Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
ITALIAN REPUBLIC	Assigned Ratings/Outlook: **BBB- /stable**	Type: Monitoring, unsolicited
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 30-08-2019 "Sovereign Ratings" "Rating Criteria and Definitions"

Rating Action

Neuss, 30 August 2019

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.

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Key Rating Drivers

1. Large economic base and high wealth levels contribute to economic resilience; we expect stagnating economic activity in 2019 followed by tepid growth in 2020, as both domestic and external demand should grow only moderately; subdued medium-term growth prospects, still high unemployment; and a challenging business environment weigh on macro performance
2. Although having ample room for improvement on governance indicators, the sovereign displays a solid institutional setup and benefits from EMU and EU membership; backtracking on structural reforms related to the labor market and pensions; recent political events resembling historical pattern of frequent government changes
3. Vulnerabilities stemming from extremely high government debt and related refinancing needs, somewhat mitigated by diversified investor base and favorable term structure; medium-term risks arising from age-related costs and contingent liabilities in the banking sector
4. After stabilizing at 2018 levels this year, we expect headline deficit to increase in 2020 in the absence of further measures; uncertainty regarding authorities' forward guidance on fiscal targets and measures
5. Limited external risks in light of stable and sustained current account surpluses, and an improving net international investment position on the back of declining external liabilities in the government and banking sector

Reasons for the Rating Decision

The Italian Republic's credit ratings mirror a generally strong institutional setting and limited external risks, balanced by the sovereign's moderate macroeconomic performance profile and, in particular, stretched public finances.

Macroeconomic Performance

Italy's macroeconomic performance profile continues to be underpinned by a large and diversified economic base coupled with high levels of wealth and healthy private sector balance sheets. These strengths are set against lackluster growth prospects, partly stemming from persisting labor market challenges and entrenched weaknesses pertaining to the business environment.

Above all, we view the high level of personal wealth to be supportive to Italy's macroeconomic resilience and in turn to its creditworthiness. Even though we observed a negative and widening income gap towards the EU-28 in recent years, mirroring the economy's subdued growth dynamics (see below), Italians still enjoy high levels of prosperity by global standards. The IMF estimates Italy to have a per capita income of USD 39,637 (PPP terms) in 2018, placing it in the top quintile in a global perspective. It is also noteworthy that Italian per capita GDP outstrips the median of our A-rated sovereigns (USD 35,938) by a wide margin.

In this context, Eurostat data reveals that Italian households are among the wealthiest in Europe, with private households' net assets equating to 186.5% of GDP in Q4-18, the third-highest reading in the euro area (behind Belgium and the Netherlands). Moderate and declining leverage further adds to households' shock-absorbing capacities, as household debt remains at a low 61.2% of gross disposable income, comparing very favorably with other major European economies (ES: 96.0%, DE 84.5%, UK: 128.4%, FR: 95.6%). By the same token, debt of non-financial corporations (NFCs) fell to 71.6% of GDP in the first quarter of 2019, below the euro area median (72.4%) and down from 84.2% of GDP five years ago.

What is more, the significant size of the Italian economy, accompanied by a high degree of diversification, are key credit strengths of the sovereign. Standing for approx. 15% of the euro area's total output in 2018 (USD 2.07tr), the Italian economy was the eighth largest in the world and the third largest in the euro area (IMF data). Moreover, Italy has a relatively low exposure to cyclical swings in global trade and economic activity, which in our view enhances economic resilience against external shocks. In 2018, the Italian trade-to-GDP ratio of 61.1% compared low not only with other major European economies (DE: 87.2%; ES: 66.6%; FR: 63.4%), but was the lowest observed in any EU-28 country.

On the other hand, we note a rather dismal performance in terms of Italy's economic activity, given that its economy has virtually stagnated over the last decade. Last year's economic output posted still 4.3% below its pre-crisis peak in 2007 (in real terms). Sluggish economic activity has been primarily attributable to weak domestic demand. While exports stood 13.7% above 2007 levels more recently, private consumption and investment were down by 2.5 and 19.7% respectively.

