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Rating Action

Neuss, 11 February 2022

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

The outlook revision on the Italian Republic reflects

- (i) remarkable progress in driving the implementation of the ambitious reform agenda in the initial stages, with the prospective strengthening of the institutional framework forming a crucial foundation to build on;
- (ii) increasing confidence in the ability to effectively implement further measures foreseen in the Recovery and Resilience Plan (RRP), which improves prospects of strengthening productivity and potential growth; and
- (iii) a higher degree of confidence in the public debt ratio embarking on a downward path amid an assumed fading of Covid-19 threats, and in light of the better-than-expected performance of tax receipts against a more favorable macro backdrop, as well as further advances in reducing non-performing loans (NPLs).

Key Rating Drivers

1. Large, diversified, and wealthy economy constrained by persistently low productivity, comparatively low investment partly held back by a complex business environment, and structural weaknesses in the labor market, which have been weighing on potential growth for a prolonged period; an unfavorable demographic outlook continues to pose headwinds to medium-to-longer-term growth
2. While assuming continued solid economic growth in 2022/23, coming on the heels of faster-than-expected output expansion last year and led by vivid investment growth, we view NextGenerationEU (NGEU) and related material financial support as a boon for the Italian economy, thus giving rise to a considerably more constructive medium-term outlook; although we deem the structural reform agenda as quite ambitious overall, we have witnessed decisive implementation in the initial stages; more generally, we believe that the probability for an efficient and stringent implementation is higher than in the last decade,

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as the current administration is backed by broad political support for now and NGEU instalments are linked to a dedicated set of milestones and targets to be achieved going forward

3. Generally strong institutional framework, with the latest set of governance indicators suggesting some room for improvement; remarkable advancements in driving crucial reforms likely strengthening governance, among others a long-awaited reform aiming to increase the quality and efficiency of the judicial system; policymaking may remain challenging in light of an essentially volatile political context and associated fragile cohesion, as the recent presidential election also seemed to suggest
4. Risks to fiscal sustainability continue to be high as reflected by weak fiscal metrics, in particular a very high debt-to-GDP level and likely continued, albeit shrinking, primary deficits over the medium term; resurfacing contingent liability risks entailed by the banking sector cannot be ruled out once Covid-19 support is fully phased out, but lower NPL levels and an overall more robust banking sector amid a stronger restructuring/resolution framework is likely to broadly contain related fiscal risks; demographic developments continue to pose fiscal challenges, and we will be monitoring ongoing discussions around the envisaged pension reform
5. Italy's public debt ratio should gradually decline over the medium term, reflecting the assumed solid economic recovery, and assuming an improving epidemiological situation requiring less fiscal support; uncertainty around the evolution of coronavirus remains pronounced; in light of a generally volatile political backdrop, sound debt management and strengthening debt affordability remain mitigating factors for the time being; we assess envisaged structural fiscal reforms as positive, in particular measures targeting tax evasion
6. We continue to deem external risks as limited; following a continued improving trend, the net international investment position (NIIP) turned positive in 2020 and increased over the course of last year, with a persistent current account surplus contributing to this

Reasons for the Rating Decision and Latest Developments¹

Macroeconomic Performance

Italy's macroeconomic performance profile is underpinned by the large size and wealth of its economy, alongside a healthy degree of diversification. Adding some element of resilience, households command over considerable net wealth, while we deem the level of overall private indebtedness as still moderate, despite increases in the course of the pandemic. If the momentum regarding the implementation of envisaged reforms can be kept up along the various layers of government and administration, implementation of the ambitious and largely EU-level funded RRP should lift potential growth meaningfully over the medium term, thus opening a window of opportunity to tackle long-standing structural weaknesses. Productivity growth will likely be enhanced in this scenario, not least via significantly ramped-up investment, whilst structural challenges on the labor market may be noticeably reduced and the business environment should emerge strengthened.

¹ This rating update takes into account information available until 03 February 2022.

While Italy's relatively large size as the world's eighth largest economy and its level of prosperity generally contribute to its economic resilience, the corona crisis halted a rather anemic recovery in the aftermath of the global financial crisis and the euro crisis. Over the period 2015-19, Italy's total economic output grew by only 1.0% on average (euro area: 2.0%). In 2020 real GDP plunged by 8.9% – also representing a steeper decline compared to the other major economies in the euro area (EA: -6.4%), partly due to stricter containment measures, as illustrated by the Blavatnik School of Government stringency index.

