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# Republic of Italy

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# Republic of Italy

## Major Rating Factors

| Sovereign Credit Rating |
| --- |
| A/Negative/A-1 |

**Strengths:**

- High levels of per capita GDP.
- Strong household and corporate balance sheets.
- Limited external imbalances.

**Weaknesses:**

- Weakening real and nominal growth prospects.
- What we view as significant political impediments to growth-enhancing reforms.
- High gross and net general government debt.
- Limited commitment to expenditure cuts under the current medium term fiscal programme.

## Rationale

The lowering of the long- and short-term sovereign credit ratings on Italy reflects our view of the Italian economy's weakening growth prospects and our view that Italy's fragile governing coalition and policy differences within parliament will likely continue to limit the government's ability to respond decisively to domestic and external macroeconomic challenges.

Under our recently updated sovereign ratings criteria, the "political" and "debt" scores are the primary contributors to the downgrade. The scores relating to the other elements of our methodology--economic structure, external, and monetary--did not contribute to the downgrade.

More subdued external demand, government austerity measures, and upward pressure on funding costs in both the public and private sectors will, in our opinion, likely result in weaker growth for the Italian economy compared with our May 2011 base-case expectations, when we revised the outlook to negative. We believe the reduced pace of Italy's economic activity to date will make the government's revised fiscal targets difficult to achieve. Furthermore, what we view as the Italian government's tentative policy response to recent market pressures suggests continuing future political uncertainty about the means of addressing Italy's economic challenges.

The government projects that its fiscal consolidation program will result in a cumulative fiscal consolidation of about €60 billion, overall, with the largest savings projected in 2012 and 2013 (see "Italy Delivers", http://www.mef.gov.it/documenti/open.asp?idd=27880).

However, we think that the government's projection of a €60 billion savings may not come to fruition for three primary reasons:

- First, as described below, we view Italy's economic growth prospects as weakening;
- Second, nearly two-thirds of the projected budgetary savings in the crucial 2011-2014 period rely on revenue increases in a country already carrying a high tax burden; and
- Third, market interest rates are anticipated to rise.

We expect that Italy's net general government debt burden will remain the key rating constraint for the foreseeable future. Under our base-case scenario (see table 1 below) we project such net debt to end-2011 to be at 117% of GDP, up from 100% of GDP in 2007. Under our current base case, the net debt burden would fall only slightly to 115% of GDP by 2014, a similar rate to the May 2011 downside scenario. By comparison, the current upside and downside cases incorporate modestly different trajectories for the net debt burden (see tables 2 and 3 below).

Our macroeconomic analysis also illustrates Italy's main credit weakness: Even under pressure, Italian political institutions, incumbent monopolies, public-sector workers, and public- and private-sector unions impede the government's ability to respond decisively to challenging economic conditions. For example, union opposition to the privatization of Alitalia in 2008 ended prospects for a takeover by Air France. Moreover, resistance in parliament in July 2011 led the government to drop proposals to liberalize professional services from its legislative agenda. Nontariff barriers to foreign direct investment (FDI) are, in our view, the key reason behind Italy's relatively low inbound FDI stock. At about 16% of GDP, it is less than one-half that of either France or Spain (36% and 43% of GDP, respectively) and lower than that of Germany (27%), despite Italy's potential efficiency gains from economic scale within Europe's common market.

With elections due in 2013, and the government's parliamentary position tenuous, it is unclear what can be done to break the deadlock between these political institutions and the government. As a result, we believe that Italy remains vulnerable to heightened fiscal, economic, and financial downside risks.

We continue to score Italy as a high-income sovereign with a diversified economy and few external imbalances, albeit one with what we see as weaker growth prospects. In addition, we view both household and corporate balance sheets as being relatively strong, which should enable the government to tap local savings on a scale that could permit a more gradual fiscal adjustment than for some of its southern European neighbors. As of end-2010, Italy's non-bank sector remains in a substantial net external creditor position, while the public sector's net external liability is equivalent to €804 billion (52% of GDP). We note that Italy's current account deficit has widened recently, to over 10% of current account receipts, but we expect this will unwind.

## Outlook

The negative outlook on the ratings reflects Standard & Poor's view of risks to the government's fiscal targets over 2011-2014, as well as the uncertainties on the timely implementation of growth-enhancing reforms. In our view, these risks would result from weaker output growth than we currently assume in our revised base case. In addition, political gridlock could contribute to delayed policy responses to new macroeconomic challenges and result in significant fiscal slippages.

If one or more of these risks materializes, Italy's net general government debt could increase from its already high level. In that event, we could lower the long- and short-term ratings. We could also lower the ratings if, against our expectations, the current account deficit remained higher than 10% of current account receipts beyond 2013. This would occur if Italy's trade balance did not improve or if the income deficits continued to widen because of rising refinancing costs.

On the other hand, if the government manages to gather political support for implementing growth-enhancing structural reforms, which in turn increase prospects for a material reduction in the net public debt burden in the medium term, we could affirm the ratings at the current level.



