Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
ITALIAN REPUBLIC	Assigned Ratings/Outlook: **BBB- /negative**	Type: Monitoring, unsolicited with participation
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	28-10-2016 21-08-2020 "Sovereign Ratings" "Rating Criteria and Definitions"

Rating Action

Neuss, 21 August 2020

Creditreform Rating has revised its outlook on the Italian Republic to "negative" from "stable" and affirmed the unsolicited long-term sovereign rating of "BBB-". Creditreform Rating has also affirmed Italy's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "BBB-".

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Key Rating Drivers

1. Overall robust macroeconomic performance profile buttressed by large, wealthy and diversified economy; persistently low productivity and structural labor market weaknesses weigh on potential growth, with unfavorable demographic outlook presenting additional challenges as regards the medium-to-longer-term growth outlook
2. Corona crisis and the necessary strict lockdown to cause a drastic fall in real GDP this year, but baseline scenario is for growth to rebound in 2021, aided by solid private sector balance sheets as well as by recently agreed EU-level funds from which Italy stands to benefit; nevertheless, the course of recovery remains hardly predictable at this stage
3. Generally strong institutional framework, although latest set of governance indicators continues to underscore room to improve; policymaking remains challenging given the essentially volatile political context; recent backtracking on pension reform to be monitored
4. Headline deficit and debt-to-GDP ratio to soar from already high levels in the face of falling economic activity and ample Covid-19 support measures; some concern over resurfacing contingent liability risks from the banking sector despite overall more robust situation and strengthened restructuring/resolution framework; demographic challenges remain in place
5. Whilst our expectation of a gradually declining debt ratio is subject to high uncertainty, sound debt management, as well as ECB and EU policies - which we deem as highly conducive to debt affordability - allay our sustainability concerns for now

6. External risks appear limited, with ongoing current account surpluses as a moderating influence and in light of NIIP being close to a balanced position

Reasons for the Rating Decision

Creditreform Rating has revised its outlook on the Italian Republic from stable to negative, mirroring

(i) that sharply falling economic growth and necessary strict confinement measures along with the support packages to mitigate the respective fallout will have the headline deficit skyrocket and cause the debt-to-GDP ratio to soar from an already high level, thus amplifying a key credit weakness

(ii) uncertainty as regards the extent to which and the pace at which the sovereign will be able to lower the debt ratio to more sustainable levels in the medium term

(iii) concern over a possible delay of productivity-raising structural reforms, as priorities may have shifted due to the devastating force of the pandemic, with negative reverberations for an already moderate medium-term growth outlook

Macroeconomic Performance

We assess Italy's macroeconomic profile as overall robust given the considerable size, diversification, and wealth of the economy, as well as the substantial net financial wealth of Italian households and the strong risk-bearing capacity of non-financial corporations, which all provide for a certain degree of resilience to economic shocks. Ongoing structural deficiencies as regards the labor market, persistently low productivity, and struggles to enhance competitiveness represent weaknesses that balance these strengths and weigh on the medium-to-longer-term growth outlook. The Covid-19 pandemic, which has hit the country very hard, will likely cause a drastic albeit short-lived decline in economic output. While the strong response from the government and relevant EU institutions, including the recent agreement among the EU countries on joint funding programs summarized under Next Generation EU (NGEU), have set the stage for a recovery from the second half of this year, the shape thereof is hard to predict at this stage. Not least in the face of probably longer lasting damage to the important tourism industry and the time it takes to develop vaccines, we think there remain pronounced downside risks to the outlook.

The Covid-19 pandemic struck at a time when the Italian economy was already in a cyclically weak state, following a late and sluggish upswing in the years 2015-2018 compared to the other major euro area economies, adding to Italy's lackluster GDP growth track record over the last two decades. From an intermediate high at 1.7% in 2017, GDP growth slowed markedly in the following year and continued to hover on the brink of recession, with annual growth coming to just 0.3% last year. Despite some support from the new minimum income scheme introduced last year and from low inflation, 2019 saw further easing of consumer spending, which expanded by only 0.4% (2018: 0.9%), largely driven by modest disposable income growth and weakening consumer sentiment. Given slowing momentum in domestic and external demand, last year's increase in gross fixed capital formation was also smaller than in the prior year (1.4%, 2018: 3.1%). Above all, investment in machinery

and equipment almost stalled (0.3%, 2018: 4.0%, Istat data) on the back of the deteriorating global trade environment and the downturn in the manufacturing sector, whereas construction investment continued to expand at a rate similar to that in the preceding year (2.6%, 2018: 2.8%). As imports shrank by 0.4% against the backdrop of decelerating domestic demand, whereas exports still expanded by 1.2% (2018: 2.3%), net exports contributed positively to GDP growth. It has to be stressed that, given the challenging international trade environment and further falling vehicle exports (-15.9%, ANFIA), export activity proved comparatively resilient after all. The fact that inventories were drawn down, ultimately taking 0.6 p.p. off GDP growth, helps to explain why this was the case, for industrial production (excluding construction) fell by 1.0% last year.