Thanks to swift and sizeable support via fiscal policy, as well as European-level funds and accommodative monetary policy, total output embarked on a recovery path from Q3-20, briefly interrupted in Q4-20, largely on account of renewed restrictions to contain the spread of the coronavirus. Due to the strong contraction in 2020, Italy's GDP per capita is estimated to have dropped by 7.5% to 41,268 USD in 2020 (IMF data, PPP terms), but may have recovered to about 45,267 USD in 2021 (+9.7%), which would still continue a declining trend in terms of percentage of EU-level income per head (2021: 93.7% of estimated EU level).

Over the course of 2021, total economic output continued to expand on the back of eased containment measures and strong vaccination discipline, as well as partly extended fiscal measures cushioning employment and incomes as well as business activities. Tourism saw some recovery as well, especially in last year's third quarter. As of Q4-21, real GDP was still 0.5% below its pre-crisis level (Q4-19), somewhat lagging the euro area as a whole (Q4-21 vs. Q4-19: 0.0%). This said, gross fixed capital investment already began surpassing its pre-pandemic level from the beginning of 2021, driven by both construction investment and investment in machinery and equipment.

Last year's final quarter saw a marked slowdown of the economic recovery, with q-o-q growth shrinking to 0.6% in light of soaring Covid-19 infections in many countries, and the spread of the Omicron strain. Supply-side problems regarding numerous commodities and intermediate products such as semi-conductors likely exacerbated the slowdown. Nevertheless, looking at high-frequency indicators, Italian industrial production continued to grow on average in October and November 2021, although at a slower pace compared to Q3-21, proving somewhat more resilient to the supply bottlenecks than peers Germany and France. Activity in the service sector also expanded to a lesser degree.

Ultimately, GDP rebounded by 6.5% in 2021, according to preliminary Istat data. Looking ahead, we expect domestic demand to remain the main growth driver this year, with private consumption supported by a relatively resilient labor market performance and stronger wage growth as more employees return from short-time work. Crucially, a high vaccination and booster rate compared to the EU level should help to prevent tight restrictions as seen in 2020, leaving the economy more room to breathe. As of 03 February, 76.5% of the total Italian population had taken up the primary course and 55.2% had received an additional dose as compared to only 70.3% and 45.1% in the EU as a whole (ECDC data). While consumer confidence has trended downward since Sep-21, it remained above the long-term average as of Jan-22. In addition to that, personal tax income relief as approved by parliament will likely prove beneficial to household expenditure. Among others, the tax rate for low salaries (EUR 15,000-28,000 per year) was reduced by 2 p.p. to 25%, and for salaries of up to EUR 35,000 per year there will be an 0.8% discount on social security contributions in 2022.

As mentioned above, job retention schemes and a dismissal ban were instrumental in shielding the labor market from greater harm in this pandemic. While most of the schemes have been

phased out by now, some parts, subject to certain conditions such as national strategic interests, have been extended until end of March 2022. Contrary to a number of its fellow European countries, Italy's annual unemployment rate continued to drop in 2020 (9.2%, EA: 7.9%, Eurostat). In monthly terms, the unemployment rate was at 9.0% in Dec-21, having slightly exceeded 10% at the beginning of 2021, remaining well above the euro area level. The decline in employment was more pronounced than in the euro area in 2020, with the quarterly employment level 0.6% below its pre-pandemic reading (Q4-19) in Q3-21 (Eurostat), compared to -0.2% in the euro area. However, employment has grown in four of the five quarters since Q3-20, with indications that the rise continued in Q4-21 as well.

Prospects for gross fixed capital formation remain very benign in view of the Recovery and Resilience Facility (RRF) funds that are likely to provide a substantial boost to both public and private investment. Business confidence fell for a second consecutive month this January, with market services acting as a significant drag, while sentiment in manufacturing and construction saw only slight dips at a high level. Moreover, financing conditions seem set to remain rather favorable. Prospects for a tighter monetary policy stance appear somewhat more remote in the euro area at this stage (see below).

Italy has asked for the maximum amount of RRF funding, i.e. for EUR 68.9bn in grants and EUR 122.6bn in loans, making it the largest beneficiary of the funds in absolute terms. Following disbursement of EUR 24.9bn in pre-financing payment, the government is confident over having achieved all 51 goals set for 2021 and has applied for the disbursement of the first installment of EUR 24.1bn (EUR 21bn net of pre-financing). With regard to 2022, there are 100 milestones/targets to be met by the end of the year, 45 of which by the end of Jun-22, to which further disbursements are linked. Forty percent of RRF funds are to be spent in 2021 and 2022.