After growth had hit a seven-year high in 2017 at 1.7%, the Italian economy lost momentum more recently as GDP growth almost halved to 0.9% in 2018. Hence, Italy not only recorded its lowest growth rate since 2015 (0.9%) and the weakest growth rate in the euro area (2018: 1.9%), it also continued to trail its euro area peers (ES: 2.6%; FR: 1.7%; DE: 1.4%) for the sixth consecutive year. Economic activity steadily deteriorated throughout 2018. Following already subdued growth at the beginning of the year (Q1-18: +0.2% q-o-q), the Italian economy stalled in Q2 before entering into a mild technical recession in the second half of the year, with q-o-q growth rates of -0.1% in the third and fourth quarters respectively. Abating domestic demand was the main reason behind the economic slowdown observed last year. Down from 1.7 p.p. in the previous year, the growth contribution from domestic demand amounted to a modest 0.9 p.p. in 2018.

Most importantly, private consumption eased considerably and added only 0.3 p.p. to real economic growth (2017: 0.9 p.p.). Last year's increase in consumer spending of 0.6% (2017: 1.6%) can be considered as lackluster from both a historical and European perspective. Household spending was in particular disappointing against the backdrop of brighter labor market conditions and accelerating wage growth. As highlighted by Istat data, nominal hourly wages set by collective agreements grew by 1.4% in 2018, following an increase of 0.6% in 2017. Meanwhile, inflationary pressures remained moderate. The annual HICP inflation rate stabilized at 1.2% in 2018 (2017: 1.3%). Comparatively soft private consumption appeared to be a result of weakening sentiment rather than of an actual deterioration in households' balance sheets. Temporary challenges, namely the implementation of the new WLTP emission standard, negatively affected car sales towards the end of the year. Adding to this, mounting macroeconomic and fiscal uncertainties caused households to raise their savings. After dissaving had supported consumer spending in 2015-17, the savings ratio turned the corner last year, inching up from 9.7 to 9.9% in 2017-18.

At the same time, investment dynamics moderated. Following a comparatively strong performance in 2017, investment growth edged down from 4.3 to a still robust 3.4% in 2018. Thanks to stronger dwellings investment (+3.8%), the mild recovery in construction investment continued, with growth gradually rising from 0.9% (2016) via 1.3% (2017) to 2.6% in 2018; however, this was not enough to offset softer business investment. Due to a confluence of domestic and external headwinds, Italian corporates cut back on their investment activities. Whilst spending on machinery and equipment almost halved from 9.1 to 5.5% in 2017-18, investment in intellectual property investment stalled (+0.8%). In our view, doubts about the government's stance on Italy's euro area membership and clashes with the European Commission over the 2019 budget (see below) did not bode well for investment. In contrast to developments in the euro area as a whole, Italian banks tightened terms and conditions on newly-extended loans in the second half of 2018, according to the latest bank lending survey.

Arguably more importantly, weaker external demand played a role in explaining last year's weaker investment growth. Apart from a slowing global economy and intensifying trade tensions, Brexit-fears and sector-specific issues dented Italian exports last year. Partly due to the adoption of the new WLTP standard, export volumes in Italy's important

automotive sector took a hit in the second half of the year, resulting in a 16.3% y-o-y decline in car exports (ANFIA data). The total volume of exported goods and services expanded by a modest 1.9% (2017: +5.9%), marking the slowest pace since 2013 (+0.7%). Since the slowdown in imports from 5.5 to 2.3% was less pronounced, the growth contribution from external trade turned negative, subtracting 0.1 p.p. from GDP growth (2017: +0.2 p.p.).

Going into 2019, we expect the Italian economy to stagnate (+0.1%). Our forecast is underpinned by a disappointing first half of the year, with GDP growth coming in at 0.1 and 0.0% q-o-q, and early indicators which do not point to an imminent economic upturn in the remainder of the year.

More than halfway through the year, available data suggest that export activity is unlikely to regain traction soon. Exports expanded by a lackluster 0.2% q-o-q in the first quarter of the year (Q4-18: +1.4%), and export expectations continued to deteriorate in Q2-19. Mirroring the cyclical slowdown in Italy's key export markets Germany, France, and the US, we do not anticipate a significant rise in external demand this year. Hence, it appears unlikely that net exports will provide a meaningful impetus to economic growth.

Against this background, and in view of significant economic uncertainties, investment activity should continue to level off in 2019. While public investment should pick up somewhat (see below), a recent Banca d'Italia survey corroborates our view that NFCs will remain cautious on new investments in machinery and equipment. The survey revealed that, except for large enterprises (500+ employees), firms of all sizes plan to reduce their capital expenditures this year. To be sure, a sharp slump in investment is rather unlikely given that capacity utilization remains somewhat above its historical average and interest rates are set to remain lower for longer. At its June meeting, the ECB's governing council decided to keep the refinancing rate at its present level, at least through the first half of 2020. Thus, NFCs should continue to benefit from low financing costs for the foreseeable future in the absence of renewed sovereign yield spikes.

