanwhile, the revenue side of the budget benefited from the ongoing economic recovery. Direct taxes increased by 2.3% y-o-y, driven by stronger CIT and PIT-receipts. Social security contributions experienced only moderate growth (1.1%), which can partly be attributed to fiscal incentives for new permanent hires – an element of the 2015 Jobs Act.

With regard to this year, the repeal of the 2015 VAT increase should result in revenue losses of approx. 0.9% of GDP. By contrast, revenue-enhancing measures add up to only 0.4% GDP. More importantly, whether the measures proposed will yield the expected results is subject to uncertainty. According to Italian authorities, better tax compliance (in particular VAT compliance) and one-off receipts from the voluntarily disclosure of assets held abroad, as well as payments of tax arrears, should result in additional revenues of EUR 6.2bn in 2017. In spite of uncertainties related to measures taken on the revenue side, we believe that the headline deficit targeted in Italy's 2017 stability program is within

reach, since stronger-than-expected economic activity should provide some fiscal buffers. As a result, we expect Italy's budget balance to come in at -2.1% of GDP in 2017, with one-off expenses related to refugees and earthquake prevention accounting for 0.3 p.p.

Beyond 2017, there is considerable uncertainty surrounding Italy's fiscal outcomes. Recently, Italy's treasury revised its deficit target for 2018 from 1.2 to 1.6% of GDP, which we view as ambitious. On the one hand, Italy has a track record of fiscal slippage. What is more, in view of the upcoming general elections (not later than May-2018) we believe it is rather unlikely that the current government will implement additional significant consolidation measures and there may be a risk of further back-tracking on reforms already implemented. After losing the constitutional referendum, Matteo Renzi (PD) resigned as PM and Paolo Gentiloni (PD) took office on 11 December 2016. In its 2017 budget, PM Gentiloni's government raised minimum pensions and eased requirements for early retirement, thus revising parts of the 2011 pension reforms. The outcome of the general election could entail risks with regard to budget consolidation, as the formation of a stable government could prove rather challenging. According to latest polls, a head-to-head race of the governing PD and the euro-sceptic Five Star Movement can be expected.

Despite showing gradual improvements, Italy's banking sector is still suffering from a high stock of non-performing loans, comparatively low capital buffers, and subdued profitability. According to EBA data, the NPL ratio of Italian banks slightly decreased from 16.6% (Q1-16) to a still high 14.8% (Q1-17) as the inflow of new non-performing loans continued to decelerate. At the same time, the NPL coverage ratio improved, reaching 50.6% (Q1-17), up from 45.8% one year before. However, higher asset quality has not translated into stronger capital buffers yet. The CET1 ratio of Italian banks posted at 11.5% in Q1-17, which is close to the 2016 level (Q1-16: 11.4%), but considerably below the EU-28 average of 14.1%. Despite the recent slight increase in return on assets (from 0.2% in Q1-16 to 0.5% in Q1-17), capital generation of Italian banks is still hampered by subdued profitability. Alongside ongoing loan loss provisioning, subdued credit demand continues to exert pressure on profitability metrics. While lending to households has shown modest growth in the 1% range since Oct-16, the outstanding volume of loans to NFCs continued to contract. Against this backdrop, a faster consolidation of Italy's fragmented banking system could be supportive to bank profits. So far, reforms aiming to consolidate the number of banks and to strengthen governance procedures are advancing according to schedule. While all but two cooperative banks (banche popolari) have already transformed into joint-stock companies, the mutual bank reform (banche di credito cooperativo) started in Nov-16.

Although we have seen a gradual recovery in the banking sector as a whole, several banks have faced serious problems in the recent past, resulting in state intervention. In order to support ailing banks, the government adopted Decree Law 237/2016 on 23 Dec-2016, which empowered the Italian Ministry of Economy and Finance to grant state guarantees on liabilities issued by Italian banks, as well as emergency liquidity assistance. The decree also contained provisions allowing for precautionary recapitalization of banks by the state. For this purpose, funds in the amount of EUR 20bn were made available by the Italian government. The adoption of the decree has to be seen in the light of the coun-

try's fourth largest bank Monte Dei Paschi di Siena's (MPS) failure to raise funds by the end of the year in order to comply with an ECB deadline. On 26 December 2016 the ECB stated that the capital shortfall of MPS has risen to EUR 8.8bn, up from the EUR 5bn previously expected. To prevent a bail in of senior creditors, Italy asked the EU Commission to make use of an exception within the European BRRD framework (Bank Resolution and Recovery Directive). Contingent on a debt-to-equity swap for subordinated creditors and the sale of NPLs in the amount of EUR 26.1bn, the commission approved Italy's restructuring plan in Jul-17, allowing the government to support MPS with funds worth EUR 5.4bn out of its precautionary recapitalization fund. Also, in summer 2017, the ECB determined that Banca Popolare di Vicenza S.p.A and Veneto Banca were failing or likely to fail. Following the EU Commission's approval of state aid, parts of the banks' activities were transferred to Intesa Sanpaolo, which received a cash injection of EUR 4.785bn and state guarantees worth up to EUR 12bn. While the claims of senior creditors were protected, sizeable costs were imposed on taxpayers and on the privately funded backstop facility Atlante, which had been encouraged to invest in both banks only months before.