The evolving Covid-19 pandemic posed grave challenges to Italy's health system in the early stages, forcing Italian authorities to impose severe confinement measures and eventually a nation-wide lockdown which ceased on 4 May. As suggested by our Pandemic Vulnerability Index, Italy generally seems less well equipped to deal with a pandemic threat than other European countries. Compared to several other fellow euro area members, Italians thus had to live through a rather strict lockdown period, as indicated by the stringency index compiled by Blavatnik School of Government. Along with disruptions to production and trade flows, closed shops, hotels, and restaurants put a stop to a wide range of economic activity, leaving the country to record one of the steepest falls in real GDP among the euro area countries in Q1-20 (-5.4% q-o-q, euro area: -3.6%). All main GDP expenditure components contracted sharply, with investment and exports experiencing the largest drops. However, with the bulk of the lockdown occurring in Q2-20, GDP results were considerably worse, as reflected in a spectacular slump to the tune of 12.4% q-o-q according to preliminary data (Istat), as both domestic demand and net exports likely exerted tremendous negative effects.

Looking forward, we would estimate the Italian real GDP to contract by about 10.5% in 2020. For 2021, we would expect GDP to see an increase to the tune of about 6.5%, acknowledging that uncertainty around such estimates remains extremely high at this juncture. Gross fixed capital formation should register a steep decline this year followed by a rather gradual recovery as corporates urge to keep liquidity afloat, capacity utilization levels off, and prospects for domestic and external demand are shrouded in uncertainty. Investment decisions could thus be postponed to next year or even be cancelled altogether.

We expect household spending to rebound in the second half of the year, supported by low HICP inflation and government measures that will at least postpone layoffs and back disposable income in the near term. The labor market, however, was already set to weaken when Covid-19 hit. As opposed to the euro area, employment had started to fall in the second half of 2019, declining by 0.1% q-o-q in the fourth quarter of 2019 (Eurostat, total employment domestic concept). In Q1-20, employment declined by 0.3% q-o-q, while in the euro area the number of jobs decreased by 0.2%. Italy's unemployment rate averaged 10.0% in 2019 and fell to 9.0% in Q1-20 (LFS, sa), continuing to compare unfavorably with the euro area as a whole (7.3% in Q1-20). According to the Parliamentary Budget Office (UPB), the share of supplemented hours used came to only about 63% of hours authorized

in April and May (roughly 943m of about 1.5bn hours authorized under the wage supplement scheme), suggesting that the uptake of this instrument was more limited than assumed. Having said this, against the backdrop of a likely rising number of insolvencies in the wake of Covid-19 and despite best efforts to shield the labor market, unemployment will likely begin to climb more steeply at some point. Faced with such prospects, many households may take precautionary measures and increase their savings. Due to the dismal first half of the year, private consumption overall will post a deep recession in 2020.

Adverse repercussions will be felt in external trade, weighed down by supply chain disruptions, extreme uncertainty, and faltering external demand. People's reluctance to travel under the current circumstances will slow the recovery of Italy's export performance going forward, bearing in mind the significance of its tourism sector. According to the OECD, tourism-related services accounted for almost 40% of Italy's overall export services in 2018. Including indirect effects, tourism accounted for 13% of GDP (2017) and provided employment to roughly 15% of the workforce, with about 8% directly employed in the industry.

With a view to a recovery in the second half of the year, industrial production data support expectations of rebound, given monthly increases of 41.6% in May and 8.2% in June (total industry excl. construction), on the heels of contractions of 28.4% and 20.5% in March and April. As confinement measures were lifted, retail trade volume saw increases of 25.1% and 12.5% in May and June, not yet compensating for similarly strong declines in the two prior months. In addition, we favorably note that sentiment indicators such as the Purchasing Managers' Index (PMI) for the manufacturing and service sectors have risen further in July, with both metrics rising above the 50-point-threshold usually associated with expanding activities, and the manufacturing PMI even exceeding pre-corona levels. The business and consumer confidence indicators compiled by Istat were less upbeat in July. While recovering to some extent, they nevertheless remained below pre-corona levels. Sentiment regarding export order books in the manufacturing sector remained rather depressed despite slight improvements. Taken together, the results seem to call for some caution as regards the strength of the expected recovery.

In order to minimize economic fallout from the pandemic, Italian authorities have adopted four main support packages since March (Cura Italia, Liquidity Decree, Rilancio, Decreto Agosto), containing measures to bolster the health care system, enable companies to retain staff through wage-supplementation schemes, and provide liquidity via grants and bank loan guarantees, as well as guarantees to sustain exports to firms of all sizes (see also below). The latest stimulus package was approved on 7 August, including an option to pay taxes in instalments and an extension of the temporary layoff scheme by 18 weeks, subject to conditions.