Near-term prospects for private consumption remain relatively poor. Consumer spending was off to a weak start to the year, posting a quarterly growth rate of only 0.1% in Q1-19, down from 0.5% in the first quarter of 2018. Retail turnover (excl. motor vehicles) is showing no signs of improvement (May-19: -1.0% y-o-y) and consumer sentiment has not overcome its weakness yet, even though the European Commission's Consumer Confidence Indicator appears to have stabilized more recently after a pronounced weakening in Q4-18 and Q1-19. Still, household spending should be supported the government's fiscal relief measures (see below), which entered into effect at the beginning of the year.

Even though we still view economic resilience as being weighed down by labor market conditions, unemployment continued to decline in the year to Q1-19, with the quarterly average of the harmonized unemployment rate falling from 10.9 to 10.4%. After expanding by 1.2 and 0.9% in 2017/18, employment growth eased to 0.6% y-o-y in Q1-19. Albeit showing signs of a slowdown, employment has continued to increase since our last review and stands close to its all-time high. We also note that fixed-term contracts continue to account for the bulk of newly-created jobs. Thus, sustained economic uncertainty and

the gradual phase-out of hiring subsidies under the 2015 job reform appear to offset a more restrictive legislative stance on temporary work. The 'Dignity Decree' enacted in August 2018 slashed the maximum length of temporary contracts from 36 to 24 months and requires employers to justify why a temporary contract is warranted for an employment duration of more than one year. Meanwhile, labor market participation was close to its historical high in Q1-19 (65.8%), but it has largely stagnated over the last two years and remains the lowest in the euro area (73.6%).

Looking forward to 2020, we assume that investment and export growth will recover slightly, bolstered by a faster euro area growth and very gradually dissipating external headwinds. Conditional on the implementation of the proposed tax relief for households, private consumption should sustain its momentum (see below). As a result, GDP growth should tick up to 0.6%, broadly in line with the economy's growth potential. According to European Commission estimates, Italy's medium- to long-term growth potential remains among the lowest in the EU-28, largely driven by anemic productivity growth and adverse demographic prospects.

Irrespective of the fact that Italy has experienced positive net migration over the last decade, demographic metrics have started to worsen. Since 2015, Italy's working-age population has declined by 0.4% per year and the share of Italians at the age of 15-64 dropped from 64.5 (2015) to 64.1% in 2018. Population ageing is anticipated to put further pressure on labor supply going forward. As documented by the European Commission's 2018 Ageing Report, Italian working-age population is forecasted to fall by another 3 p.p. by 2030. Against the background of adverse demographics, productivity gains are crucial to sustain economic growth. However, we view weak productivity as a major weakness of the Italian economy. Both real labor productivity per hour worked and TFP growth have been sluggish since the financial crisis, averaging at only 0.4 and 0.3% respectively in 2010-18, as compared with 1.1 and 0.8% in the EA-19. Low productivity growth can be partly attributed to subdued R&D spending in the Italian economy. In 2010-17, research and development expenditures averaged at 1.3% of GDP in Italy as compared with 2.1% in the euro area.

In view of a challenging business environment, the state's budgetary constraints and the banking sector's need to restore its financial health, capital accumulation may also fall short of providing a significant stimulus to potential growth. As highlighted by AMECO data, public investment fell to 2.1% of GDP in the last year (2017: 2.2%), the lowest level in twenty-four years (Eurostat records). More importantly, the investment-to-GDP ratio of Italy's private sector has been consistently lower than that of the euro area since 2003. Although private spending on investment has recovered somewhat from its trough in 2014 (14.5% of GDP) to 15.9% in 2018, this still compares low to private investment ratios of 18.4, 19.1 and 19.5% in Germany, Spain and France, respectively. We believe that restrained investment activity in the private sector may be partly due to challenging conditions for entrepreneurs in Italy. Slipping from rank 46 to 51 out of 190 economies, the country's ranking in the World Bank's Doing Business Report compares unfavorably with most euro area peers. In particular, the complex tax system (rank 118/190 economies),

dealing with construction permits (rank 104), and contract enforcement (rank 111) stand out as major weaknesses.