Amid the ongoing global recovery and an assumed gradual ebbing of global shortages of various materials and products, Italian exports should continue to grow this year and next, partially benefiting from NGEU-backed demand in the EU. Given our assumption of strong domestic demand going forward, we expect net exports to make only a small contribution, if any, to GDP growth this year and next.

We currently expect real GDP to grow by 4.0% this year and 2.0% in 2023. With regard to the medium-term, we think that a maintained implementation momentum on all government levels, and effective realization of reform measures, implies significant upside risks and would strengthen economic prospects considerably. Stimulus via the RRF could lift real GDP by between 1.5% and 2.5% by 2026, drawing on EC estimates, with possible further positive effects via structural reforms.

Against this background, capacities to absorb EU funds will play a crucial role. Judging by the ESIF absorption rate concerning the Multiannual Financial Framework 2014-20, Italy is somewhat lagging in this respect, having decided on 78% of the planned funds (spent: 47%), compared to the EU average of 99% (spent: 57%) as of 26 January 2022. However, authorities are aware of this issue and have initiated specific reforms to enhance the efficiency of public administration, thus giving some confidence that fund absorption can be improved effectively and in a timely fashion.

Effective implementation of the RRF could eventually markedly enhance potential growth, not least via productivity growth, which in terms of real labor productivity per hour worked has more or less stagnated over the last twenty years (2001-20: 0.2% p.a., EA: 0.9%, Eurostat). Productivity

growth has been weighed down by a number of factors, including the long-standing North-South-gap, a relatively small average size of companies and a prominent role of industries which tend to be less productive, as well as laggard investment growth. Regarding the latter, public and business investment in percentage of GDP have been trailing the euro area as a whole, with business investment averaging 10.0% of GDP over the period 2015-19 (EA: 13.0%, Eurostat). If current forecasts by AMECO materialize, Italy could substantially narrow the gap to the other three major euro area economies when it comes to potential growth (avg. 2011-20: -0.1% vs. 1.1% and 1.3% in 2022 and 2023 respectively).

Moreover, employment and value added is more concentrated on SMEs than in the EU overall, and in particular on micro enterprises, which in 2020 accounted for 42.5% of total employment (EU: 29.6%, EC) and 25.4% of value added (EU: 18.7%). These micro enterprises have less access to finance, as e.g. Banca d'Italia (BdI) and OECD findings suggest, and tend to be more affected by bureaucratic obstacles, both of which tends to hamper growth performance despite continuously improving innovation performance relative to the EU over the last few years (European Innovation Scoreboard). To be sure, cutting red tape for SMEs and improving access to finance is part of the RRP and could thus help to brighten growth prospects. Similarly, Italy's gross domestic expenditure on R&D averaged 1.4% of GDP over 2011-20, comparing unfavorably with the euro area (2.2% of GDP), but edged up over these years, reaching 1.5% of GDP in 2020. Tax credits for R&D as envisaged in the RRP could prove a vital lever to further increase this ratio.

Another factor that has been weighing on Italy's growth performance is being addressed as well: The tax wedge on labor is among the highest in the EU (2020: 2-earner household/2 children, average wage: 44.1%, EU: 36.0%, EC), so that the abovementioned personal income tax reform should bring some relief. Considering taxation more generally, changes have occurred frequently over the years, complicating planning processes for firms and thus adding to a comparatively less friendly business environment.

The last available Doing Business Report by the World Bank, referring to the year 2019 and to which we still pay some attention, had highlighted particular challenges when it comes to paying taxes, enforcing contracts, and getting credit. In the meantime, there have been efforts to tackle these challenges, and we will be closely monitoring any progress on these fronts, also awaiting the 2022 Global Competitiveness Report by the World Economic Forum. Crucially, the justice reform bill adopted by parliament in November 2021 (see below) could contribute to enhancing legal certainty for firms, thus addressing a pivotal element with regard to the business environment.

Reflecting on other factors associated with Italy's cost competitiveness, we note that real unit labor costs have continued to develop rather favorably compared to the euro area as a whole, and broadly against Italy's main European trading partners. Real compensation per employee has held up better vis-à-vis those partners, helping to stabilize economic development at home. In case of a prolonged phase of misaligned wage and productivity growth, we would flag some concern over price competitiveness. While the sovereign's global export market share has continued to edge down to 2.5% in 2020 (2019: 2.6%), this has happened mostly on account of a tourism-driven decrease of the share in global services exports, which dropped to 1.7% (2019: 2.0%). However, we would expect some reversal when tourism sees a more sustainable recovery once there is conviction in having gained control over the coronavirus.