In addition to the national support packages, the ECB's non-standard monetary policy measures should help to keep financing conditions for households and NFCs at moderate levels. In the medium term, Italy's economic recovery will also be backed by the recently agreed recovery plan for Europe (NGEU), of which the Recovery and Resilience Facility (RFF) represents the largest chunk, with payments commencing from 2021 onwards. Italy will be a beneficiary of the package, with grants according to the foreseen allocation key amounting to an estimated EUR 85bn or approx. 4.7% of 2019 GDP. The hard-fought agreement

among EU members might even prove to be a springboard for business and consumer sentiment in the second half of this year, although this would likely be trumped by concern in the event of renewed significant virus infection waves. We note that the EU Parliament's consent to NGEU is still pending, but do not expect this to present a major obstacle with regard to the implementation of the RFF.

We think that Italy's highly diversified economy and pronounced risk-bearing capacities in the private sector will be conducive to next year's recovery. Italy's diversification ratio of 3.2 (Q1-20), measured as the ratio of gross added value contributed by the service sector and the industry, is similar to that of the euro area overall (3.0) and does not point to excessive concentration in one sector. The high degree of diversification is further buttressed by UNCTAD's merchandise export product concentration index, according to which Italy ranks first in a worldwide comparison (2018: 0.053). Private debt levels seem to offer some buffers in terms of risk-bearing capacities, rather than adding to any vulnerabilities. We recall that Italian private households are among the wealthiest in the euro area given a net financial wealth posting at roughly 183% of GDP (Q4-19, Eurostat data), the third highest level in the euro area. As regards private household debt in relation to disposable income, Italy continues to display a significantly lower level than other major euro area economies (Q1-20: 61.9%, ECB data). NFC debt totaled 72.3% of GDP in Q1-20, continuing a flattish downward trend and moving in mid-field among the EU countries. Moreover, we would reiterate that the size of the Italian economy, which amounted to roughly USD 1.99tn in 2019 (IMF), constituting the eighth largest in the world, provides for some resilience to economic shocks. With an estimated per-capita income of USD 40,470 (2019, PPP terms, current prices), the country continues to enjoy a relatively high level of prosperity.

We note, however, that the gap to the EU-27 has continued to widen until recently, as the Italian GDP per capita edged down to 95% of the EU-27 level in 2019 (2018: 97%). We take the view that laggard per capita incomes are mostly explained by low productivity growth, which remains one of Italy's main weaknesses, as for instance reflected in a very subdued increase of real labor productivity per hour worked by 1.2% between 2010 and 2019, well behind the increase of 7.9% recorded for the euro area as a whole. Compared to 2015, labor productivity virtually stagnated in Italy, while rising by 2.5% in the euro area. Furthermore, Italy's total factor productivity averaged 0.3% in 2010-19 (AMECO data), against 0.7% in the euro area.

Low productivity remains a key weakness persistently obstructing Italy's potential growth, which international organizations reckon to lie below the levels seen in other major euro area economies, averaging 0.3% since 2001, compared to 1.3% in Germany and France respectively and 1.7% in Spain (AMECO data). Pertinent deterrents to labor productivity, in our view, include innovation gaps and lagging digitization in the non-financial corporate sector, demographic headwinds, public administration capacities, a comparatively large informal economy, and structural impediments on the labor market.

Part of the problem is thus to be seen in a low labor participation, pertaining to which Italy displays the lowest rate in the EU. The rate posted at 65.7% in 2019 as compared to 73.4% in the EU27. While we observe some progress, the share of young people neither in employment nor in training also remains very high compared to the euro area economies, at

18.1% against 10.2% in the euro area (2019, 15-24yrs), pointing to pressing needs to enhance labor market inclusion with a view to raise potential growth. As hinted at by the EU's social scoreboard, Italy's labor market structure compares rather poorly with other euro area economies overall. Against the backdrop of headwind to labor input, we also remain vigilant of adverse demographic developments. Demographic projections for Italy remain dim. Already facing a very high median age (2019: 46.7y) and a high old-age dependency ratio (35.7 in 2019), we note that the country's population is forecast to shrink by 0.7% between 2019 and 2030, against an increase of 1.4% in the euro area as a whole (Eurostat), thus putting pressure on labor supply and public finances, as also elaborated further below.

Italy's modest level of public investment in percent of GDP, averaging at 2.5% in 2010-19, adds to woes pertaining to low potential growth. Posting at 2.3% of GDP last year, public investment remains among the lowest in Europe (euro area: 2.8% of GDP), and has only recently paused a downward trend. In particular, increasing R&D investment appears pivotal, as this has been trailing the euro area as a whole for a number of years. At 1.4% of GDP (2018, Eurostat), Italy's capital spending on R&D remains well below levels in Germany (3.1%) and France (2.2%), as well as below the euro area as a whole (2.2%). Against this backdrop, we would monitor closely how the EU funds to be paid out from next year will be used, in particular in how far they will be geared towards strengthening Italy's lackluster potential growth. In this vein, we recall that according to the latest Digital Economy and Society Index (DESI, European Commission), Italy counts among the least advanced digital economies, being in 25th position of the 2019 EU-28 as regards the overall index.

