Republic of Italy Rating Report

SCOPE A- NEGATIVE OUTLOOK

Credit strengths

- EU and euro area membership
- Large and diversified economy
- Track record of primary surpluses and manageable pension liabilities
- Moderate private sector debt

Credit weaknesses

- Elevated public debt stock and refinancing needs
- Uncertain policy direction and risk of reversal of earlier reforms
- Weak potential growth
- Continued banking system fragilities, though NPLs are falling

Rating rationale and Outlook: The assignment of a Negative Outlook on Italy's A- sovereign ratings reflects: i) progressive changes in Italy's political landscape towards anti-establishment groups, a broader development than only the inauguration of this new government, with implications longer-term vis-à-vis the resolution of Italy's significant structural challenges; and ii) the policy programme of the new government – which seeks to undo a series of past fiscal, pension and banking system reforms, although many promises are unlikely to be acted on in their current forms. The affirmation of the ratings reflects continued meaningful credit strengths including euro area membership, a large, diversified economy, a track record of primary surpluses, and moderate private sector debt.

Figure 1: Sovereign scorecard results

Scope's sovereign risk categories	Italy	Peer comparison	
		Average	France
Domestic economic risk			
Public finance risk			
External economic risk			
Financial risk			
Political and institutional risk			
Qualitative adjustment (notches)	-1		3
Final rating	A-		AA

AAA AA A BBB BB B CCC CC C

NB. The comparison is based on Scope's Core Variable Scorecard (CVS), which is determined by relative rankings of key sovereign credit fundamentals. The CVS peer group average is shown together with two selected countries chosen from the entire CVS peer group. The CVS rating can be adjusted by up to three notches depending on the size of relative credit strengths or weaknesses.

Positive rating-change drivers

- Renewed attention on fiscal consolidation and structural reform, supporting debt sustainability
- Relations with Europe prove less confrontational than anticipated

Negative rating-change drivers

- Questions on the direction of economic policymaking, risking rising debt ratio
- A weaker commitment to fiscal consolidation and structural reform
- Tensions heighten with European institutions, compromising crisis-time access to European facilities

Ratings & Outlook

Foreign currency

Long-term issuer rating	A-/Negative
Senior unsecured debt	A-/Negative
Short-term issuer rating	S-1/Negative

Local currency

Long-term issuer rating	A-/Negative
Senior unsecured debt	A-/Negative
Short-term issuer rating	S-1/Negative

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Bloomberg: SCOP

Domestic economic risk

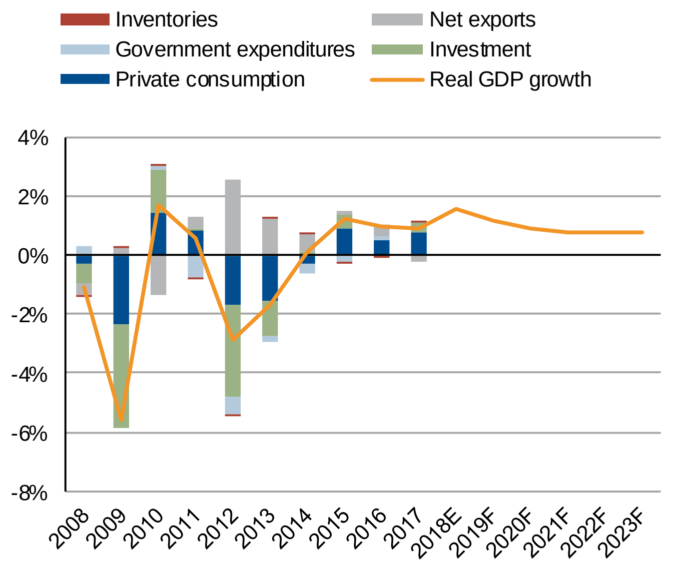
Growth potential of the economy

Recent economic recovery

Coming into political uncertainties, the Italian economy is entering on a phase of sustained recovery since 2014, with real growth of 0.3% QoQ in Q1 2018, after 0.35% in Q4 2017. In Q1 2018, YoY growth stood at 1.4%. For the calendar year 2017, growth rose to 1.6%, after 1.0% in 2016. The cyclical rebound is supported by gains in household consumption as well as a pick-up in private investment.

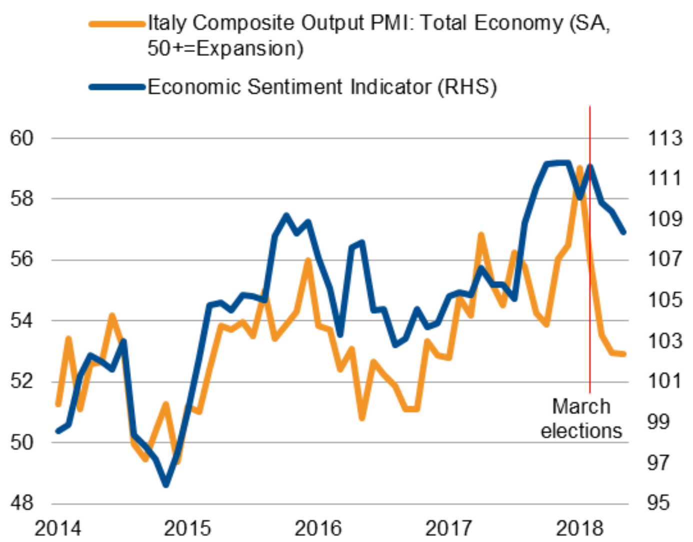
However, despite recent growth, Scope observes that Italy's economic recovery remains fragile. The economy grew only 0.1% on average between 2010 and 2017, and the level of real GDP remains 5.5% under Q1 2008 peaks near a full decade after the financial crisis. As such, given still tenuous economic conditions, even more modest shocks like recent political and financial market instability can be meaningful.

Figure 2: Real GDP growth by expenditure contribution, with IMF 2018-2023 forecasts



Source: IMF, ISTAT, Scope Ratings GmbH calculations

Figure 3: Italy's Composite PMI and Economic Sentiment Indicator



Source: IHS Markit, European Commission

Political uncertainty has occurred by and large overly recently for the impact to be easily measured in hard data; however, some soft survey data have begun to suggest modest effects in the early stages after the 4 March elections: ISTAT's business confidence indicator remained high at 104.7 in May but dipped from 108.3 in February. Meanwhile, Italy's Composite PMI fell to 52.9 in May, the lowest since January 2017 (**Figure 3**). The European Commission's Italian Economic Sentiment Indicator dropped marginally to 108.4 in May, from 111.6 as of February. Survey data suggests a degree of slowdown in the manufacturing and services sectors, which may be tied to a larger trend of a slowdown in the euro area but could be partially attributed to domestic political uncertainty. Scope will be scrutinising closely incoming economic figures, to gauge the scope of the impact of recent events on confidence.

Meanwhile, the unemployment rate has continued a gradual drift downwards, standing at 11.2% in April 2018, down from 2014 peaks of 13.1%[1]. Employment growth has been supported by tax incentives for hiring alongside the lagged effect of labour market reforms

Table of Content

[1] Eurostat data

implemented from 2012 onwards. Nonetheless, youth unemployment stands at 33.1% in April[2].

Importantly, inflation is tepid, at just 1.1% YoY in May 2018. Core inflation stood at only 0.7% YoY in May. The low level of inflation in the middle of an economic recovery is an area of concern, adversely impacting debt sustainability.

Wage growth has picked up, at 0.9% YoY as of April 2018, after lows of 0.3% YoY in February 2017[3]. Given the contribution from household consumption to recent growth, continued resilience in the labour market is critical to ensuring an unperturbed economic rebound, as political uncertainties assert themselves. Here, lending growth has been a modest positive, with lending to households standing at 1.3% YoY in March 2018 (and overall loan growth to the non-financial private sector negative at -2.4% YoY, with credit to the corporate sector still contracting).