In order to drive the digital transformation forward, 25% of the RRP funds are to be directed towards this area. Italy ranked 20th among the 27 EU members in the Digital Economy and Society Index (DESI) 2021, trailing the average especially in terms of connectivity, but also with regard to human capital concerning digital skills of internet users. In terms of investments in technological innovation among banks and financial companies, it may be worth mentioning that resources allocated to projects planned for the two-year period 2021-22 reached almost twice the amount of the period 2017-18, although most of these resources (85%) were accounted for by just ten out of 158 operators (Bdl survey).

Institutional Structure

Buttressed by euro area/EU membership, benefits of which not least include the large funds provided via NGEU to enhance the recovery and resilience of EU economies in the face of the global health crisis, we continue to assess Italy's institutional framework as generally strong. This assessment is balanced to some degree by a generally volatile political context complicating policymaking, as recently shown by a difficult presidential election that hints at a continued political divide. At the same time, we assess as positive that the Draghi administration has been able to build on a strong parliamentary backing that has enabled it to swiftly turn reform proposals into law. Whilst challenges could arise in implementing reforms on a sub-national level, the 2023 parliamentary election could result in higher political uncertainty after a phase of broad-based government support, posing downside risks in the shape of potential delays in implementing the agreed reform agenda or parts thereof.

Looking at the latest vintage of the World Bank's Worldwide Governance Indicators, there remains plenty of room to improve with regard to government effectiveness (relative rank 69 vs. EA median 35), rule of law (rank 83 vs. EA median 32) and control of corruption (rank 65 vs. EA 43), when comparing Italy's rankings with the respective euro area median readings. That said, we note that the perception with regard to control of corruption has continuously improved between 2015 and 2020, the most recent reference year. On the other hand, judging by the perception of prevalence of rule of law, i.e. including quality of contract enforcement, property rights, the police, and the courts, Italy's relative ranking has fallen to its lowest level since inception of the indicator in 1996.

However, the establishment of the current national unity government, which is supported by a broad range of political parties, has enabled tangible progress in terms of initiating structural reforms and NGEU-related measures that will improve governance aspects as well. In order to facilitate full implementation of the projects included in the NRRP, simplifying procedures have been introduced by decree, constituting an important pre-condition for effective management and execution of the measures. Public procurement should also benefit from these simplifications.

We favorably view advancements made in enhancing the efficiency and quality of the justice system amid a range of initiatives including efforts to shorten the length of proceedings, streamlining civil and criminal procedures, strengthening judicial independence, as well as increasing qualified staff. In this vein, we would highlight further steps made towards these goals following the publication of the European Commission's (EC) rule of law report (Jul-21), which had flagged positive developments in this respect. Parliament adopted the reform of the civil justice system in November 2021. In addition, there have been further advances towards fighting corruption and strengthening the framework to prevent it.

A higher degree of legal certainty should prospectively contribute to improving the environment for doing business. To this end, we would also highlight positively government commitment to the annual adoption of competition laws in 2021 to 2023, with the aim to e.g. facilitate starting a business, remove entry barriers in a number of strategic sectors, reduce public arrears, among others. Especially with regard to SMEs, cutting red tape as also intended through these initiatives would seem conducive to strengthening the business environment. We understand that the competition bill for 2021, approved by the Council of Ministers in November and affecting various sectors including local public services, energy and transportation, still awaits approval by parliament. Controversy over the bill, which had led to some delay, may serve as a reminder of the risks surrounding implementation of the ambitious agenda in full and in a timely manner.

Apart from that, we expect that the envisaged measures to reinforce digital and human resource capacities of the tax authority and to strengthen the sanction framework in the case of non-cooperation, as set out in the RRP, will foster tax compliance (see also below).

While there is the impression of generally accelerated reform activity over the past year or so, we are aware that parts of a reformed insolvency framework meant to enter into force from September 2021 have again been postponed to 16 May 2022. What is more, the early warning procedures for identifying and potentially remediating early-stage crises (i.e., Title II of Part I of the Insolvency Code) has been postponed to 31 December 2023, apparently in order for this part to be adapted to the framework set by EU Directive 2019/1023, requiring transposition before July 2022.