To be sure, we note that policy-makers are attentive to these developments. The multi-year plan adopted by the government in December 2019 ('Italia 2025'), aiming to drive the digital transformation of the country forward, thus seems to be pointing into the right direction. Other than that, we acknowledge the government's intention to implement measures aiming at labor inclusion and activation policies, and to boost growth with special focus on environmental sustainability. Under the so-called 'Green New Deal', the government also aims at enhancing public investment as well as private-public-partnerships with the help of two new investment funds.

Despite trending upward, private investment measured against GDP (2019: 15.8%) has also lagged behind that of Germany (19.2%), France (19.7%), and Spain (18.0%). The necessity for the banking sector to decisively address its non-performing loan (NPL) legacy following the global financial crisis and apply stricter conditions as regards NFC lending may have contributed here, but we see that the sovereign is also struggling to improve its business environment, i.e. factors mostly relating to non-cost competitiveness. This is exemplified by Italy's slipping seven places to rank 58 out of 191 economies in the World Bank's Ease of Doing Business ranking. With that, Italy remains well above the EU-27 median of 40. A glance at the sub-categories reveals that there are a number of challenges left to tackle. Paying taxes (rank 128) and enforcing contracts (rank 122) are perceived as particularly arduous, with starting a business (rank 98) and dealing with construction permits (rank 97) likewise not perceived as particularly smooth procedures. By contrast, we observe that the Italian economy has climbed one position to 30 out of 141 economies as regards the World

Economic Forum's Global Competitiveness Index. With that, Italy matches the median of the euro area members. Still, the report identifies weaknesses that mainly concern the labor market category, skills, and ICT adoption. All these points seem to fit in with the impression of an ongoing struggle to increase productivity and push up potential growth.

Having said this, we would conclude that Italian enterprises were able to broadly sustain their global export market share, although it inched down from 2.64% to 2.58% in 2018-19 (2012: 2.62%). This ties in with AMECO data on Italy's cost competitiveness, as measured by real unit labor costs. While comparing favorably against the euro area and key European trading partners over a longer time span (2010-19), which was mainly achieved on the back of a decline in real compensation per employee, Italy's competitiveness has slightly deteriorated more recently, as real compensation increased, whereas productivity growth remained negative.

Institutional Structure

We assess Italy's institutional framework as generally strong and underpinned by euro area/EU membership. The latter seems particularly beneficial in light of substantial support to the financial system through the ECB's monetary policy, including the asset purchase programs and bank supervisory decisions, not least in the face of the corona crisis. The Recovery programs (NGEU) agreed among the EU countries this July represent another case in point, as Italy is set to receive substantial EU support to assist an economic recovery and adjust necessary levers towards achieving higher and more sustainable growth rates.

This being said, the latest vintage of the Worldwide Governance Indicators (WGI) highlights weaknesses that continue to constrain our assessment of the sovereign as far as institutional conditions are concerned. In this vein, we observe that the sovereign's scores remain well below those of the euro area median in terms of the WGIs we consider crucial. With regard to the quality of effectively formulating and implementing policies, the sovereign ranks 44 out of 209 economies (EA median rank 35), while being placed at rank 38 regarding the freedom of speech and media (EA: rank 25). When it comes to control of corruption and the quality of property rights and courts (rule of law), the sovereign only ranks 80 and 81 compared to the EA median of 41 and 32 respectively, but we are aware of continued improvement as regards the former.

Going forward, we believe that measures geared towards tax evasion and the enhancement of the anti-corruption framework are likely to further ameliorate the sovereign's performance on that matter. In this vein, we note that in February, the cabinet approved the so-called 'Bonafede reform' pertaining to the controversial Statute of Limitations, with the effect that termination of trials if a new verdict is not reached within a set time limit is no longer possible after a first-instance ruling. With that, the anti-corruption system has been strengthened. By the same token, efforts to streamline civil procedures are underway, as the Council of Ministers approved an extensive reform at the end of 2019. We understand that the respective Atto Senato n.1662 has not been endorsed by Parliament yet. The judicial system continues to display some deficiencies by European comparison, in particular as regards efficiency, and progress concerning speeding up legal procedures seems slow. While according to the 2020 EU Justice Scoreboard the estimated time it takes to resolve

civil, commercial, administrative and other cases has come down from 399 to 373 days (2018), this time span remains one of the longest among EU countries.