Admittedly, authorities are aware of the importance of stronger investment growth to enhance productivity. To stimulate investment, law No. 58 – the so called "Growth Decree" – was enacted this June. The decree provides tax incentives to encourage qualified Italians working abroad to return, introduces a permanent tax rebate on reinvested corporate profits, and extends existing tax credits for investments in R&D and innovative technologies.

In the same vein, boosting competition in the service sector may have positive repercussions on productivity growth. According to the 2018 edition of the OECD's Product Market Indicators, Italy features the most heavily regulated retail sector of all OECD members, and barriers to competition are also disproportionately high in professional services such as accounting, engineering and architecture. While the partially implemented 2015 annual competition law has somewhat opened up service markets, recent policy steps go in the opposite direction. Among others, the 2018 budget law introduced new minimum rates ('equo compenso') for professional services, and the government has also envisaged restricting shop opening hours.

Institutional Structure

Our institutional assessment continues to reflect the sovereign's solid institutional setup, as well as political and economic benefits related to Italy's EU and EMU membership.

In our view, advantages associated with Italy's euro area membership outweigh the lack of monetary flexibility. Monetary policy is conducted by the highly credible and accountable ECB. Since the adoption of the euro, we have not observed sizeable inflation differentials as consumer prices have moved broadly in line with the EA-19 average. Given its elevated government debt levels, the Italian state continues to be a main beneficiary of the ECB's monetary policy, including its asset purchase program. Under the PSPP, which was terminated in Dec-18, the ECB has acquired Italian government debt securities totaling EUR 367.2bn (Jun-19), thereby lowering the sovereign's funding costs. Given the economic slowdown in the euro area, we believe that the ECB will reactivate the PSPP next year. In March, the ECB announced it would prolong its targeted longer-term refinancing operations (TLTRO III) that provide credit institutions with favorable refinancing conditions, and in June the governing council decided to further postpone monetary policy normalization, keeping the refinancing rate at its present level at least through the first half of 2020. More generally, we believe that economic developments in Italy as the third-largest EMU member will continue to have a notable impact on monetary policy considerations going forward.

Institutional weaknesses continue to somewhat constrain the sovereign's rating. This is underpinned by the latest edition of the Worldwide Governance Indicators (WGI), according to which Italy scores below average on all sub-indicators as compared to its euro area peers. Being placed 81th, 79th and 64th respectively, Italy ranked second to last on the WGI's 'control of corruption', 'rule of law' and 'government effectiveness' in the euro area,

with only Greece receiving lower scores. According to the World Economic Forum's Global Competitiveness Report, persisting inefficiencies pertaining to the regulatory and judicial framework continue to hamper the quality of public services.

While it is too early to assess their effectiveness, we regard it as a positive that the government is aware of these weaknesses and is pushing ahead with anti-corruption and judiciary reforms. On 31 January 2019, the Italian parliament approved a package of measures to combat public sector corruption (Law No. 3/2019). The new legislation prohibits persons sentenced for corruption-related crimes from doing business with the state and from holding public offices. We also note that some steps were taken to improve the efficiency of the judiciary. On 1 August, the cabinet approved a reform of Italy's civil law procedures; however, the coalition was unable to reach an agreement on an overhaul of the criminal-law system.

In general, we believe that cohesive policymaking and more specifically the implementation of far-reaching reforms, is adversely affected by Italy's track record of frequent government changes. Since 1946, Italy had 65 governments headed by 29 prime ministers, and only one prime minister served a full five-year term. Adding to this, political uncertainty has increased more recently. In our opinion, conflicting views on fiscal matters, which became apparent against the backdrop of the presentation of budgetary plans (Draft Budgetary Plan 2018, Stability Program 2019), have stirred significant uncertainty among market participants as the governing coalition remains principally committed to expansionary fiscal policies. Yet, authorities do not seem to want an escalation of tensions with Brussels. In this context, we reiterate our belief that an Italian withdrawal from the euro area is an unlikely scenario, even though we see an elevated probability of renewed clashes with the EU Commission in October, when Italy has to file its draft budget for 2020.