Low medium-term growth dynamics are a credit weakness

Informing the Negative Outlook, Italy's long-term growth picture is weak. Scope estimates medium-run growth potential at 0.75%. Population dynamics are one drag: Italy's working-age population declined on average 0.5% per annum from 2010-2017 and is foreseen to continue an annual decline of 0.5% between 2018 and 2023[4], according to United Nations projections. In Scope's medium-run growth estimate, modest contributions from rising labour force participation and higher employment over time are assumed (reducing slack in the labour market), but with labour productivity growth at just above 0%. Scope's estimate on medium-run potential is near that of the IMF's medium-run forecast[5] of 0.8% in the April 2018 World Economic Outlook. Redressing low growth prospects is critical to improving the long-term outlook, in Scope's view. Scope will review the policies underscoring the government's objective to eliminate the growth differential with the rest of the European Union (EU).

Economic policy framework, and macro-economic stability and sustainability

Significant efforts should be made to address multiple challenges

Significant efforts should be made to address challenges. After the Jobs Act 2015 sought to counter duality in the labour market and boosted the numbers of those on permanent jobs, bolder reforms are still required to: liberalise product and service markets, to increase investment and productivity; reform the wage bargaining framework to align wages with productivity, and strengthen competitiveness; and broaden reform of public administration and the court systems.[6] These urgent priorities seek to raise productivity and growth, and reduce institutional bottlenecks.

Credit strengths include euro area membership, a large, diversified economy, and moderate private debt

Italy's ratings are bolstered by euro area membership within a large common market. Scope believes that institutional developments and adjustments of past years have increased euro area member states' protections against adverse shocks. In addition, Italy's sovereign ratings are underpinned by its large, diversified and high value-added economy, with nominal GDP in 2017 of EUR 1.72tn – the third largest in the euro area. The economy's manufacturing sector – the second largest in the euro area after that of Germany – has helped to generate current-account surpluses since 2013.

Domestic non-financial private debt stands at a moderate 159% of GDP as of Q4 2017, comparing favourably with that of European peers and down somewhat on peaks of 176% of GDP in Q4 2011. The recovery in the housing market has lagged that of regional peers, however, with contraction of 0.3% YoY as of Q4 2017. GDP per capita (of USD 31,984 in

[2] Youth unemployment rate (aged 15-24), provisional data, source: ISTAT
[3] An editorial error in the original rating report was corrected on 25.06.2018. The original rating report included an erroneous end to the sentence "translating to modest real wage gains (after a period of negative real wage growth entering 2018)".
[4] An editorial error in the original rating report was corrected on 25.06.2018. The original rating report miswrote "2018 and 2023" as "2018 and 2013".
[5] Referring to the IMF's April 2018 WEO's forecast for 2023 growth.
[6] International Monetary Fund. "2017 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for Italy." Country Report No. 17/237, 27 July 2017.

2017) and human development indicators are stronger than those in Italy's "a" sovereign peer group.

Public finance risk

Fiscal policy framework

Cyclical improvement in the fiscal balance in 2017

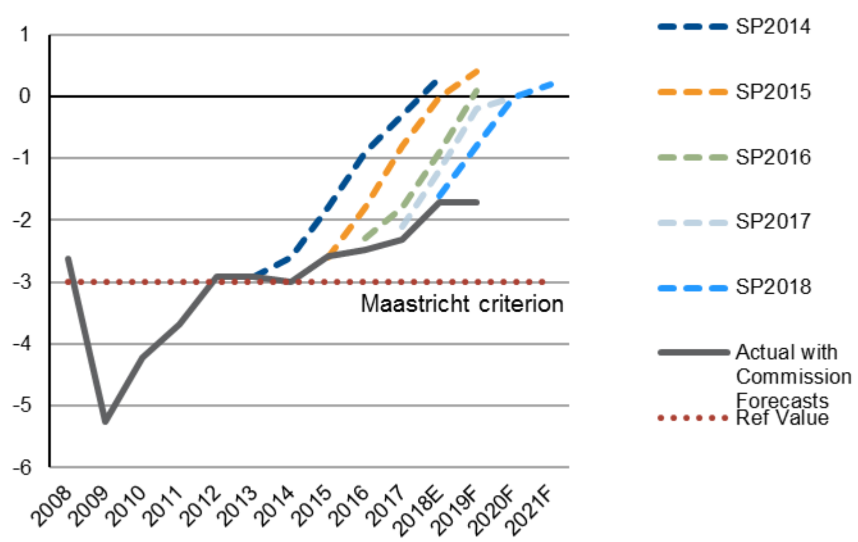
Italy's general government balance improved from -2.5% of GDP in 2016 to -2.3% of GDP in 2017[7]. However, excluding cyclical improvements, there was a structural deterioration of 0.2% of GDP. Moderate increases in public wages and pension spending, a reduction in the corporate tax rate from 27.5% to 24%, cancellation of previously legislated increases in the VAT and other taxes, and boosts to investment incentives helped facilitate this.

Improvement in the budget balance in 2018, but smaller than anticipated structural adjustment

In 2018, the European Commission foresees the budget balance improving to -1.7% of GDP (from -2.3% of GDP), with the structural balance unchanged at -1.7% of GDP, indicating limited fiscal effort.

The measures in the 2018 budget raise the deficit by 0.6% of GDP, including a VAT hike repeal worth 0.9% of GDP. In recent years, Italy has maintained successive neutral to expansionary budgets and lower-than-anticipated structural deficit adjustments. In Scope's view, in light of Italy's medium-run growth limitations (outlined earlier in the "Domestic economic risk" section of this report), the pursuit of pro-cyclical fiscal policies and lack of reduction of high debt levels during good economic times raise debt sustainability risks in a future downturn. Scope notes that the European Commission's forecast (of -1.7% of GDP) for the 2018 budget compares with a target as of the 2015 Stability Programme to balance the budget in 2018. Repeated revisions to fiscal targets (**Figure 4**) and gradualisation of fiscal consolidation have increased risks even prior to the substantial fiscal expansion sought in the new government's programme.

Figure 4: Government balance projections in successive Stability Programmes, % of GDP



Source: European Commission, European Central Bank, calculations Scope Ratings GmbH

Track record of primary surpluses a credit strength

Except in 2009, Italy has maintained a significant track record of primary surpluses in recent decades, including a primary surplus of 1.9% of GDP forecasted in 2018 (after 1.5% of

[7] The 2017 deficit includes a zero (one-off) impact from the liquidation of Banca Popolare di Vicenza and Veneto Banca and the precautionary recapitalisation of Banca Monte dei Paschi di Siena.

GDP in 2017). In Scope's view, this is credit-positive as it signals Italy's ability to service costs related to its high public-debt stock using its own revenues.

Policy programme risks fiscal trajectory

In view of the new *Government of Change* of the Five Star Movement (M5S) and Lega, and the programme for substantial tax cuts and spending increases, the 2019 budget – to be negotiated later this year – represents a significant risk. The coalition agreement includes Lega's proposed tax reduction to a rate of as low as 15% for companies and individuals, the rolling back of 2011's flagship pension reform, the cancellation of a VAT hike due in January 2019, as well as M5S's citizenship income. Estimates have placed these actions at a cost of more than EUR 100bn (more than 5.8% of GDP) per annum[8], and largely uncovered by revenue increases or spending rationalisation elsewhere (though the platform includes minor deficit-reducing measures, including cutting politician perks, increasing the efficiency of public expenditure, and combating tax expenditures and corporate tax evasion). The unsustainable fiscal programme contributes to Scope's decision to revise the Outlook to Negative.

However, Scope believes these proposals will run into the reality of governance within a divided government and extant checks and balances. In practice, the most parties can hope for is to pass an eventual toned-down version of some areas. In that, a much more moderated version of some programme areas, if accompanied with offsetting measures to ensure fiscal neutrality, Scope notes, might indeed be consistent with several areas of desired reform, including expansion of the income inclusion programme, increasing capital expenditures, broadening the tax base, and gradually lowering tax rates on productive factors. Nonetheless, the potential implementation of some of suggested measures *absent* offsets, inaction on other areas of needed reform, and extended political uncertainty represent risks. Earlier government targets for the fiscal balance to reach -0.8% and 0.0% of GDP in 2019 and 2020 see significant downside risk.