As for the political environment, Italy has a long-standing track record of frequently changing governments. To this end, last year's break-up of the coalition formed between the Lega and the 5-Star Movement in 2018 did not come as a major surprise, even less so as common ground seemed limited. Nevertheless, this stresses the persistent difficulties in cohesive policymaking and decisive tackling of pressing reform needs, exacerbated by the characteristics of the political system, which yields virtually equal powers to the two chambers of parliament and has proven very difficult to reform despite numerous attempts to do so. This being said, parliament recently backed the government's proposal to reduce the number of parliamentarians from 945 to 600, with (elected) seats in the Chamber of Deputies being reduced from 630 to 400 and from 315 to 200 seats in the Senate, with a referendum on that issue to follow on 20 September. However, the intended referendum on this matter, which was supposed to take place between March and June, was delayed until further notice due to the Covid-19 pandemic.

The new government alliance, under continued leadership of non-partisan Giuseppe Conte and sworn in in September 2019, consists of the Five Stars with the Democratic Party (PD) as well as a the Free and Equal (LeU) from the political left and Italia Viva (IV) which has split from the Democratic Party under leadership of former prime minister Renzi. Currently commanding a majority in both chambers, the coalition is explicitly pursuing a more pro-EU course compared to the predecessor government. However, while there seems to be necessary consensus over the management of the corona crisis, the new coalition ultimately appears fragile as well, as for instance demonstrated by attempts of IV to set conditions for a continued cooperation in February and threats to pull out of government over controversy pertaining to the Bonafede reform.

In this context, it is worth pointing out that according to latest polls, Fratelli d'Italia seems to be gaining traction, reaching about 15% of declared voting intentions. Combined with the lately declining Lega, the main right-leaning parties thus account for about 40% of voting intentions. The recent extension of the state of emergency until 15 October, in place since 31 January and equipping the government with enhanced powers, has also drawn criticism from the opposition, not least as the state of emergency is lasting longer than in other euro area countries similarly hard hit by the Covid-19 pandemic. Upcoming regional elections in seven of the 20 regions on 20 September might deliver further insights, and we will continue to follow developments in this regard.

Fiscal Sustainability

We continue to view risks relating to fiscal sustainability as a key credit weakness of the sovereign, against the backdrop of a high debt level, repeated fiscal slippage and postponed debt reduction targets. Adding to this is a comparatively weak banking sector, notwithstanding significant improvements over recent years and substantial benefits from the ECB's monetary policy measures, as well as unfavorable prospects as regards age-related spending. We think that fiscal sustainability risks have increased considerably in light of the corona crisis, as efforts to combat the pandemic and the associated economic damage

have seen the deficit and debt level surging, the latter from an already high level. The track record of short-lived government coalitions and doubts over the longevity of the current one to our mind weighs heavier under these circumstances.

At the same time, we view sound debt management and the prospect of significant funding via NGEU as elements that are mitigating fiscal risks to some degree, informing our decision to affirm the sovereign's credit rating. Perhaps even more importantly, public debt is becoming increasingly affordable and the current interest rate environment, further buttressed by the ECB's Covid-19 measures, bode well for a prospective decline in the interest rate growth differential going forward.

Over the last few years, the sovereign managed to lower the general government deficit from 2.6% of GDP in 2015 to 1.6% of GDP in 2019, while continuing to achieve a primary surplus (2019: 1.7%). The final outturn was significantly lower than projected in the DBP20 (2.2%), where a cautious projection was made on the back of relatively low revenues in the first half of the year due to postponed tax payments to the end of 2019, and in view of uncertain results from new measures against tax evasion. Revenues increased strongly by 2.8% last year, thereby well exceeding the rise in total outlays (1.6%), driven by strong PIT and CIT revenue growth (3.6% respectively), enhanced by more mandatory use of electronic payments. Net social contributions also posted a healthy rise of 3.2% (2018: 3.9%), while the VAT intake picked up more strongly by comparison (2.3% vs. 1.6%). Concurrently, spending growth was tamed by an only small increase in compensation of employees, which grew by 0.4%, following a strong rise of 3.2% in the prior year. Social benefits expanded by 3.2%, compared to 2.1% in 2018, boosted by new benefits targeted at low-income groups.

In view of measures provided for in the Budget Law for the year 2020, a general government deficit to the tune of 2.2% of GDP may have been expected this year. Main initiatives envisaged in the law had included the repeal of the safeguard clause for 2020 and the partial reduction of those envisaged for 2021 and 2022, initiatives to enhance public and private investments, lowering the tax wedge on labor, ramped-up R&D funds, and policy efforts devoted to the combat of tax evasion. However, with the corona crisis unfolding and imposing other priorities, the near- and medium-term outlook for Italy's public finances has changed drastically. Falling revenues amid interruptions to production and the strict lockdown phase, as well as the emergency packages to alleviate the fallout on the economy and, more recently, adopted packages to assist the economic recovery will give a massive rise to the general government deficit and the debt level this year.