Recent political events resemble the historical pattern of frequent government changes. Disputes between the governing parties Lega and the 5-Star Movement thus further exacerbated policy uncertainty, leading to a breakup of the coalition. On 9 August, Lega leader Salvini announced that the coalition had failed, calling for snap elections. After Prime Minister Conte had resigned on 21 August, President Mattarella began consultations with party leaders to see whether there is an alternative majority in parliament. Eventually, M5S and the Social Democrats (PD) declared to form a new left-wing coalition (327 of 630 seats), and the President will likely instruct Prime Minister Conte to form a new government (as of 28 August). We believe that the incoming Italian government will presumably not put greater emphasis on fiscal sustainability than the current administration does. Still, it may result in a somewhat less confrontational atmosphere between the respective authorities in Rome and Brussels.

Fiscal Sustainability

The sovereign's key credit weakness continues to lie in the lack of a credible path of fiscal consolidation, very high general government debt levels, and a comparatively weak banking sector which continues to carry elevated contingent liability risks for public finances.

We consider Italy to have a weak track record in terms of achieving budgetary targets, as we have observed repeated fiscal slippages and the postponement of budgetary targets under various governments in the recent past. While the activation of a VAT safeguard clause established in the 2016 budget has been repeatedly postponed in recent years, privatization proceeds have fallen consistently short of expectations.

We acknowledge that the Italian budget deficit steadily narrowed from 3.0 (2014), via 2.4 (2017) to 2.1% of GDP in 2018. This development, however, was largely driven by falling interest expenditures. Partly owing to the ECB's extraordinarily accommodative monetary policy, including significant government bond purchases under its PSPP, interest outlays fell from 4.6 to 3.7% of GDP over the last five years.

Primary expenditure grew at a slower pace than in the previous year. Excluding interest payments, government expenses increased by a moderate 1.2%, lagging behind nominal GDP growth (+1.6%). Above all, higher expenditures on social benefits contributed to the increase in primary spending, with 22.5% of GDP the largest budgetary item. Mainly driven by the broadening of access to the social inclusion income ('Reddito di Inclusione'), higher pensions, and the clearance of arrears to healthcare providers, spending on social benefits rose by 2.2% y-o-y (2017: +1.4%). Meanwhile, growth of the public wage bill, which had averaged at a modest 0.7% in 2015-17, edged up by 3.1%, mirroring the suspension of the wage freeze for civil servants.

Revenues evolved less dynamically than in 2017, expanding by 1.2% y-o-y, down from 2.0% in 2017. Apart from slowing growth of VAT receipts, which increased by only 1.2% (2017: 5.2%), contracting receipts from direct taxes weighed on revenue generation. Mirroring among others the delayed impact of the previous government's CIT rate cut and the extension of various tax deductions on corporate investment, taxes on income and wealth were down 0.7% on the year (+1.2% in 2017), representing the first decline since 2014. By contrast, growth in net social security contributions picked up from 2.2 to 4.2%, aided by sustained employment growth and the phase-out of social security rebates for hiring young workers on open-ended contracts.

Looking forward, we are somewhat concerned about Italy's fiscal performance. As outlined in the 2019 Stability Program, authorities intend to lower the tax burden, while stepping up public spending considerably. In fact, the government has already begun to deliver on some of its key promises. To tackle poverty and social exclusion, the new citizenship income ('Reddito di Cittadinanza') was launched in April, substituting the social inclusion income with a more generous minimum income scheme. Citizens earning less than EUR 780 per month are eligible to have this topped up under the new legislation. The coalition also adopted costly policy changes to the pension system. To support low-income pensioners, the so called 'citizenship pension' was introduced and eligibility criteria on early retirement eased ('Quota 100'). According to the Italian Ministry of Finance, the implementation of these policies will raise government expenditures by approx. EUR 11.1bn or 0.6% of GDP in 2019.

On the revenue side, previously legislated VAT and excise duty hikes in the amount of 0.7% of GDP (safeguard clause) were deactivated, putting additional strain on the budget.

As economic growth will ease in 2019 and discretionary expansionary policies appear to be only partly counter-financed through the repeal of the business tax (IRI), a spending review, and somewhat stricter rules on tax deductibility, there was an elevated risk of non-compliance with European fiscal rules in 2019. In order to avoid the opening of an Excessive Deficit Procedure, the government approved consolidation measures totaling EUR 7.6bn or 0.4% GDP on 1 July. Alongside higher-than-expected revenues, partly driven by extraordinary dividend payouts from CDP and the Bank of Italy, additional savings should be generated by a lower-than-expected take-up of the government's "citizenship income" and "Quota 100" schemes, as well as by the activation of the EUR 2bn safeguard clause agreed on with European Commission at the end of 2018. Eventually, the EU Commission therefore concluded that the opening of an Excessive Deficit Procedure is no longer warranted. Taking into account the policy package, we expect the headline deficit to come in at 2.1% of GDP this year.