Italy's creditworthiness is supported by the nation's fiscal framework

Italy's creditworthiness is supported by credit strengths in the nation's fiscal framework, in Scope's view. In the near term, Scope will scrutinise the robustness of constitutional, European-level as well as market-predicated checks and balances that impede present and future governments from unsustainable programmes. The informal check placed by markets was shown in recent market-politics interactions which saw: i) President Sergio Mattarella's decision to veto the original candidate for finance minister, Paolo Savona, and ii) the rekindling of negotiations between M5S and Lega to conclude a government, in both cases amid market pressure. While market signals may sometimes keep a lid on fiscal excesses, such pressures also can stress an economy's resilience, raise interest costs and damage business confidence.

The constraints include moreover those via Italy's EU membership. Italy is subject to the preventive arm of the EU's Stability and Growth Pact (SGP), which requires it to ensure progress towards a medium term budgetary objective (MTO). As Italy's debt ratio still stands at a very high 131.8% of GDP as of Q4 2017, the country must also comply with the SGP's debt reduction benchmark. As a signatory of the European Fiscal Compact, Italy is mandated to maintain a structural deficit objective of not more than 0.5% of GDP over the medium term, a debt brake rule, alongside an automatic correction mechanism. Moreover, should the general government deficit rise back above the 3.0% of GDP Maastricht criterion, Italy could be subject to the threat of a reopening of an Excessive Deficit Procedure, which was abrogated in 2013.

The robustness of the EU's fiscal rules will be tested

Recently, the European Commission issued a warning in November 2017 regarding greater efforts needed to reduce the debt stock and questioned the speed of reductions in the

[8] http://osservatoriocpi.unicatt.it/cpi-tavola_contrattodigoverno.pdf

structural deficit. However, in May 2018, the Commission recommended that no further action be taken against Italy. To date, Italy has used flexibility facilitated under the structural reform and investment clauses, and for additional spending on refugees and security, to avoid violations with regards to the MTO and debt reduction benchmark. The fiscal programme of the new government (alongside its desire to renegotiate the EU's fiscal treaties) may test the enforcement of Europe's fiscal institutions.

The domestic fiscal framework complements EU-level oversight

The EU-level framework is complemented by enhancements made during the debt crisis to Italy's domestic fiscal framework.[9] A balanced budget rule was incorporated as a constitutional requirement, with linkages to a sustainability constraint for general government debt. All levels of government are required to achieve an MTO, set as a balanced structural budget and a balanced nominal budget for sub-national governments.[10] In addition, a spending rule was introduced limiting growth rates in public expenditure by local government bodies.

In 2012, the Parliamentary Budget Office (PBO) was created, acting as Italy's independent fiscal monitoring institution. PBO is responsible for assessing macroeconomic and fiscal forecasts and for verifying compliance with national and European fiscal rules. It also evaluates the macroeconomic effects of major legislations and debt sustainability. How resilient these fiscal institutions prove moving ahead in ensuring budgetary prudence will be one critical area to be reviewed.

Debt sustainability

Leveraged balance sheet remains key credit weakness

At 131.8% of GDP as of Q4 2017, Italy's public debt remains 32pp higher than Q4 2007 levels and the second-highest in the euro area, after that of Greece. Importantly, Italy's debt ratio peaked around current levels in 2014, with the beginnings of an economic recovery. However, Scope observes that the ratio has since stagnated and not declined to this stage despite a growing economy (with above-potential 1.0% and 1.6% growth respectively in 2016 and 2017). This is important as it speaks to the scale of challenges in bringing about meaningful debt reduction[11]. The lack of deleveraging is also, however, a reflection of the pro-cyclical fiscal stance pursued by the government in recent years, which in Scope's view, raises debt sustainability risks in a future downturn.

IMF's projection of a declining debt ratio to 116.6% of GDP is optimistic

In its April World Economic Outlook, the IMF projected Italy's public debt ratio to have peaked in 2016 at 132% of GDP, with a gradual decline picking up pace in 2018 and beyond, reaching 116.6% of GDP by 2023 (**Figure 5**). The IMF's baseline scenario assumes an increasing primary surplus each year through 2023, remaining sustainably above 3% of GDP from year 2020 onwards. In addition, the scenario assumes continued economic growth, even with mean reversion towards a lower trend growth rate.

Scope considers the IMF's baseline to be optimistic, with room for more adverse outcomes. While Italy's debt trajectory will be supported by still low financing rates, debt dynamics are negative owing to low nominal growth. Scope moreover notes that even small shocks to the fiscal trajectory reduce the scale of decline in the debt ratio to a near halt. However, a combination of higher interest rates, fiscal slippage and subdued growth would place Italy's debt back on a clear upward path.

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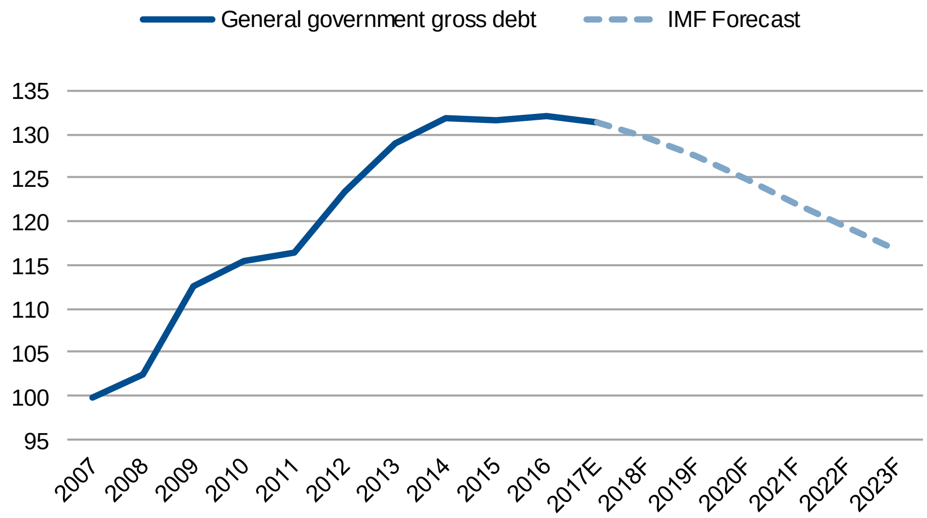
[9] FIRSTRUN – Fiscal Rules and Strategies under Externalities and Uncertainties. "Fiscal rules and other rule-based mechanisms in practice: introduction to case studies of four Member States", FIRSTRUN Deliverable 6.5, 12 April 2017.

[10] These objectives may take into account the impact of structural reforms on public finances and allow temporary deviations from the structural balance objective in the case of exceptional circumstances and with the contemporaneous definition of a recovery plan.

[11] For example, the debt ratio was raised in 2017 due to banking sector interventions totalling 0.6% of GDP.

Figure 5: General government gross debt, % of GDP

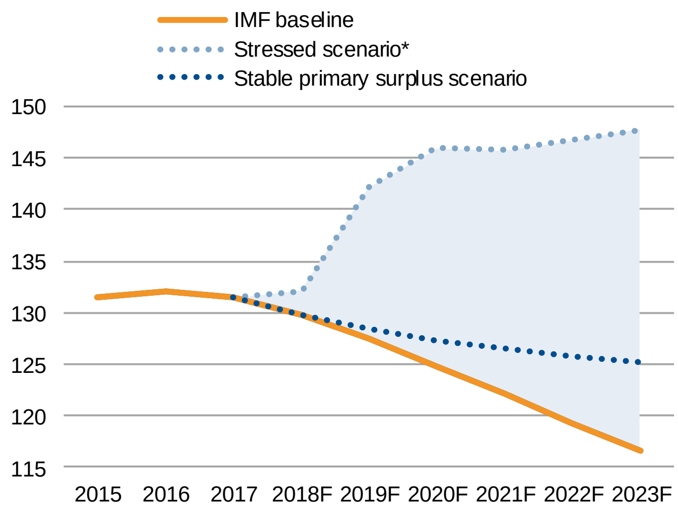


Source: IMF

Italy's debt trajectory can easily near flat-line or even move back up

In **Figure 6**, we show that a modest change in the IMF's primary surplus assumption alone results in a near flat-lining in the debt ratio. In this *stable primary surplus* scenario, Scope assumes the primary surplus remains stable at the 2017 level of 1.5% of GDP from 2019 on, rather than rising towards 3.6% of GDP by 2023 – in this case, the debt ratio ends the forecast horizon at 125% of GDP. Next, in a *stressed scenario*[12] – in which a global economic shock damages public finances alongside a simultaneous shock to Italian market financing rates, Italy's debt ratio rises well above 140% of GDP. The assumptions for these two scenarios are shown in **Table 1**.