According to MEF, the impact of announced measures on net borrowing requirements would amount to roughly EUR 100bn in 2020, including Decreto Agosto. Tax deferrals and guarantees/credit lines would add up to roughly EUR 570bn, corresponding to 35.6% of GDP. Overall, we expect the deficit to leap to approx. 12.1% of GDP this year. The assumed GDP growth rebound should lead to a marked reduction of the deficit in the following year, provided there is no broad-based new round of infections requiring large-scale lockdowns again. Our estimates do not include fiscal effects from the NGEU package. Obviously, the

uncertainty surrounding these hypotheses remains vast, and as long as effective medication and vaccines are not available on a sufficient scale, risks seem firmly skewed to the downside.

The sharply increasing headline deficit, coupled with strongly declining economic activity, will at least temporarily let Italy's public debt ratio swell to even higher levels. At 134.8% of GDP last year, general government debt was stable compared to 2018, but hardly reduced from a peak of 135.4% of GDP in 2014, as the absolute debt level continued to edge up and nominal GDP growth remained anemic. At this level, Italy continues to display the second-highest debt-to-GDP ratio in the euro area, posting far above the ratio recorded for the euro area as a whole (84.1%). Latest data relating to Q1-20 show that the ratio climbed to 137.6% of GDP, with worse to come given the spectacular drop in GDP in Q2-20 and as the government's initiatives began to reach their full bearing from that time.

While there seemed to be no viable alternative to the actions taken, the pandemic highlights and further exacerbates the sovereign's key vulnerability. Against this background, we have to emphasize that the sovereign achieved an annual average primary surplus of 1.5% of GDP over the last ten years, one of the highest readings among the EU27 member states. Hence, the disappointing development of the public debt ratio is, in our view, to a considerable extent driven by insufficient nominal growth coming on the back of weak labor productivity (see above), implying a rather unfavorable interest rate growth differential.

We project the public debt ratio to soar to about 160.5% of GDP this year, while 2021 should see the ratio decrease from this level, as GDP growth will presumably resume and some of the aid measures will have phased out. As suggested, uncertainties around these estimates remain pronounced, not least as this also depends on the materialization of public guarantees, among other factors. In 2019, public guarantees amounted to 4.9% of GDP, a moderate level when compared to other European countries, with 1.4 p.p. thereof dedicated to the financial sector (SP20). The envisaged nationalization of Alitalia, as well as taking over stakes or even fully nationalizing further companies could add to contingent liabilities. However, this is not our baseline scenario at this stage.

Medium-term fiscal risks arising from the banking sector seem to have declined recently, but look set to become more pronounced again, given the deteriorating economic and fiscal environment due to the pandemic. We note that in its recently published Financial Sector Assessment Program, which took place before the outbreak of the Covid-19 pandemic, the IMF among other things attests substantial progress pertaining to the financial safety net and crisis-management framework since its last review in 2013. However, the IMF also identified persisting vulnerabilities, in particular with regard to less systemically important institutions.

Capital provision has continued to improve in the year to Q1-20, rising from 13.7% to 14.1% and bolstering risk-bearing capacities. Over the same period, NPLs have declined markedly, from 8.3% to 6.4% of total loans, continuing on the downward trajectory seen over the last years (EBA data). Nevertheless, the ratio compares high, representing the third-highest reading in the EU – thus signaling elevated risks. In spite of best efforts to minimize the fallout from the crisis, we expect a rising number of insolvencies in the wake of the Covid-

19 pandemic. As a consequence, Italy's NPL ratio is likely to pick up going forward. As far as the relatively large exposure of banks to Italian government debt is concerned, we observe that MFI holdings of Italian bonds had diminished from 10.7% to 10.0% of total assets in the year to Jan-20, before the pandemic broke out. Since then, exposure has risen by about 14% to EUR 428bn or 11.1% of total assets in April, adding to concern over a resurfacing vicious circle between ailing banks and possibly called-for state support that would aggravate fiscal perspectives. For the time being, such a scenario seems somewhat less likely against the backdrop of stepped-up bank restructuring/resolution mechanisms as well as of the ECB's non-standard monetary policy measures, thus containing financial stability risks.

Having said that, bank restructurings are by no means smooth procedures yet. To this end, we are aware of the recent case of Banca Popolare di Bari (BPB), which was put under special administration by Banca d'Italia (BDI) last December, serving as a reminder that the sector's consolidation still has some way to go when it comes to implementing the reform of the large cooperative banks. More challenging appears the case of the systemically important Monte dei Paschi, of which the Italian state currently holds 68%. Presentation of a plan for an exit strategy has been postponed. In the meantime, there are ongoing negotiations over reducing the bank's NPL portfolio. The ECB's consent to the bank's plan to offload NPLs to state-owned asset management company AMCO will reportedly be subject to the bank's increasing its capital ratio.