With regard to Italy's macroeconomic performance, the economic recovery seen in 2015 was sustained last year. After expanding by 1.0% in 2015, Italy's real GDP growth stabilized at 0.9% in 2016. Last year's growth was mainly driven by firm domestic demand. Private consumption expenditure remained on its growth trajectory and increased by 1.5% (2015: 2.0%), driven by improving labor market conditions, some tax relief, and subdued inflation. Moreover, domestic demand benefited from a pick-up in investment, which grew by 2.8% y-o-y supported by tax incentives and favorable financing conditions. In particular, investment in machinery and equipment strengthened in the second half of the year and expanded by 7.1% y-o-y, posting the strongest growth in seventeen years. In addition, construction investment, which has continuously contracted since 2008, reported small but positive growth last year (1.1% y-o-y). Net exports did not contribute to growth, with both import (3.1%) and export growth (2.4%) decelerating in 2016.

Real GDP growth should gain some momentum in 2017-18, averaging at 1.3%. Our expectation is underpinned by the latest data, according to which y-o-y growth has accelerated to 1.5% in Q2-17, up from 1.2% in Q4-16 and Q1-17. We expect domestic demand to remain the key driver of economic expansion. Private consumption spending should display positive growth this year despite higher inflation rates and job creation somewhat slowing down – we expect consumption to lose some steam in 2018. While the number of employed persons increased by 1.3 and 1.2% in Q1-17 and Q4-16 respectively, it edged down to 0.9% in Q2-17 (Istat data, s.a.). Consumer prices, which were broadly stagnant in 2014-16, are expected to increase by 1.4% this year. According to Eurostat data, HICP inflation stood at 1.4% (Aug-17), up from -0.1% a year before, as the effect of declining energy prices is fading out. Investment should continue to recover in 2017-18, buttressed by favorable financing conditions and the prolongation of tax incentives. While net exports should contribute negatively to growth in 2017, this drag should diminish going forward, mainly due to a brighter outlook in key export markets.

Notwithstanding the solid growth performance we expect in the near term, medium-term growth prospects appear less favorable, due to anemic TFP and labor productivity trends,

which persisted in 2016. Real labor productivity per person employed (-0.3%, Eurostat) and TFP growth (0.1%, AMECO) continued to be weaker than in the euro area (+0.4 and +0.6%). In order to boost potential growth, the Italian government has pursued a multi-pronged approach since 2015, including labor market reforms and liberalization of several industries. With regard to the latter, progress has been limited so far. After two years of discussion, the Annual Competition Law, which aims to open up the some network industries and professional services, was finally approved by parliament in Aug-17. However, the law adopted was less ambitious than the initial draft. Thus, the impact on TFP growth may be moderate in the medium term. By contrast, the implemented labor market reforms seem to be yielding positive results. While unemployment (annual average) only experienced a moderate decline from 11.9 to 11.7% in 2016, employment growth accelerated for the third consecutive year and came in at 1.2% (+268.500 persons). Notably, the number of new hires with open-ended contracts increased significantly – likely the result of fiscal incentives provided by the 2015 Jobs Act. To be sure, it has to be seen whether this development can be sustained as hiring subsidies are gradually phased out. At the same time, negotiations between social partners on a decentralized wage setting framework have not yielded results yet. In our view, more bargaining at the firm level may better align wage and productivity growth in the future and prevent a build-up of ULC gaps with Italy's euro area peers. Although unit labor costs have been stagnating since 2014, past losses in cost competitiveness have not yet been recovered.

Alongside external cost competitiveness, we regard institutional inefficiencies as a major impediment to a stronger recovery of the Italian economy. According to WEF's Global Competitiveness index, Italy ranks at 44/138 (EA-19 median 32). Meanwhile, Italy's institutional setting (GCI 1st pillar) is of mediocre quality, though the country improved somewhat from rank 106 to 103/138 countries in the 2016-17 report. Nevertheless, as compared to the euro area median (rank 38), Italy still scores below average on institutional quality. As highlighted by the recent report, Italy has ample room to improve the performance of its public sector and to fight its' still prevalent corruption. Results of the ongoing public administration (Law 124/2015) reform are mixed. Several implementing decrees regarding the reorganization of public sector employees and state-owned enterprises were adopted in Nov-16, but declared unconstitutional by the Constitutional Court. In its decision, the court stated that the reforms would require the participation of local administrations in the legislative process. As a result, some decrees were amended and finally approved, while others have expired.