Figure 6: Government debt projections, % of GDP



*Scope's stressed scenario does not embed the crystallisation of contingent liabilities during the shock or stock-flow adjustments.
Source: IMF, Scope Ratings GmbH

Table 1: Government debt projections, assumptions

Scenario	Time Period	Real GDP growth (%)	Primary bal. (% of GDP)	Real eff. int. rate (%)	Debt, end period (% of GDP)
History	2013-2017	0.3	1.5	2.2	131.5
IMF Baseline	2018-2023	1.0	3.1	1.4	116.6
Stable Primary Surplus Scenario	2018-2023	1.0	1.6	1.4	125.1
Stressed Scenario*	2018-2023	-0.5	0.3	1.8	147.8

*Scope's stressed scenario does not embed the crystallisation of contingent liabilities during the shock or stock-flow adjustments.
Source: IMF, Scope Ratings GmbH

[12] Scope's stressed scenario assumes a significant global economic shock, sending the Italian economy into two years of economic recession (with associated deterioration in the cyclical fiscal balance) alongside a simultaneous shock to government financing rates.

During the coming period, Scope will assess the actualisation of the new government's programme and seek to gain greater clarity on the long-term durability of anti-establishment forces and likelihood of implementation of expansionary fiscal policy. While Scope concurs on the government's programme to raise growth to reduce debt, it notes that a complementary attention on fiscal discipline ought to be preserved. Should Scope conclude that significant questions exist with relation to the quality of economic and fiscal policymaking over an extended time window, this could cast doubt on the trajectory of debt and, in association, Italy's rating.

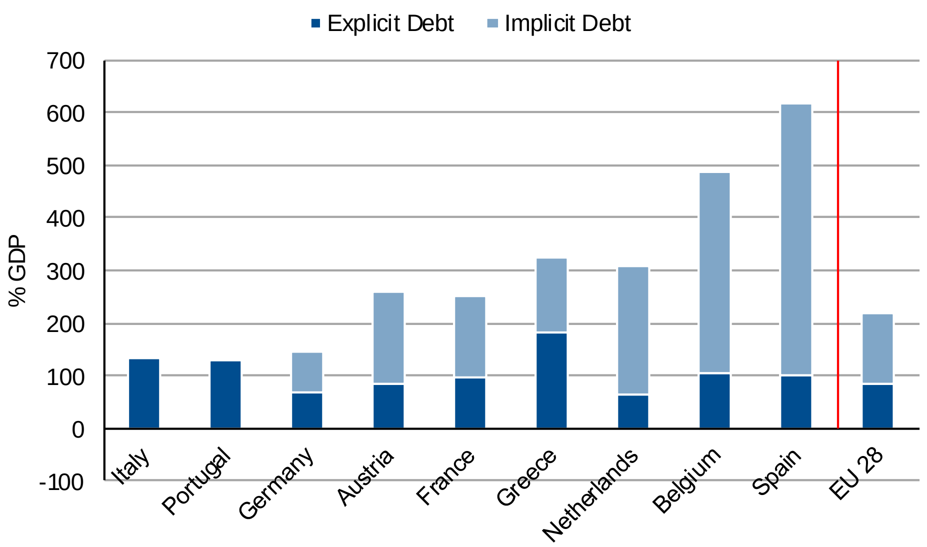
Long maturity and strong domestic investor base mitigate impact during global risk-offs

Scope believes that Italy's gross financing needs are supported by the relatively long 6.9-year average maturity of Italy's debt stock, nearly 70% of which is held by residents (compared to 56.7% in 2010). The sovereign is, as such, modestly less exposed to sudden shifts in international investor confidence. Short-term bills (BOTs, etc.) and long-term bonds (BTPs) account for about 84% of Italy's outstanding general government debt. As of April 2018, the European Central Bank held EUR 342bn in Italian government bonds via its Public Sector Purchase Programme (amounting to holdings totalling around 20% of Italian GDP), with further holdings via the defunct Securities Markets Programme.

Italy's limited implicit debt improves credit profile when considered

Despite the challenges that accompany the high public debt stock, Italian public finances compare better when one accounts for implicit debt (**Figure 7**). This is mainly due to a well-financed pension system that has limited unfunded pension liabilities, and contrasts with the positions of most euro area countries, which face age-related liabilities that are a multiple of the explicit general government debt. Italy's robust position is supported by the 2011 reforms that have raised the statutory retirement age to 66 as of 2018 (however, there is risk around discussions to reverse pension reforms). The critical nature of the 2011 reforms is exhibited in Italy's old-age dependency ratio[13], which is on track to increase from 34.5 in 2016 to 60.3 by 2070.[14] Italy spends 15.6% of GDP on public pensions in 2016, the highest ratio in the EU outside of Greece, and any reduction in retirement ages can threaten the sustainability of the social security system.

Figure 7: Explicit and implicit debt, % of GDP, 2017



Source: European Commission, Eurostat, Albert-Ludwigs-Universität Freiburg

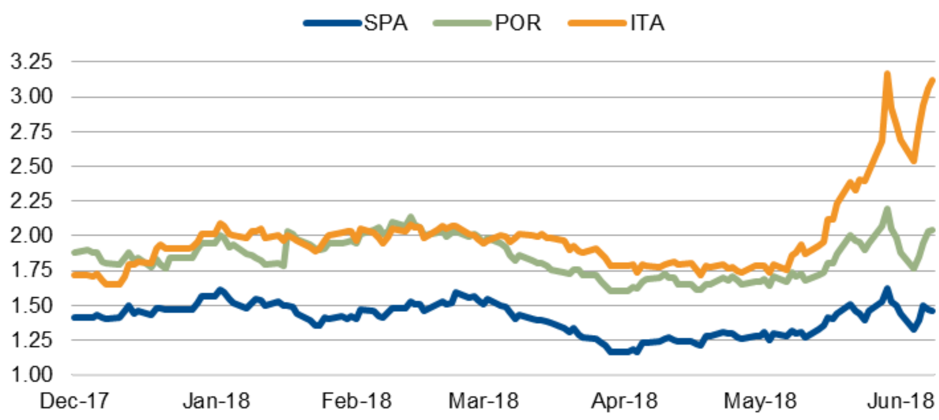
[13] Old-age dependency ratio = population aged 65 and over as a % of the population aged 15-64
[14] European Commission. "The 2018 Ageing Report: Underlying Assumptions & Projection Methodologies", Institutional Paper 065 | November 2017.

Market access and funding sources

Higher yields in current political uncertainty

We've seen a period of higher volatility in Italian markets, which will probably persist at the minimum in the near term. Scope spoke of the risk of a 'meaningful repricing' in Italian markets in its February comment[15] before the March election, given complacency in markets at the time. Italy's 10-year yield stood at 3.12% on 8 June, after it was 1.72% in mid-April (**Figure 8**). Italy's spread to German Bunds stood at 267 basis points on 8 June, more than double lows of 114 bps in late April.

Figure 8: 10-year government bond yield, %, Italy and euro area peers



Source: Bloomberg, as of 8 June 2018

Long maturity and primary surpluses reduce immediate impact of higher yields

Italy's long average government debt maturity alongside primary surplus should mitigate the pace of the impact of present higher government yields on debt sustainability (though overall gross financing needs for this year and next are significant). Despite increasing, the 10-year yield is still at only near the same level as Italy's weighted average interest cost on outstanding debt (of 2.8%). The ECB's quantitative easing programme, with ongoing eurobond government bond purchases of around EUR 30bn a month continuing until September 2018, and potentially longer, continues to boost government bond markets in all euro area countries, including Italy.