We will continue to closely monitor implementation progress on the broad range of measures and reforms that would represent a general overhaul of long-standing deficiencies in Italy's institutional framework. In our view, risks continue to persist with a view to the generally volatile political context, and specifically with a view to the next parliamentary election to be held in 2023 at the latest, as doubts remain over political cohesion. Lack thereof might have reverberations to administrative and organizational efforts required for the RRP to become reality, potentially posing an obstacle to implementing the ambitious RRP agenda effectively on all levels of governance and within a reasonable period of time. While the outcome of January's presidential election may ultimately suggest continuity at a critical point in time, the election process exposed divisions among the governing parties.

In terms of greening the economy, Italy scores well above the EU average when it comes to the EC's 2021 Eco-Innovation Index, ranking 10th among the 27 member states. Moreover, greenhouse gas emissions per capita, standing at 7.2 tons of CO₂ equivalent in 2019 (-1.7 tons compared to 2010, Eurostat), were well below the level observed in EU-27 in 2019 (8.4 tons). Looking at the overall share of energy from renewable sources, Italy moves somewhat below the EU level, amounting to 20.4% in 2020 (EU-27: 22.1%), with a somewhat larger gap to the EU level regarding its share of renewable energy in heating and cooling, whereas the share of renewable energy sources is slightly higher than in the EU with regard to gross electricity consumption and with regard to transport.

Fiscal Sustainability

Fiscal sustainability risks remain the major weakness in our assessment of the sovereign's creditworthiness, given the further increased debt ratio from an already high level in 2020, and a historical backdrop of repeated fiscal slippages and postponed reduction targets. A recent phase of political

stability and cohesion allowed for significant headway regarding reforms that could considerably improve budget execution and lay the ground for having the debt ratio shrink over the medium term. However, uncertainty over a sufficiently stable political context in seeing the ambitious reform agenda through remains prominent. Vulnerabilities in the banking sector, essentially regarding asset quality, have been reduced further, whereas contingent liability risks related to public guarantees have increased somewhat. While sound debt management, strengthening debt affordability, and financial relief via NGEU mitigate fiscal risks over the medium term, age-related costs and expected changes continue to add to fiscal pressure in the long run.

Having been on a gradually declining path since 2015, the Covid-19 pandemic had Italy's general government deficit soar to 9.6% of GDP in 2020 (2019: -1.5% of GDP). On the back of the continued economic recovery, improving tax collection and the end of a number of support measures, the headline balance will likely have shrunk meaningfully last year. In the first three quarters of 2021, total revenue rose by 8.4% compared to the same period in 2020 (whole year 2020 vs. 2019: -6.8%, Eurostat). Total outlays on the general government level increased by 3.8% (whole year 2020 vs. 2019: 8.4%). Pandemic-related measures in 2021 were significantly lower than in the preceding year, likely coming to roughly 0.8% of GDP (EC). Overall, the deficit looks set to come in markedly lower than expected in the Update to the 2021 Economic and Financial Document (-9.4% of GDP), dating from September 2021. We expect it to have shrunk to about 8.1% of GDP in 2021.

With a view to the current year, the expected ongoing recovery and associated rising revenue intake should result in a significantly narrowing headline deficit, along with some expired government support. Since publishing the DBP22, which included new discretionary measures estimated to have a deficit-increasing effect of 1.2% of GDP, mainly via the expenditure side and including the draft enabling law on reforming taxation of personal income, a personal income tax reform has indeed been adopted by parliament with the budget 2022 on 30 December 2021.

The reduction of personal income tax and corporate tax included in the budget comes to about EUR 8bn combined for 2022. As mentioned above, the personal income tax reform reduces the number of income tax bands from five to four and foresees relief for lower incomes in particular. Moreover, the budget 2022 entails close to EUR 4bn in aid to consumers in the face of rising energy prices and extends the 'building superbonus', subsidizing home renovation for energy-efficiency purposes. At this stage, we would expect the headline deficit to narrow to roughly 5.5% of GDP this year, and further to about 4.0% next year.

We would point to the risk of potentially necessary government support in the event of a worsening of the epidemiological situation and possible stricter containment measures. Further out, we will closely monitor any decisions regarding a pension reform currently debated with trade unions and other agents. The same applies to VAT compliance which has been on a path of improvement. The estimated VAT gap had decreased to 21.3% of VAT total tax liability by 2019 (2015: 26.9%, EC), although still comparing rather unfavorably against most EU countries.

In its 2022-2024 budget law approved by the parliament at the end of December 2021, the government envisages maintaining an expansionary fiscal stance until GDP and employment growth have caught up with the pre-crisis trend – which is expected to be the case in 2024. We pay attention to the notion that, while the consolidation strategy will mainly rest upon RRP-supported GDP growth, medium-term consolidation (primary budget surpluses) is also to be achieved via restraining current public expenditure and via stronger tax revenue amid enhanced

efforts to reduce tax evasion. As mentioned above, we think the introduction of a spending review framework, as is planned, will prove beneficial to meeting these goals.