In the run-up to the presentation of Italy's 2020 budget proposal, disputes with the EU commission over Italy's fiscal trajectory may resurface. Exerting this power for the first time, the European Commission rejected Italy's initial draft budget 2019 in October 2018. Recently enacted changes pertaining to pensions and social benefits will continue to exert pressure on the expenditure side of the budget. Furthermore, the government plans to significantly ramp up public investment. Gross fixed capital formation at the general government level is envisaged to rise from currently 2.1% (2018) to 2.4% of GDP in 2020. More specifically, new legislation allows local authorities to use surpluses to fund investment projects, with higher funds earmarked to be allocated to infrastructure improvements. Moreover, the implementation of tax cuts should weigh on revenues. Following the increase of the maximum income taxed at the reduced 15% rate from EUR 45,000 to 65,000 in 2019, the government plans to provide self-employed and small enterprises with further tax relief. From 2020 onwards, a 20% rate shall apply to income between EUR 65,000 and 100,000. Given that the activation of the safeguard clause has been repeatedly suspended in recent years, we believe that its activation in 2020 is unlikely, and consequently we do not factor potential revenues from higher VAT receipts. We expect Italy's headline deficit to increase to 2.8% in 2020, albeit we caution that there is significant uncertainty pertaining to the size and composition of fiscal effort in 2020.

In the face of subdued growth prospects and the projected widening of the budget deficit, we anticipate a further increase in government debt. Having risen from 131.4 to 132.2% 2017-18, the Italian debt-to-GDP ratio is the sixth-highest in the world and the second-highest in the EU-28 (IMF data). We do not expect the public debt ratio to stabilize before 2020, and debt levels should remain very high in the medium term.

Sharply rising risk premia or slower-than-projected GDP growth could pose a risk to Italy's medium-term debt sustainability. Italy has to roll over upcoming bond maturities of more than EUR 300bn by the end of 2020, which does not yet include additional borrowing requirements to cover fiscal deficits in 2019/20. In general, we believe that refinancing risks are mitigated by the sovereign's average residual maturity of 6.8y (Jun-19) and a well-diversified investor base. Nevertheless, we note that investor confidence, and in turn the sovereigns financing conditions, remain susceptible to rising political uncertainty.

Government bond yields have trended downwards more recently, posting 1.3% at the end of August 2019. However, during periods of dispute with the EU commission over Italy's fiscal consolidation path in September/October 2018, and again in April/May 2019, 10y-yields temporarily climbed above the 3%-mark.

Dynamically rising ageing costs represent a downside risk to fiscal sustainability in the medium to long term. According to EU Commission forecasts, the fiscal costs of ageing will rise by 1.5 p.p. to 29.5% in 2016-30, one of the fastest increases in the EU-28. The projected increase in age-related expenditures is mainly attributable to higher pension outlays (+ 1.6 p.p. GDP) and, to a lesser extent, health care spending (+0.2 p.p. GDP). To be sure, the eventual increase may turn out even higher, as the government rolled back cost-cutting elements to the 2011 pension reform. For the years 2019-21, Decree Law No. 4/2019 introduced the so called 'Quota 100', a retirement scheme for persons at least 62 years old, having accrued at least 38 years of social security contributions. Furthermore, the link between life expectancy and necessary contributory years for early retirement age will be deactivated until 2026. To combat old-age poverty a 'new citizenship pension' was launched, which provides pensioners with a minimum income of EUR 9,360 per year.

Unlike in 2017, we observed no direct state interventions to support ailing banks last year. However, the protracted stalemate preceding Banca Carige's rescue has shown that the banking sector continues to harbor contingent liability risks. After Carige had failed to attain stockholders' approval to raise its share capital in December 2018 to address its capital shortfall, the ECB appointed three special administrators in January, and the Italian government backed a EUR 2bn bond issuance with state guarantees. Attempts to find a market solution for the bank proved difficult. Finally, Italy's depositor protection fund (EUR 630m), alongside Cassa Centrale Banca (EUR 70m), contributed to a 900m rescue plan which includes the issuance of a convertible bond (EUR 200m).