Scope will evaluate the impact of tensions with Europe on the accessibility of European support

In the future, one area Scope will assay is the impact of eurosceptic and populist propensities, especially should support for relevant populist groups prove durable, on the future *capacity* and *willingness* of Italian governments to access European support institutions in a stressed scenario, including financing support and interventions vis-à-vis the European Central Bank. In Scope's last rating action, it cited an independent ECB effectively acting as a lender of last resort alongside access to European financial facilities as reasons underpinning Italy's ratings. However, such regional assistance, critical to easing market panic and stemming sovereign default in extreme moments of stress, depends nonetheless on a government agreeing to certain economic governance norms. Scope will assess the stance of the new government vis-à-vis European institutions in assessing the level of jeopardy to such European support long term.

External economic risk

Current account vulnerability

Current account surplus has grown

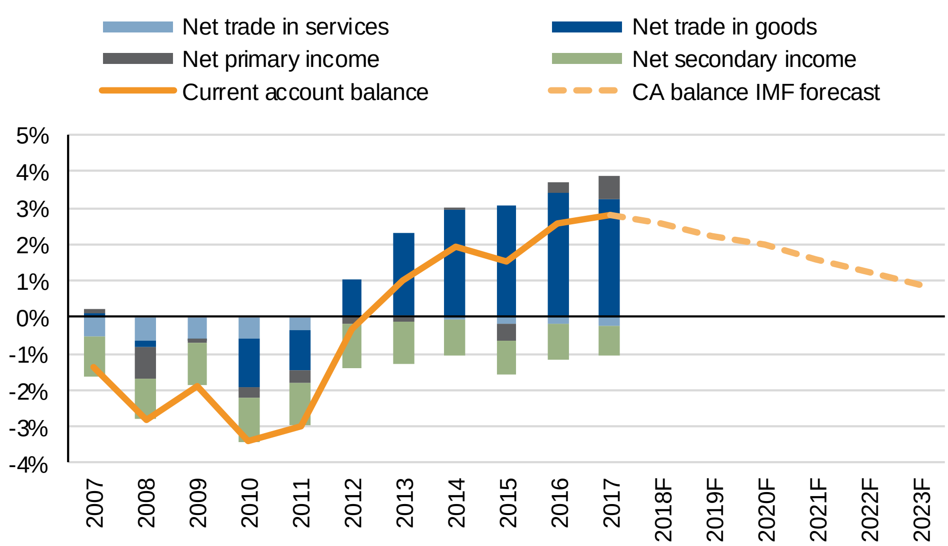
Italy's current account position has improved, moving into surplus since 2013. This transition was driven by the trade in goods balance, in which there's been both a boost to goods export as well as a degree of earlier import contraction. The current account is estimated to have reached a surplus of 2.8% of GDP in 2017, compared with a deficit of

[15] Scope Ratings. "Election Risk to Reforms Clouds Italian Sovereign Outlook", 5 February 2018.

3.4% of GDP in 2010. In sharp contrast to its performance in the early years of monetary union, when the country was systematically losing market share, Italy has recently maintained its export market share within the euro area.

Italy's trading performance is dampened by longer-term shifts in its real effective exchange rate (REER), reflected in increases in unit labour cost-adjusted REERs vis-à-vis euro area trading partners of around 10% since 1999, though this includes a correction of 2.6% since 2010. Going forward, the IMF envisions the current account surplus slowly regressing, towards 0.9% of GDP by 2023 (**Figure 9**).

Figure 9: Current account balance, % of GDP



Source: Banca d'Italia, IMF, calculations Scope Ratings GmbH

External debt sustainability and vulnerability to short-term external shocks

Italy has gross external debt of 124% of GDP in 2017. The net international investor position stood at -6.7% of GDP as of Q4 2017, representing an improvement from -22.7% of GDP at end-2013.

TARGET2 net liabilities have risen

TARGET2 net liabilities have risen further to a record 26% of GDP at end-March 2018 (from about 9% of GDP as of mid-2014). This matches financial outflows and shows an increase in Italian residents' portfolio investments abroad and a reduction in foreign exposures to Italy. Private financial outflows suggest some impact from Italian risks and lagging growth.

Financial stability risk

Banking sector performance and financial imbalance/fragility

High NPLs remain a challenge, though the situation has improved

Italian banks' stock of non-performing loans (NPLs) is still very high compared with the European average (Italy's at 14.5% of total loans in Q4 2017, though this is down significantly from 17.4% a year earlier and compared with 18.2% during a 2015 peak (**Figure 10**), thanks to a lower rate of deterioration in loan quality and disposals of bad loans). Non-performing loans net of provisions to capital have also fallen since Q1 2015.

In Scope's view, bad debts and other non-performing exposures (NPEs) are a legacy of the crisis and a large portion of NPLs are on the block and being actively marketed to private equity investors.[16] NPLs continue to dampen the banking sector's lending activities, even as credit supply conditions improve. Privately funded and government-sponsored

[16] See Scope Ratings comment, "The Scope Debate: do bad loans still pose risks to European financial stability?", 15 May 2018.

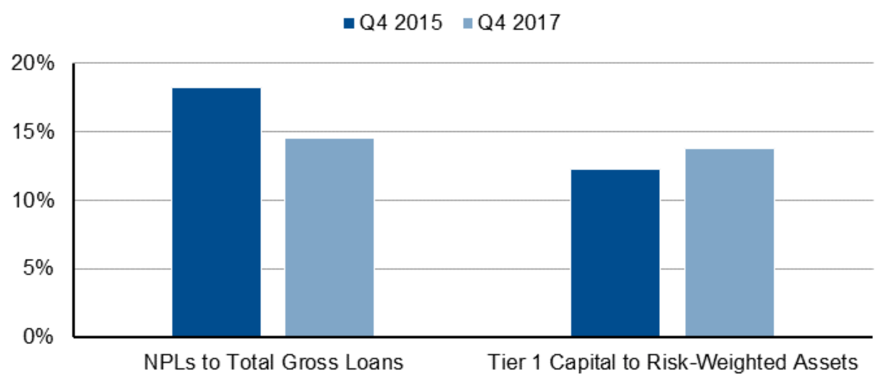
solutions, such as the Atlante II fund, which is supported by the Italian Treasury's guarantee scheme on NPL securitisation (GACS), are in place.

GACS runs until September 2018, with a six-month extension now under review by the European Commission. Banks had been slow to utilise the guarantee scheme; however, in recent months, there has been a surge in interest.[17]

Resolution and recapitalisation of the banking system are credit positive

Risks in the banking sector are a continued rating constraint, though Scope notes the recapitalisation and restructuring of several problem banks in 2017. Overall, tier 1 capital ratios rose to 13.8% of risk-weighted assets (RWAs) in Q4 2017, compared with 11.3% a year earlier and 9.5% as of Q2 2011. Government measures were, however, required to step in, including the EUR 5.4bn precautionary recapitalisation of Monte dei Paschi di Siena and the splitting of two large regional banks in Veneto (Banca Popolare di Vicenza and Veneto Banca) into good banks and bad banks. These actions reduced the risk of a systemic crisis, but with an associated cost to the government of about EUR 10.2bn (0.6% of GDP) in 2017. In 2016, the government set aside up to EUR 20bn for emergency capital injections alongside guarantees on up to EUR 150bn in bank liquidity.

Figure 10: NPLs (% of total loans) and system tier 1 capital ratio (as a % of RWAs)



Source: Banca d'Italia

Banking sector oversight and governance

Domestic concerns on bail-in procedures are a risk

However, setting in motion efficient and cost-effective solutions to insolvent banks has been onerous, owing to domestic concerns about resolving banks using bail-in on private sector savers. That has brought about additional costs on a government that lacks fiscal space and on other Italian banks.[18] Learning the lessons from the financial crisis, EU bail-in rules aim to allow state aid only if and when all other means of rescue (with creditors and shareholders having shared the burden) have been exerted without success.