Having stabilized just under 135% of GDP over the last few years prior to the corona crisis, Italy's debt-to-GDP ratio swelled by 21.3 p.p. to 155.6% of GDP in 2020 (Eurostat). We expect the public debt ratio to have shrunk in 2021, mainly driven by last year's better-than-expected economic performance and related tax receipts, to about 152.3% of GDP, a level lower than expected by the government in its Update to the 2021 Economic and Financial Document and markedly below our estimate in our last review (158.1% of GDP). Nevertheless, at this level, Italian debt-to-GDP remains among the highest in the EU.

We project the public debt ratio will follow a gradual downward trend over the medium term, led by a narrowing primary deficit and robust economic growth, penciling in 148.0% of GDP in 2022 and 147.2% of GDP in 2023. The primary deficit should remain in place until 2024. While the epidemiological developments continue to pose downside risks as vaccines may have to catch up with mutations, we would also echo some reservations expressed by the PBO that full implementation of the NRRP measures appears challenging, accentuating risks around the envisaged path of gradually improving public finances.

Assessing fiscal risks related to contingent liabilities, we note that the estimated take-up of guarantees given in response to the corona crisis, primarily via the Central Guarantee Fund for SMEs, came to 8.8% as of Jun-21 (DBP22). Together with other guarantees, mainly in connection with non-market risks in favor of export credit agency SACE and the Guarantee Fund for SMEs, the take-up of total central government guarantees amounted to 14.5% of GDP by the middle of last year, thus pointing to somewhat more elevated. From 4.8% of GDP in 2019, the stock of guarantees has thus inched up further, following the substantial leap to 13.0% of GDP in 2020.

Having said this, Italy's banking sector is currently in more robust shape, with asset quality having been significantly improved over recent years, judging by EBA data on the non-performing loan (NPL) ratio. The gap towards the overall EU level with respect to this indicator has been substantially narrowed. As of Q3-21, Italy's NPL ratio has dropped to 3.6% (Q3-20: 5.4%, Q3-16: 16.4%). This compares with 2.1% for the EU as a whole. The falling ratio was to a large degree supported by the successful and swift implementation of the GACS scheme to facilitate securitization of NPLs. Due to expire on 14 June 2022, we gather that the Italian authorities would prefer to extend the scheme beyond this date and would like to open talks with the European Commission to gain consent. Reportedly, there may also be negotiations over statistical treatment of the guarantees with possible repercussions for the debt level.

Apart from improving on asset quality, we also observe increasing capital buffers, with the CET1 ratio reaching 15.4% in Q3-21 (Q3-20: 15.2%, EBA data), roughly in line with the EU average (Q3-21: 15.7%). Having experienced a weaker phase in the first year of the pandemic, profitability of the banking sector recovered to pre-pandemic levels in 2021 judging by return on assets, standing slightly above the EU level as of Q3-21 (0.6%, EU: 0.5%). Provisions for loan losses have been reduced, thus no longer weighing so heavily on profitability.

This said, the increase in restructured loans and loans with a significant increase in credit risk (stage 2 loans) could lead to rising loan losses, although the extent of this is likely to be lower than experienced in previous crisis episodes, as BdI points out. Drawing on EBA data, Italy's share of stage 2 loans and advances with non-expired moratoria stood at 44.1% in Q3-21 (Q3-

20: 22.4%). Related vulnerabilities of the sector should be limited in light of the expected constructive macro backdrop.

Given that the sovereign-bank nexus remains relatively prominent in Italy's case, with the share of domestic general government debt securities held by Italian banks at 10.5% of banks' total assets (Nov-21, ECB), we will also continue to monitor developments around Monte dei Paschi (MdP). Talks between the government and potential candidates for taking over the state stake of MdP apparently did not result in viable solutions. Apart from that, while not part of a base scenario, we would flag some risks associated with the tensions between Russia and Western states over Ukraine. Given threats of sanctions, these might raise risks for banks with exposure to Russia.

With a medium-to-longer term view, demographic challenges continue to add to fiscal sustainability risks, as highlighted by estimates including in the EC's latest Ageing Report (2021). Already burdened with comparatively high age-related expenditure in 2019 (26.5% of GDP), primarily due to pension costs, Italy is likely to experience one of the largest increases of these until 2030. The approved budget 2022, widening the range of people and jobs eligible to early pensions under 'APE sociale', will likely add to this. As further parameters of the pension reform are currently under discussion between the government and trade unions, it remains to be seen whether it will be politically feasible to integrate some cost-mitigating elements.