Another factor adding to fiscal sustainability risks in the medium-to-longer term has to be seen in Italy's unfavorable demographic structure and projections associated with that. Italy's high old-age dependency ratio is estimated to rise by 8.2 p.p. by 2030, against the backdrop of already high age-related costs as measured against GDP (see e.g. EU 2018 Ageing Report). To this end, we would continue to flag some concern over pension measures implemented in 2019 and extended into 2020.

Sound debt management and increasingly affordable debt, also supported by ECB and EU policies, allay our sustainability concerns for now. We note that in its SP20, the government reaffirmed its commitment to medium- to long-term fiscal sustainability. Given the sovereign's well-diversified investor base and a relatively comfortable average weighted maturity of the general government debt profile, which has been stable at 7.3y as of the end of June 2020 compared to the same month in the preceding year (BDI data), we would still deem fiscal risks as somewhat mitigated. We assume that the Italian state should be able to replace high interest-bearing debt by lower yielding refinancing options going forward, thereby potentially improving the interest rate-growth differential.

The ECB's current very accommodative policy should keep bond yields low for the time being. More recently, the ECB initiated its Pandemic Emergency Purchase Program (PEPP), now totaling EUR 1,350bn and running at least until the end of June 2021. Reinvestments of maturing principal payments from securities purchased under PEPP until at least the end of 2022 will add further to the accommodative stance. An additional envelope of EUR 120bn to the Asset Purchase Program until the end of the year remains in place, as do a number of measures to ensure liquidity to the banking sector, a comprehensive set of collateral measures to mitigate the tightening of financial conditions across the euro area, and

measures to temporarily mitigate the effects of rating downgrades on counterparties' collateral availability.

In a more favorable interest rate environment, interest outlays fell by a further 6.7% last year (2018: -1.3%), resulting in a declining interest-to-GDP ratio from 3.7% to 3.4% in the preceding year. Measured against government revenue, the ratio came down to 7.2% (2018: 7.9%), which, however, still represents the highest reading in the EU. As of end-July, 10-year Italian bond yields were moving at around 1.08%, thus at historically low levels. This notwithstanding, a still comparatively high share of general government debt maturing in up to 12 months, amounting to 22.6% in Jun-20 (BDI data), would cause some vulnerability towards sudden increases in bond yields, although we consider the likelihood thereof as limited at this stage.

Finally, we view the funds that Italy is to receive via NGEU as a significant factor which should attenuate some fiscal pressure over the medium term. What is more, the Eurogroup have decided on an economic policy response to Covid-19, which may also act as some fiscal relief going forward. On the one hand, decision-makers endorsed a precautionary credit line, the so-called Enhanced Conditions Credit Line (ECCL), according to which a euro area member may draw up to 2% of the respective member states' end-2019 GDP, roughly EUR 36bn in the case of Italy. While this may imply savings of an estimated EUR 5bn over a period of ten years, we gather that the sovereign has not applied for the ECCL yet. On the other hand, Italy will reportedly make use of the option to tap the Commission's SURE initiative, which provides funding of up to EUR 100bn by covering part of the costs related to the creation or extension of national short-time work schemes.

Foreign Exposure

We continue to see risks relating to Italy's external position as broadly contained at the current juncture, although we recall that interest-bearing debt makes up 74.6% of the sovereign's external liabilities, thus constituting sensitivities towards abrupt changes in investor preferences.

Italy has been operating a current account surplus since 2013 that has tended to become larger, mainly through sustained surpluses in goods trade. Its current account surplus increased from 2.5% to 3.0% of GDP in 2018-19, mainly on the back of an expanding goods surplus, a result of weaker import activity. In Q1-20, the current account surplus climbed to 3.1% of GDP, as the goods surplus widened further. For the year as a whole, we would expect the current account balance to post around recently observed levels, as we assume steep declines for both exports and imports, with the effects of curbed tourism-related activities being offset by lower energy prices.

Aided by the ongoing surplus in the current account balance, and to some extent by valuation effects, the sovereign's net international investment position (NIIP) moved even closer to a balanced position, totaling -1.7% of GDP in 2019 (2018: -5.0%) and corresponding to the least negative stance since inception of the euro. Looking at the components, we notice that 'other investment', which includes BDIs position towards the Eurosystem's gross settlement system (TARGET 2), was the major driver behind the falling stock of net external

liabilities, reducing the latter by about EUR 90bn. In Q1-20, the NIIP became more negative again, amounting to -3.7% of GDP, but we expect Italy to remain in a net creditor position over the medium term as of now.

Rating Outlook and Sensitivity

Our rating outlook for Italy's long-term credit ratings is negative, mainly due rising fiscal sustainability risks stemming from a presumably soaring public debt ratio from an already high level, and elevated uncertainty as regards the extent to which and the pace at which the sovereign will be able to lower the debt ratio to more sustainable levels in the medium term. We would refrain from providing some forward guidance on the time frame underlying our outlook at this stage, owing to the very high uncertainty pertaining to developments around the novel coronavirus as well as the related economic fallout.