Instead, troubled Italian banks have been addressed on a case-by-case basis, reflecting political in addition to financial stability considerations. The large-scale recapitalisation of Monte dei Paschi used an exemption clause in EU rules that allows a "precautionary recapitalisation" to an institution judged *solvent* instead of resolution to remedy a serious financial disturbance.[19] The liquidation of the two Venetian banks under *national* insolvency rules, rather than EU rules, with state support was similarly conducted to protect depositors and senior creditors and allow relief for retail junior bondholders.[20]

[17] See Scope Ratings comment, "Scope raises Italian NPL securitisation forecast amid acceleration in asset disposals", 29 May 2018.
[18] International Monetary Fund. "2017 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for Italy." Country Report No. 17/237, 27 July 2017.
[19] https://www2.deloitte.com/de/de/pages/financial-services/articles/Bail-out-in-italy-the-first-severe-violation-of-the-single-resolution-mechanism.html
[20] http://www.eiu.com/industry/article/75659991/fixing-italys-banks-avoiding-bail-ins/2017-07-06

86% of non-equity instruments eligible for bail-in are held by the wealthiest 10% of citizens[21]; as such, bail-in ought to be considered both from the standpoint of breaking the sovereign-bank nexus, so fundamental in exacerbating the global financial crisis, as well as from a fairness angle. Italian households have amongst the world's highest levels of available net wealth, with the latter standing at 194% of GDP in 2016.

Significant reforms still needed to the banking system, with the new programme proposing instead reversals

Reforms of the banking system remain incomplete. The overhaul announced early in 2016 to replace the insolvency law did not materialise. The reform of civil procedures also needs to be accelerated alongside greater use of out-of-court restructuring. In general, significant actions still need to be taken to improve insolvency and debt enforcement procedures, facilitate bank rationalisation and consolidation, and make timely and effective use of the resolution framework.[22]

The new government's programme instead proposes a review of Basel accords and bankruptcy laws, a radical reform of bail-in rules to protect savers and backs the reimbursement of retail shareholders of banks for earlier losses imposed, alongside a strategic review of Monte dei Paschi. While these proposals are far from easy to implement, they suggest that prevailing weaknesses in the system may go unattended to.

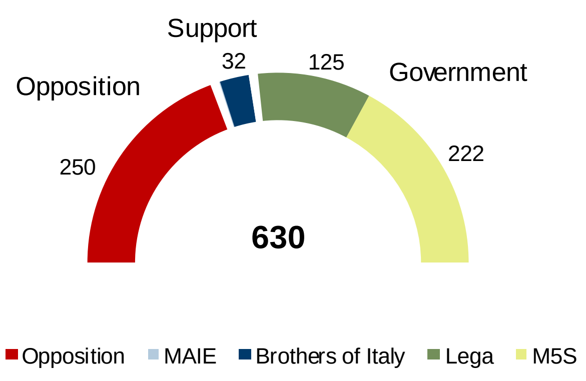
Institutional and political risk

Recent events and policy decisions

Rise of populist and Eurosceptic trends

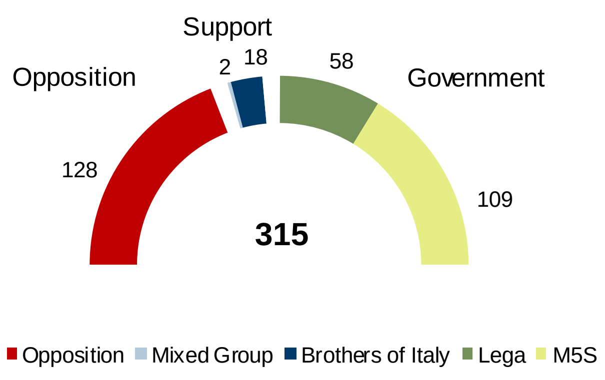
The Five Star Movement and Lega displaced mainstream parties in the March general election, holding now 55% of seats in the lower house alongside 53% of seats in the Senate (**Figures 11 and 12**). The two populist groups have joined forces in a coalition government, under the compromise prime minister Giuseppe Conte, with party leaders Luigi Di Maio and Matteo Salvini as deputy premiers and leaders respectively of the labour and economic development ministry and interior ministry. The composition and inexperience of this new government, including Giovanni Tria as finance minister and Paolo Savona as European affairs minister, cast doubt on the country's future commitment and ability to resolve significant macroeconomic and institutional challenges.

Figure 11: Chamber of Deputies, seat distribution



Source: Italian Chamber of Deputies

Figure 12: Senate, seat distribution



Source: Italian Senate

[21] Banca d'Italia. "Financial Stability Report No. 1 - 2016", 29 April 2016.
[22] International Monetary Fund. "2017 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for Italy." Country Report No. 17/237, 27 July 2017.

Structural alteration in Italy's political landscape is a driver of the Negative Outlook

An important driver behind Scope's outlook change is the alteration in Italy's political landscape since the global financial crisis in favour of anti-establishment groups, and the associated implications for the nation's longer-term economic and institutional policymaking. The populists have continued to accrue gains even in the middle of an economic rebound. An alteration in expectations from domestic policymaking extends potentially beyond this current administration to future Italian governments – for instance, even in the scenario of early elections, anti-establishment groups might be similarly competitive in a repeat election and in the government formation process.

The two government parties' small parliamentary majority, especially in the Senate, Lega's polling gains, and the probability of forced moderation of campaign promises (and forced prioritisation between party objectives) will test the unity and longevity of this government. Lega achieved its best-ever result in the March 2018 elections (with 17.4% of votes) and could stand in a good position to strengthen its parliamentary footing in case of an early election. Lega sees around 26% of voting intentions in polls, up from 17.4% in the March elections (with its centre-right coalition polling around 41% altogether, from 37% in March). M5S polls around 30.5% of voting intentions, compared with its March election result of 32.7%. Establishment groups like the Democratic Party and Forza Italia are still down, with 19% and 10.5% of voting intentions respectively.

An extended phase of political instability appears on the cards, with probable prolonged inaction in this environment on areas of needed reform, alongside a turn of policy in a possibly more regressive direction. Scope notes Italy's elevated debt stock and weak growth potential as only two reasons why the government can ill afford such inaction on fiscal and structural policies. Over the coming period, Scope will seek to gain greater clarity on the degree to which party policy priorities moderate when in government.

Scope notes that earlier controversial proposals, like the request to write off EUR 250bn of Italian government debt and language referencing EU treaty change to facilitate exits from the Economic and Monetary Union were excluded from the final two-party agreement between M5S and Lega.

Risks of 'Ital-exit' are limited

Scope believes the possibility of a euro exit is limited, as it was during the debt crisis. Rhetoric (or even actions) centred on a euro or EU exit or a parallel currency falters once the significant economic, financial and political cost and complications around such an exit strategy become clear. Lega's Salvini and Five Star's Di Maio have recently denied any plan to leave the euro. Although a coalition proposal for a form of government IOU (titled "mini-BOTs") to pay state arrears amounts to in effect proposing a parallel currency, it is unlikely to see implementation.

Holding a euro exit referendum in Italy requires a complicated legislative process, with a constitutional amendment (requiring two votes at a two-thirds majority in each house of parliament, or failing that, a preliminary referendum to facilitate a euro referendum) needed before a referendum on the euro could be held. In addition, a poll published on 31 May showed 72% of Italians backed the euro, while 23% said they'd vote to leave.

Largely-proportional electoral system problematic in a highly divided political landscape

After former premier Matteo Renzi's constitutional referendum on Senate reform was turned down in December 2016, Parliament approved in October 2017 the electoral reform (Rosatellum[23]) to harmonise the electoral systems for the Chamber and the Senate. But, while the risk of significant misalignment between the Chamber and the Senate has been reduced, the largely-proportional electoral system in conditions of a divided Italian political landscape has also made a strong, stable and reform-oriented government elusive.