We remain of the view that sound debt management, the favorable debt profile and improving affordability of government debt continue to mitigate risks to fiscal sustainability. Apart from the RRF loans, Italy receives e.g. EUR 27.438bn (1.5% of 2021 GDP) in loans via the EU labor market instrument SURE. Cumulative net asset purchases under PEPP as of end-Nov 21 amounted to EUR 250.9bn, adding to cumulative net purchases to the tune of EUR 429.4bn as of Dec-21 (24.1% of GDP), and contributing to still advantageous refinancing conditions.

This notwithstanding, interest payments increased by 8.1% y-o-y in the first three quarters of 2021, after having shrunk by 5.2% to 3.5% of GDP (7.3% of total revenue) in 2020. Despite signals of less accommodative monetary policy on the global level, which had yields on government bonds edge up and led to an increase of the yield on 10-year Italian government bonds to 1.356% as of 21 January (weekly data), the highest level since Jun-20, yields still move near historically low levels. At its monetary policy meeting this February, the ECB confirmed its intention to discontinue the PEPP in Mar-22, as well as the previously communicated smoothing mechanism. An interest rate hike by the ECB in 2022 currently appears more likely, following February's Governing Council meeting – depending on assessments as to duration, depth, and breadth of price pressures.

Foreign Exposure

We view risks related to the sovereign's external position as limited, while recalling some sensitivity to abrupt changes in investor preferences, given a relatively large share of interest-bearing debt in Italy's external liabilities. The NIIP turned positive in 2020, increasing further in the course of 2021, partly aided by a persistent current account surplus.

Continuing an improving trend, Italy's NIIP turned positive in 2020 (2.3% of GDP), mainly driven by a larger positive balance in portfolio investments amid outflows in the non-financial private

sector. More recently, the NIIP rose further, to 6.1% of GDP as of Q3-21, supported by an increasing current account surplus amounting to 3.8% of GDP in Q3-21, expressed as the four-quarter moving sum (Q4-20: 3.8% of GDP).

By the same way of measuring, the service deficit stood at -0.5% of GDP as of Q3-21 (Q3-20: -0.4% of GDP), whereas the goods surplus increased to 4.1% of GDP (Q3-20: 3.6%). According to Bdl data, the current account surplus came to roughly EUR 53.9bn in the first eleven months of 2021, only slightly changed compared to the same period of the preceding year, as a larger deficit in the energy balance exacerbated by rising prices saw more or less offsetting effects elsewhere. While there was some recovery in tourism, the services deficit widened slightly. Going forward, we would expect the current account surplus to decrease somewhat, especially once tourism recovers more forcefully.

Rating Outlook and Sensitivity

Our rating outlook for Italy's long-term credit ratings is stable. Downside risks to fiscal sustainability are balanced by more favorable medium-term perspectives as regards the macroeconomic performance profile in connection with the impression of a strengthening institutional framework and improvements concerning external exposure. We would continue to highlight that the assessment and forecast of economic development remains much more challenging due to the still high degree of Covid-19-related uncertainty, as is the case for other metrics.

We could contemplate a positive rating action if we gain further confidence that the public debt ratio will follow a firm downward path amid a steadfast implementation of NRRP reforms. Upward pressure would also result from robust economic activity over the medium term, 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 lifting real GDP trend growth and bringing debt-to-GDP onto a sustainable downward path, could also prompt a positive rating action.

Conversely, we could lower our ratings or the outlook, if the public debt ratio fails to resume a persistent downward trajectory, if our expectations of further tangible and timely progress in implementing productivity- and growth enhancing reforms as set out in the NRRP do not materialize, with negative reverberations in terms of scarring effects and for public finances. Materializing contingent liability risks, possibly related to rising NPLs and/or comprehensive public guarantees could also have us consider a negative rating action. Resurging political volatility could raise concerns over potential delays in implementing the agreed reform agenda or parts thereof, with the 2023 parliamentary election representing a key event in this respect.

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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

ESG Factors

ESG Factor Box



Creditreform Rating has signed the ESG in credit risk and ratings statement formulated within the framework of the UN Principles for Responsible Investment (UN PRI). The rating agency is thus committed to taking environmental and social factors as well as aspects of corporate governance into account in a targeted manner when assessing creditworthiness.