Notwithstanding improvements, Italy's banking sector still suffers from a high stock of non-performing loans, comparatively low capital buffers, and subdued profitability. The NPL ratio of Italian banks fell from 10.8% (Q1-18) to a still high 8.3% in Q1-19 (EBA data), as the inflow of new non-performing loans continued to decelerate, while NPL sales and securitization activity progressed. Regarding the latter, we consider the EU Commission's decision to approve another extension of the Italian guarantee scheme to facilitate the securitization of non-performing loans (GACS) as positive. As EC data suggest, GACS appears to be an effective tool for reducing non-performing loans. Between February 2016 and November 2018, NPLs with a gross book value of EUR 51bn were removed from the banking sector under the GACS; thus the scheme has contributed almost two thirds of the total reduction in non-performing loans over that period.

The banking sector is sufficiently capitalized, although we note that improving asset quality has not yet translated into stronger capital buffers. The CET1 ratio of Italian banks posted at 13.0% in the first quarter of the year, on par with 2018 levels (Q1-18: 13.2%), and well below the EU-28 average of 16.2%. Given that domestic government bonds account for a large share of Italian banks' total assets (Apr-19: 10.9%), rising sovereign yields as observed last summer drag on banks' funding costs, liquidity, and capital ratios.

Foreign Exposure

Risks arising from Italy's external position appear contained at the moment. The current account balance, which has been positive since 2013, remained broadly stable at 2.5% of GDP last year (2017: 2.6% of GDP), as a weakening trade balance was offset by a higher primary income surplus. Whilst the trade in service balance remained at 2017 levels (-0.2% of GDP), the trade in goods surplus slipped from 3.2 to 2.7% of GDP in 2017-18, owing to higher oil prices and slowing external demand. Meanwhile, the primary income balance climbed from to 0.5 to 1.0% of GDP, reflecting lower interest payments on external liabilities and the ongoing accumulation of foreign assets.

Italy's net international investment position (NIIP) strengthened for the fifth consecutive year and was almost balanced in 2018. The improvement in Italy's NIIP from -6.4 (2017) to -3.9% of GDP in 2018 was largely explained by a continuous decline in the banking and government sector's external liabilities. Partly reflecting heightened policy uncertainty, foreign investors cut back on their Italian government debt exposure by 7.5% or EUR 51.1bn in the year to December 2018. Still, some risks pertaining to the composition of external liabilities remain. At the end of 2018, interest-bearing debt accounted for 76.4% of Italy's external liabilities, somewhat increasing the economy's vulnerability to sudden shifts in investor sentiment.

Rating Outlook and Sensitivity

Our Rating outlook on Italy's sovereign ratings 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 in the next twelve months.

While an upgrade is rather unlikely at this stage, we could raise the Italian Republic's sovereign rating to BBB if medium-term growth significantly outperforms our expectations, or if public finances improve substantially and sustainably. In this regard, we view the government's commitment to European fiscal rules underpinned by a credible budget consolidation strategy as imperative for a rating upgrade. Apart from that, faster progress on the resolution of non-performing loans is also an upside risk.

By contrast, downward pressure on the ratings or the related outlook could arise if we observe significant fiscal slippages resulting in further deterioration of the sovereign's debt trend, or if protracted policy uncertainty leads to renewed government yield spikes, with negative repercussions on banks, corporates, and households. In the same vein, we could lower the rating if we see significant backtracking on already adopted growth-enhancing structural reforms, potentially eroding the economy's medium-term growth prospects.

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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

	2013	2014	2015	2016	2017	2018	2019e
Real GDP growth	-1.7	0.1	0.9	1.1	1.7	0.9	0.1
GDP per capita (PPP, USD)	34,878	35,419	36,121	37,004	38,358	39,637	40,206
HICP inflation rate, y-o-y change	1.2	0.2	0.1	-0.1	1.3	1.2	0.8
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	82.9	83.2	82.7	83.4	83.1	n.a.	n.a.
Fiscal balance/GDP	-2.9	-3.0	-2.6	-2.5	-2.4	-2.1	-2.1
Current account balance/GDP	1.0	1.9	1.3	2.5	2.6	2.5	n.a.
External debt/GDP	119.1	124.1	125.2	122.5	122.1	120.3	n.a.

Source: International Monetary Fund, Eurostat, own estimates

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

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.

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The rating was conducted on the basis of CRAG´s "Sovereign Ratings" methodology in conjunction with its basic document "Rating Criteria and Definitions". 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 the following internet page: www.creditreform-rating.de/en/regulatory-requirements/.

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, European Stability Mechanism (ESM), 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”.

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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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