[23] Under which 61% of seats in both the lower and upper houses are to be assigned on a proportional basis and 37% on first-past-the-post ballots (with the remaining 2% decided by Italians abroad).

Methodology

The methodology applicable for this rating and/or rating outlook "Public Finance Sovereign Ratings" is available on www.scoperatings.com.

Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

A comprehensive clarification of Scope's definition of default, definitions of rating notations can be found in Scope's public credit rating methodologies at www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is, however, not automatically ensured.

I. Appendix: CVS and QS Results

Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on relative rankings of key sovereign credit fundamentals, signals an indicative "A" ("a") rating range for the Republic of Italy. This indicative rating range can be adjusted by the Qualitative Scorecard (QS) by up to three notches depending on the size of relative credit strengths or weaknesses versus peers based on analysts' qualitative analysis.

For Italy, the QS signals relative credit strengths for the following analytical categories: 1) market access and funding sources; and 2) vulnerability to short-term external shocks. Relative credit weaknesses are signalled for: 1) growth potential of the economy; 2) economic policy framework; 3) fiscal policy framework; 4) debt sustainability; 5) recent events and policy decisions; and 6) banking sector performance.

Combined relative credit strengths and weaknesses generate a downward adjustment and signal an A- sovereign rating for Italy. The results have been discussed and confirmed by a rating committee.

Rating overview	
CVS indicative rating range	a
QS adjustment	A-
Final rating	A-

To calculate the rating score within the CVS, Scope uses a minimum-maximum algorithm to determine a rating score for each of the 22 indicators. Scope calculates the minimum and maximum of each rating indicator and places each sovereign within this range. Sovereigns with the strongest results for each rating indicator receive the highest rating score; sovereigns with the weakest results receive the lowest rating score. The score result translates to an indicative rating range that is always presented in lower-case letters.

Within the QS assessment, analysts conduct a comprehensive review of the qualitative factors. This includes but is not limited to economic scenario analysis, a review of debt sustainability, fiscal and financial performance assessments, and policy implementation assessments.

There are three assessments per category for a total of 15. For each assessment, the analyst examines the relative position of a given sovereign within its peer group. For this purpose, additional comparative analysis beyond the variables included in the CVS is conducted. These assessments are then aggregated using the same weighting system as in the CVS.

The result is the implied QS notch adjustment, which is the basis for the analysts' recommendation to the rating committee.

Foreign- versus local-currency ratings

Italy's debt is predominantly issued in euros or hedged. Italy has no record of default in the modern, post-war era. Scope sees no evidence that Italy would differentiate among any of its contractual debt obligations based on currency denomination.

II. Appendix: CVS and QS results

CVS

Rating indicator	Category weight
Domestic economic risk	**35%**
Economic growth	
Real GDP growth	
Real GDP volatility	
GDP per capita	
Inflation rate	
Labour & population	
Unemployment rate	
Population growth	
Public finance risk	**30%**
Fiscal balance	
GG public balance	
GG primary balance	
GG gross financing needs	
Public debt	
GG net debt	
Interest payments	
External economic risk	**15%**
International position	
International investment position	
Importance of currency	
Current-account financing	
Current-account balance	
T-W effective exchange rate	
Total external debt	
Institutional and political risk	**10%**
Control of corruption	
Voice & accountability	
Rule of law	
Financial risk	**10%**
Non-performing loans	
Liquid assets	
Credit-to-GDP gap	
Indicative rating range	**a**
QS adjustment	**A-**
Final rating	**A-**

QS

Maximum adjustment = 3 notches

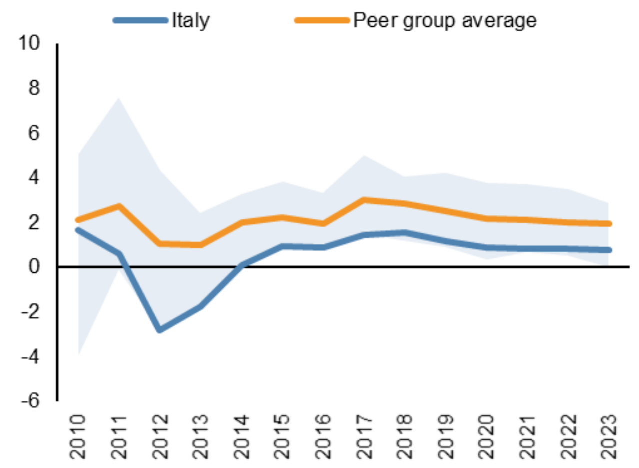
	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy	○ Excellent outlook, strong growth potential	○ Strong outlook, good growth potential	○ Neutral	◉ Weak outlook, growth potential under trend	○ Very weak outlook, growth potential wel under trend or negative
Economic policy framework	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Macro-economic stability and sustainability	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Fiscal policy framework	○ Exceptionally strong performance	○ Strong performance	○ Neutral	◉ Weak performance	○ Problematic performance
Debt sustainability	○ Exceptionally strong sustainability	○ Strong sustainability	○ Neutral	◉ Weak sustainability	○ Not sustainable
Market access and funding sources	○ Excellent access	◉ Very good access	○ Neutral	○ Poor access	○ Very weak access
Current account vulnerability	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
External debt sustainability	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Vulnerability to short-term external shocks	○ Excellent resilience	◉ Good resilience	○ Neutral	○ Vulnerable to shock	○ Strongly vulnerable to shocks
Perceived willingness to pay	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Recent events and policy decisions	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Geopolitical risk	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Banking sector performance	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Banking sector oversight and governance	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Financial imbalances and financial fragility	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate

* Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10

Source: Scope Ratings GmbH

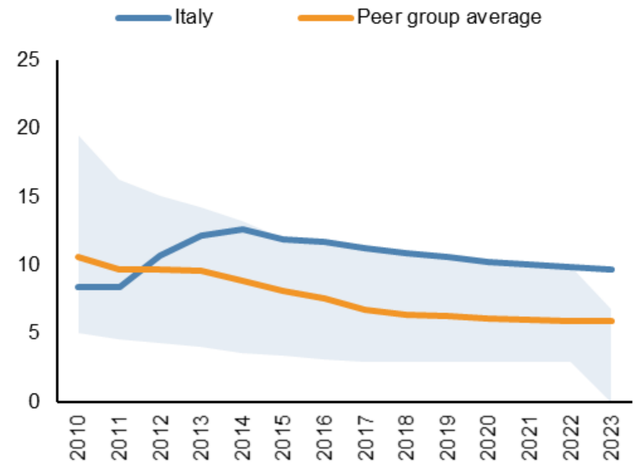
III. Appendix: Peer comparison

Figure 13: Real GDP growth



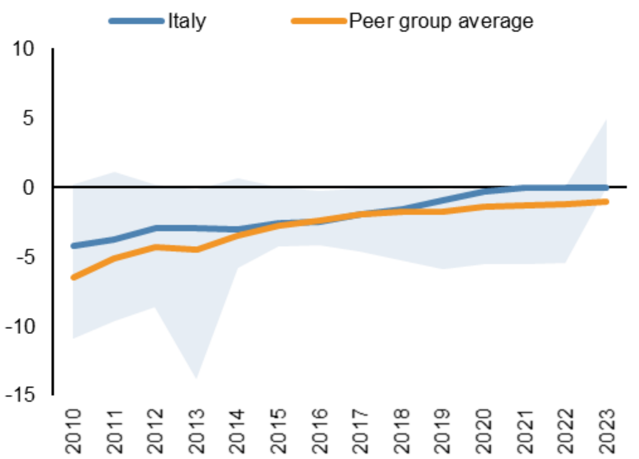
Source: IMF, Calculations Scope Ratings GmbH

