Press Release: Neuss, 05 March 2021

Creditreform Rating affirms the Italian Republic's ratings at BBB- /negative

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 negative.

Italy's sovereign ratings and the related rating outlook were published on 05 March 2021 at 11:30pm CET. According to Creditreform Rating's Sovereign Rating Calendar 2020, the publication was originally scheduled for 19 February 2021. The deviation from the announced publication date is due to internal operational reasons. The Italian Ministero dell'Economia e delle Finanze (MEF) was informed of the deviation from the publication date in a timely manner, and took notice of the postponement.

While this sovereign rating is an unsolicited credit rating, MEF participated in the credit rating process as it provided additional information and commented on a draft version of the rating report. Thus, the published rating update 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.

Reasons for the Rating Decision

In addition to featuring a large and wealthy economy, Italy's creditworthiness remains buttressed by a good degree of economic diversification. Risk-bearing capacities with a view to a high net wealth of the household sector and a comparatively moderate level of non-financial debt add to resilience, whereas persistently low productivity growth, structural deficiencies on the labor market, and room to improve on the business environment put a strain on potential growth. We think that the sizeable EU-level funding to overcome the corona crisis, for which there is now somewhat more detail, represents a potentially decisive credit positive element, as it could not only help to prevent longer-lasting adverse effects on the economy, but also boost potential growth over the coming years, if used effectively.

Italy's credit rating is supported by its generally strong institutional framework, also involving EU/EA membership which entails

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significant benefits such as the ECB's credible and currently very accommodative monetary policy, and substantial EU-level support during the current crisis, not least via NGEU. Political volatility indicated by frequent changes in government balances this to some extent, as it presents the risk of a possible delay for timely and decisive implementation of reform proposals to enhance potential growth. Furthermore, the modest track record with respect to the absorption of EU funds (ESIF) is adding to some reservations here. Against this backdrop, broad-based cross-party support for the new Italian government and the suggested reform priorities seem constructive, but it remains to be seen whether political stability will be retained beyond the acute pandemic phase.

We maintain our view that, given Italy's high debt level and track record of repeated fiscal slippages as well as postponed debt reduction targets, fiscal sustainability risks constitute the main credit weakness of the sovereign. Remaining vulnerabilities in the banking sector and potentially counterproductive political volatility that could hamper budget execution add to that. As, for instance, a relatively high estimated VAT gap suggests, structural challenges persist with regard to the latter. With a longer-term view, unfavorable projections as far as age-related spending is concerned also weigh somewhat on the sovereign's fiscal prospects. While extraordinarily costly, though indispensable, Covid-19 measures aggravate fiscal sustainability risks, also in light of a higher contingent risk related to public guarantees, we think that these risks are partly mitigated by high debt affordability amid ongoing accommodative monetary policy, and by financial relief via NGEU. If implemented effectively and in a timely manner, we think the EU-level initiative could become a decisive stepping stone to lift potential growth and thus be a crucial step towards sending the debt level on a downward trajectory in the medium-to-longer term.

Despite a relatively high level of gross external debt, risks regarding the sovereign's external position seem broadly manageable. A comparatively resilient current account surplus contributes to this, helping to push the net international investment position (NIIP) to a balanced position.

Rating Outlook and Sensitivity

Our rating outlook for Italy's long-term credit ratings is negative, as the temporarily soaring public debt ratio from an already high level amid still high pandemic-related uncertainty and renewed political volatility accentuates the sovereign's key credit weakness. While prospects have brightened somewhat on account of higher visibility on NGEU-backed reform plans, we think that uncertainty over the ability to bring public debt on a sustained downward trajectory over the medium term remains in place. We continue to refrain from providing some forward guidance on the time frame underlying our outlook at this stage, owing to the unpredictability pertaining to developments around coronavirus as well as the related economic fallout.

We could contemplate a positive rating action if we gain sufficient confidence that the debt trend will embark on a firm downward path and we start to see envisaged action being implemented with a view to ultimately lowering the public debt ratio to more sustainable levels over the medium term. Upward pressure would also result from a more pronounced rebound in economic activity, with no lasting effects from Covid-19 weighing on Italy's medium-term growth potential. More importantly, consequent implementation of initiatives aimed at enhancing productivity growth and potential growth, which would contribute to bringing debt-to-GDP onto a sustainable downward path, could also prompt a positive rating action.

Contrary to our belief, and less likely against the backdrop of reinforced EU-level support to overcome the pandemic and assist the economic recovery, we could lower our ratings if the expected significant deterioration of the public debt ratio becomes more entrenched, meaning that the public debt ratio fails to resume a downward trajectory. Materializing contingent liability risks related to rapidly rising NPLs and/or comprehensive public guarantees might also feature in such an adverse scenario. A negative rating action could also be triggered if medium-term growth prospects fail to pick up, e.g. if vaccination campaigns are delayed or prove less effective against virus mutations, if we witness more lasting damage incurred by the labor market, or in the event of lacking progress in terms of enhancing productivity.

ESG Factors

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.

Visit our website to read the full rating report, which contains the rating outcome as well as the reasons for the rating decision and the related outlook.