That being said, we could reinstate the stable outlook if the debt trend embarks on a firm downward path and we see credible commitment and decisive action to bring the public debt ratio down to more sustainable levels over the medium term. Upward pressure would result from a more pronounced rebound in economic activity, with no lasting effects from Covid-19 weighing on Italy's medium-term growth potential. In this vein, new impetus regarding structural reforms which address low productivity growth, thereby lifting Italy's potential growth and contribute to bringing debt-to-GDP on a sustainable downward path, could also trigger a positive rating action.

We could lower our ratings if public finances fail to improve and the expected significant deterioration of the public debt ratio becomes more entrenched. A broad-based surge in infections requiring repeated lockdowns, as well as a protracted economic downturn or an only weak recovery, might also feature in such an adverse scenario. The same applies to contingent liability risks related to rapidly rising NPLs and/or comprehensive public guarantees. A negative rating action could also be prompted if medium-term growth prospects fail to pick up, possibly on the back of more lasting damage for the labor market, but also in the event of lacking progress in terms of enhancing productivity.

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Ratings*

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

*) Unsolicited

Economic Data

[in %, otherwise noted]	2014	2015	2016	2017	2018	2019	2020e
Real GDP growth	0.0	0.8	1.3	1.7	0.8	0.3	-10.5
GDP per capita (PPP, USD)	35,405	36,096	36,957	38,335	39,676	40,470	n.a.
HICP inflation rate, y-o-y change	0.2	0.1	-0.1	1.3	1.2	0.6	0.0
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	83.2	82.7	83.4	83.1	83.4	n.a.	n.a.
Fiscal balance/GDP	-3.0	-2.6	-2.4	-2.4	-2.2	-1.6	-12.1
Current account balance/GDP	1.9	1.4	2.6	2.6	2.5	3.0	n.a.
External debt/GDP	124.0	125.5	122.8	122.1	120.8	124.7	n.a.

Source: International Monetary Fund, Eurostat, own estimates

ESG Factors

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In the following, we explain how and to what degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor, and outline why these ESG factors were material to the credit rating or rating outlook.

For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and to Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down key principles of the impact of ESG factors on credit ratings.

The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank's Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact on Creditreform Rating's assessment of the sovereign's institutional set-up, which we regard as a key rating driver, we consider the ESG factors 'Judicial System and Property Rights', 'Quality of Public Services and Policies', 'Civil Liberties and Political Participation', and 'Integrity of Public Officials' as highly significant to the credit rating.

Since indicators relating to the competitive stance of the sovereign such as the World Bank's Ease of Doing Business index and the World Economic Forum's Global Competitiveness Indicator add further input to our rating or adjustments thereof, we judge the ESG factor 'Business Environment' as significant.

The social dimension plays an important role in forming our opinion on the creditworthiness of the sovereign. Labor market metrics constitute crucial goalposts in Creditreform Rating's considerations on macroeconomic performance of the sovereign, and we regard the ESG factor 'Labor' as significant to the credit rating or adjustments thereof. Indicators or projections providing insight into likely demographic developments and related cost represent a social component affecting our rating or adjustments thereof. We regard the ESG factor 'Demographics' as less significant.

While Covid-19 may have significant adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing concerning economic prospects and public finances. To be sure, we will follow ESG dynamics closely in this regard.

ESG Factor Box

Environmental Quality	Ecological Risks	Ressource Management	Education	Health	**Demographics**
Labor	Equality	Technology & Infrastructure	Safety & Security	**Judicial system**	**Quality of Public Services**
Integrity of Public Officials	Quality and Efficacy of Regulations	**Civil Liberties/ Political Participation**	Market Access	**Business Environment**	Data Transparency

Environment	Social	Governance	Highly significant	Significant	Less significant	Hardly significant

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	28.10.2016	BBB- /stable
Monitoring	29.09.2017	BBB- /stable
Monitoring	31.08.2018	BBB- /stable
Monitoring	30.08.2019	BBB- /stable
Monitoring	21.08.2020	BBB- /negative

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation.

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

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	YES
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's "Sovereign Ratings" methodology (v1.2, July 2016) in conjunction with its basic document "Rating Criteria and Definitions" (v1.3, January 2018). 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 and basic document "Rating Criteria and Definitions" is published on our website.

To prepare this credit rating, CRAG has used the 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, World Economic Forum, European Investment Bank, Bruegel Insitute, Blavatnik School of Government, Dipartimento del Tesoro/ Ministero dell'Economia e delle Finanze, Banca d'Italia, Istituto Nazionale di Statistica, Ufficio Parliamentare di Bilancio.

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. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. 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".

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

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as “initial rating”; other updates are indicated as an “update”, “upgrade or downgrade”, “not rated”, “affirmed”, “selective default” or “default”.

In accordance with Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

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