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

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

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

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

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

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

Economic Data

| [in %, otherwise noted] | 2016 | 2017 | 2018 | 2019 | 2020 | 2021e | 2022e |
|--|--------|--------|--------|--------|--------|--------|--------|
| Macroeconomic Performance | | | | | | | |
| Real GDP growth | 1.3 | 1.7 | 0.9 | 0.4 | -8.9 | 6.5 | 4.0 |
| GDP per capita (PPP, USD) | 40,231 | 42,112 | 43,617 | 44,615 | 41,268 | 45,267 | 48,523 |
| Credit to the private sector/GDP | 103.0 | 98.1 | 93.6 | 91.9 | 100.3 | n/a | n/a |
| Unemployment rate | 11.7 | 11.3 | 10.6 | 9.9 | 9.3 | n/a | n/a |
| Real unit labor costs (index 2015=100) | 99.0 | 98.1 | 98.8 | 99.4 | 99.5 | n/a | n/a |
| Ease of doing business (score) | 71.8 | 73.2 | 73.0 | 72.9 | n/a | n/a | n/a |
| Life expectancy at birth (years) | 83.4 | 83.1 | 83.4 | 83.6 | 82.4 | n/a | n/a |
| Institutional Structure | | | | | | | |
| WGI Rule of Law (score) | 0.4 | 0.3 | 0.3 | 0.3 | 0.2 | n/a | n/a |
| WGI Control of Corruption (score) | 0.1 | 0.2 | 0.2 | 0.3 | 0.5 | n/a | n/a |
| WGI Voice and Accountability (score) | 1.0 | 1.0 | 1.0 | 0.9 | 1.1 | n/a | n/a |
| WGI Government Effectiveness (score) | 0.6 | 0.5 | 0.4 | 0.5 | 0.4 | n/a | n/a |
| HICP inflation rate, y-o-y change | -0.1 | 1.3 | 1.2 | 0.6 | -0.1 | 1.9 | 3.5 |
| GHG emissions (tons of CO2 equivalent p.c.) | 7.4 | 7.3 | 7.3 | 7.2 | n/a | n/a | n/a |
| Default history (years since default) | n/a | n/a | n/a | n/a | n/a | n/a | n/a |
| Fiscal Sustainability | | | | | | | |
| Fiscal balance/GDP | -2.4 | -2.4 | -2.2 | -1.5 | -9.6 | -8.1 | -5.5 |
| General government gross debt/GDP | 134.8 | 134.2 | 134.4 | 134.3 | 155.6 | 152.3 | 148.0 |
| Interest/revenue | 8.4 | 8.1 | 7.9 | 7.2 | 7.3 | n/a | n/a |
| Debt/revenue | 288.8 | 289.5 | 291.0 | 285.8 | 327.4 | n/a | n/a |
| Total residual maturity of debt securities (years) | 6.8 | 6.9 | 6.8 | 6.9 | 7.0 | 7.1 | n/a |
| Foreign exposure | | | | | | | |
| Current account balance/GDP | 2.6 | 2.6 | 2.5 | 3.2 | 3.8 | n/a | n/a |
| International reserves/imports | 0.3 | 0.3 | 0.3 | 0.4 | 0.5 | n/a | n/a |
| NIIP/GDP | -12.0 | -7.4 | -5.0 | -1.1 | 2.3 | n/a | n/a |
| External debt/GDP | 122.8 | 122.1 | 120.5 | 124.3 | 140.1 | n/a | n/a |

Sources: IMF, World Bank, Eurostat, AMECO, ECB, Istat, 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 |
| Monitoring | 21.08.2020 | BBB- /negative |
| Monitoring | 05.03.2021 | BBB- /negative |
| Monitoring | 11.02.2022 | 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. The rating was not endorsed by Creditreform Rating AG from a third country as defined in Article 4 (3) of the CRA-Regulation.

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

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

The rating was conducted on the basis of CRAG's ["Sovereign Ratings" methodology](#) (v1.2, July 2016) in conjunction with its basic document ["Rating Criteria and Definitions"](#) (v1.3, January 2018). CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG's rating methodologies and basic document "Rating Criteria and Definitions" is published on our [website](#).

To prepare this credit rating, CRAG has used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, World Economic Forum, European Investment Bank, Blavatnik School of Government, ECDC, Dipartimento del Tesoro/ Ministero dell'Economia e delle Finanze, Banca d'Italia, Istituto Nazionale di Statistica, Ufficio Parlamentare di Bilancio (PBO).

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG's "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

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

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

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

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