Turning to Italy's external position, the risk situation somewhat improved in 2016, with the current account surplus increasing to 2.6% of GDP (Eurostat data; 2015: 1.4% of GDP), driven by stronger trade in goods and primary income balances. While the trade in goods surplus was up from 3.1 to 3.6% of GDP in 2015-16, the primary balance increased to 0.2% of GDP, partly reflecting lower interest payments on government debt held by foreign investors. At the same time, Italy remained a net borrower vis-a-vis the rest of the world. While households and NFCs sustained strong net asset positions, deposit-taking corporations and the government displayed sizeable net external liabilities totaling at 52.5% of GDP (end-2016). However, last year's improvement in Italy's NIIP from -23.5 to

-15.0% of GDP was mainly explained by a continuous decline in the banking and government sector's external liabilities. Nevertheless, some risks pertain to the composition of external liabilities. At the end of 2016, interest-bearing debt accounted for 75% of Italy's external liabilities, increasing the economy's vulnerability to sudden shifts in investor sentiment.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating of BBB- is stable, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – will remain fundamentally unchanged over the next 12 months.

We could consider a downgrade of our rating if medium-term GDP growth falls significantly short of our current expectations. In the absence of additional consolidation measures, weaker growth would imply a further deterioration of the government's already stretched debt-to-GDP ratio. Furthermore, public support for struggling banks could exceed the EUR 20bn provided by the precautionary recapitalization fund and result in a further increase of public debt. Against the backdrop of the upcoming general elections, uncertainty regarding future economic and fiscal policies is considerable. Backtracking or delaying structural reforms could lead to fiscal slippages, negatively affecting the government's credibility and in turn increase refinancing costs.

Factors which could translate into a rating upgrade include economic growth above our current expectations, coupled with a continuing recovery of the labor market. In that respect, a faster-than-projected workout of NPLs could improve banks' lending capacity and in turn boost real GDP growth. We could also consider an upgrade of our ratings if we see sustained and credible fiscal consolidation. Achieving a durable reduction in the headline deficit and a stabilization of the debt-to-GDP ratio should remain high priorities to any new government. Meanwhile, the implementation of important reforms (public sector reform, wage-setting framework) should advance without substantial delays and not be watered down in social dialogue and in the parliamentary process.

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Ratings*

Long-term sovereign rating	BBB- /stable
Foreign currency senior unsecured long-term debt	BBB- /stable
Local currency senior unsecured long-term debt	BBB- /stable

*) Unsolicited

Economic Data

[in %, otherwise indicated]	2011	2012	2013	2014	2015	2016	2017e
Real GDP growth	0.6	-2.8	-1.7	0.1	1.0	0.9	1.3
GDP per capita (PPP, USD)	35,896	35,509	35,286	35,309	35,961	36,833	37,905
Inflation rate, y-o-y change	2.9	3.3	1.2	0.2	0.1	-0.1	1.4
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	82.2	82.2	82.7	83.1	83.5	n.a.	n.a.
Fiscal balance/GDP	-3.7	-2.9	-2.9	-3.0	-2.7	-2.4	-2.1
Current account balance/GDP	-3.0	-0.4	1.0	1.9	1.4	2.6	n.a.
External debt/GDP	104.9	122.5	123.7	113.6	123.6	119.7	n.a.

Source: International Monetary Fund, World Bank, Eurostat, own estimates

Appendix

Regulatory Requirements

This sovereign rating is an unsolicited credit rating. The Dipartimento del Tesoro at the Ministero dell'Economia e delle Finanze (DT) participated in the credit rating process as the DT provided additional information and commented on a draft version of the report. Thus, this report represents an updated version which was augmented in response to the factual remarks of DT during their review. However, the rating outcome as well as the related outlook remained unchanged.

The rating was conducted on the basis of CRAG´s “Sovereign Ratings” methodology. CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies is published on the following internet page: www.creditreform-rating.de.

To prepare this credit rating, CRAG has used following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, Dipartimento del Tesoro - Ministero dell'Economia e delle Finanze, Banca d'Italia, and Istituto Nazionale di Statistica.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with and that the rating action was and is free of any existing or potential conflicts of interest. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all

risk factors is described in CRAG´s "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

In the case of a rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report.

There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In regard to the rated entity CRAG regarded available historical data as sufficient.

In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

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An explanatory statement of the meaning of CRAG`s default rates are available in the credit rating methodologies disclosed on the website.

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