Figure 14: Unemployment rate, % of total labour force



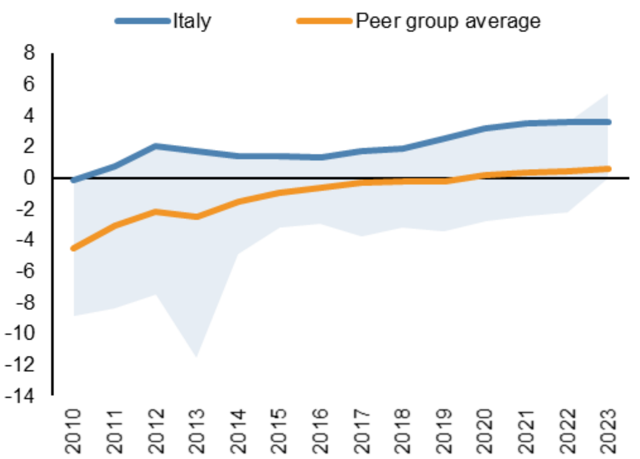
Source: IMF, Calculations Scope Ratings GmbH

Figure 15: General government balance, % of GDP



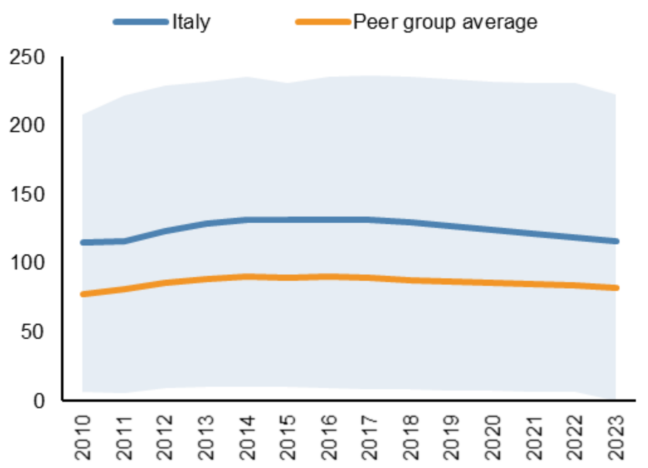
Source: IMF, Calculations Scope Ratings GmbH

Figure 16: General government primary balance, % of GDP



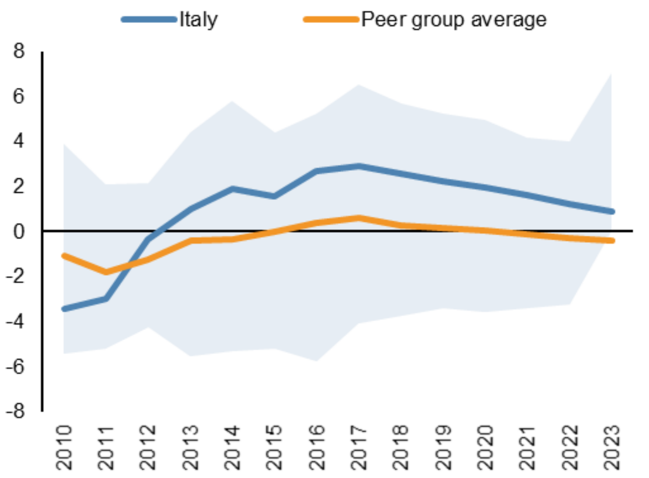
Source: IMF, Calculations Scope Ratings GmbH

Figure 17: General government gross debt, % of GDP



Source: IMF, Calculations Scope Ratings GmbH

Figure 18: Current account balance, % of GDP



Source: IMF, Calculations Scope Ratings GmbH

IV. Appendix: Statistical Tables

	2013	2014	2015	2016	2017	2018E	2019F
Economic performance							
Nominal GDP (EUR bn)	1,604.6	1,621.8	1,652.6	1,680.9	1,716.2	1,760.0	1,803.5
Population ('000s)	60,510.0	60,783.0	60,796.0	60,666.0	60,589.0	60,756.0	60,740.0
GDP per capita PPP (USD)	36,131.1	36,070.8	36,640.1	38,380.2	-	-	-
GDP per capita (EUR)	26,517.8	26,682.4	27,183.3	27,708.5	28,325.7	28,968.8	29,691.4
Real GDP, % change	-1.7	0.1	1.0	0.9	1.5	1.5	1.1
GDP growth volatility (10-year rolling SD)	2.5	2.4	2.4	2.3	2.3	2.3	1.5
CPI, % change	1.2	0.2	0.1	-0.1	1.3	1.1	1.3
Unemployment rate (%)	12.1	12.6	11.9	11.7	11.3	10.9	10.6
Investment (% of GDP)	17.0	17.0	17.3	17.1	17.5	17.7	17.9
Gross national savings (% of GDP)	17.9	18.9	18.9	19.8	20.4	20.2	20.1
Public finances							
Net lending/borrowing (% of GDP)	-3.0	-3.0	-2.6	-2.5	-1.9	-1.6	-0.9
Primary net lending/borrowing (% of GDP)	1.7	1.4	1.4	1.3	1.7	1.9	2.5
Revenue (% of GDP)	48.1	47.9	47.7	46.9	46.6	46.7	47.5
Expenditure (% of GDP)	51.1	50.9	50.3	49.3	48.6	48.2	48.4
Net interest payments (% of GDP)	4.7	4.4	3.9	3.8	3.6	3.5	3.4
Net interest payments (% of revenue)	9.7	9.2	8.3	8.1	7.8	7.4	7.2
Gross debt (% of GDP)	129.0	131.8	131.5	132.0	131.5	129.7	127.5
Net debt (% of GDP)	116.7	118.8	119.5	120.2	119.9	118.5	116.5
Gross debt (% of revenue)	268.1	275.0	275.6	281.7	281.9	278.0	268.5
External vulnerability							
Gross external debt (% of GDP)	119.1	124.1	125.2	123.2	124.2	-	-
Net external debt (% of GDP)	56.4	58.5	59.0	55.0	55.1	-	-
Current account balance (% of GDP)	1.0	1.9	1.5	2.7	2.9	2.6	2.2
Trade balance (% of GDP)	-	2.9	3.1	3.4	3.3	3.3	3.4
Net direct investment (% of GDP)	0.0	0.1	0.1	-0.2	-0.7	-	-
Official forex reserves (EOP, EUR bn)	24.9	27.4	31.6	32.3	31.3	-	-
REER, % change	0.0	0.0	0.0	0.0	0.0	-	-
Nominal exchange rate (EOP, USD/EUR)	1.4	1.2	1.1	1.1	1.2	-	-
Financial stability							
Non-performing loans (% of total loans)	15.9	17.8	18.0	17.1	14.4	-	-
Tier 1 ratio (%)	10.5	11.8	12.3	11.3	14.3	-	-
Consolidated private debt (% of GDP)	121.6	119.0	115.3	113.5	-	-	-
Domestic credit-to-GDP gap (%)	-6.5	-12.0	-17.7	-17.7	-17.4	-	-

Source: IMF, European Commission, European Central Bank, World Bank, Bank of Italy, ISTAT, Scope Ratings GmbH

V. Regulatory disclosures

Responsibility

This credit rating and/or rating outlook is issued by Scope Ratings GmbH.

Rating prepared by Dennis Shen, Lead Analyst

Person responsible for approval of the rating: Dr Giacomo Barisone, Managing Director, Public Finance

The ratings/outlook were first assigned by Scope as a subscription rating in January 2003. The ratings/outlooks were last updated on 30.06.2017.

The senior unsecured debt ratings as well as the short-term issuer ratings were last updated by Scope on 30.06.2017.

Rating Committee: i) the political environment outlook; ii) Italy's low productivity and growth potential; iii) macroeconomic stability and sustainability; iv) fiscal consolidation outlook; iv) public debt sustainability and vulnerability to shocks; v) banking sector resilience; vi) peers considerations.

Solicitation, key sources and quality of information

The rating was initiated by Scope and was not requested by the rated entity or its agents. The rated entity and/or its agents did not participate in the ratings process. Scope had no access to accounts, management and/or other relevant internal documents for the rated entity or related third party.

The following material sources of information were used to prepare the credit rating: public domain and third parties. Key sources of information for the rating include: Ministry of Economy and Finance (MEF), Banca d'Italia, ISTAT, European Commission, Eurostat, ECB, IMF, and Haver Analytics.

Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.

Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds upon which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

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