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**Table 1**

**Italy (Republic of) -- Base-Case Assumptions**

| Selected indicators | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| (%) | 2007 | 2008 | 2009 | 2010 | 2011e | 2012f | 2013f | 2014f |
| GDP per capita, $US | 35,788 | 38,519 | 35,160 | 33,995 | 35,680 | 37,975 | 38,720 | 39,509 |
| Real GDP (% chg) | 1.5 | (1.3) | (5.2) | 1.3 | 0.7 | 0.5 | 0.7 | 0.7 |
| Real GDP per capita (% chg) | 0.8 | (2.1) | (5.9) | 0.8 | 0.2 | 0.0 | 0.2 | 0.2 |
| General govt. balance/GDP | (1.8) | (3.0) | (5.7) | (4.9) | (4.5) | (2.9) | (1.8) | (1.7) |
| General govt. debt/GDP | 103.6 | 106.3 | 116.1 | 119.0 | 121.4 | 122.4 | 121.4 | 120.0 |
| Net general govt. debt/GDP | 100.0 | 102.9 | 111.6 | 113.8 | 117.1 | 117.9 | 116.8 | 115.4 |
| GG interest/GG revenues | 10.8 | 11.2 | 9.9 | 9.7 | 10.6 | 11.6 | 12.4 | 12.8 |
| Dom. credit private & NFPEs/GDP | 107.1 | 111.9 | 117.6 | 119.5 | 119.6 | 119.5 | 119.9 | 120.3 |
| CPI (% chg) | 2.1 | 3.5 | 0.7 | 1.7 | 2.4 | 1.8 | 1.8 | 1.8 |
| Current account balance/GDP | (3.0) | (3.0) | (2.0) | (3.0) | (4.0) | (4.0) | (3.0) | (3.0) |
| Narrow net ext. debt/CARs | 223.4 | 192.3 | 276.8 | 247.0 | 238.5 | 224.2 | 223.5 | 222.7 |

e--Estimate. f--Forecast. GG -- General government. CARs -- Current account receipts.

**Table 2**

**Italy (Republic of ) -- Positive Scenario Assumptions**

| Selected indicators | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| (%) | 2007 | 2008 | 2009 | 2010 | 2011e | 2012f | 2013f | 2014f |
| GDP per capita, $US | 35,788 | 38,519 | 35,160 | 33,995 | 35,691 | 38,037 | 38,849 | 39,839 |
| Real GDP (% chg) | 1.5 | (1.3) | (5.2) | 1.3 | 0.8 | 0.6 | 0.9 | 1.2 |
| Real GDP per capita (% chg) | 0.8 | (2.1) | (5.9) | 0.8 | 0.3 | 0.1 | 0.4 | 0.6 |
| General govt. balance/GDP | (1.8) | (3.0) | (5.7) | (4.9) | (4.4) | (2.7) | (1.6) | (1.5) |
| General govt. debt/GDP | 103.6 | 106.3 | 116.1 | 119.0 | 121.3 | 122.0 | 120.5 | 118.4 |
| Net general govt. debt/GDP | 100.0 | 102.9 | 111.6 | 113.8 | 117.0 | 117.4 | 115.9 | 113.9 |
| GG interest/GG revenues | 10.8 | 11.2 | 9.9 | 9.7 | 10.5 | 11.6 | 12.2 | 12.4 |
| Dom. credit private & NFPEs/GDP | 107.1 | 111.9 | 117.6 | 119.5 | 119.6 | 119.3 | 119.7 | 120.1 |
| CPI (% chg) | 2.1 | 3.5 | 0.7 | 1.7 | 2.4 | 1.8 | 1.8 | 1.8 |
| Current account balance/GDP | (3.0) | (3.0) | (2.0) | (3.0) | (4.0) | (4.0) | (3.0) | (3.0) |
| Narrow net ext. debt/CARs | 223.4 | 192.3 | 276.8 | 247.0 | 238.5 | 224.2 | 223.0 | 220.6 |

e--Estimate. F--Forecast. GG -- General government. CARs -- Current account receipts.

**Table 3**

**Italy (Republic of) -- Negative Scenario Assumptions**

| Selected indicators | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| (%) | 2007 | 2008 | 2009 | 2010 | 2011e | 2012f | 2013f | 2014f |
| GDP per capita, $US | 35,788 | 38,519 | 35,160 | 33,995 | 35,651 | 37,533 | 38,024 | 38,711 |
| Real GDP (% chg) | 1.5 | (1.3) | (5.2) | 1.3 | 0.6 | (0.6) | 0.1 | 0.5 |
| Real GDP per capita (% chg) | 0.8 | (2.1) | (5.9) | 0.8 | 0.2 | (1.1) | (0.4) | (0.1) |
| General govt. balance/GDP | (1.8) | (3.0) | (5.7) | (4.9) | (4.4) | (3.0) | (2.0) | (1.9) |
| General govt. debt/GDP | 103.6 | 106.3 | 116.1 | 119.0 | 121.4 | 123.9 | 123.7 | 122.7 |
| Net general govt. debt/GDP | 100.0 | 102.9 | 111.6 | 113.8 | 117.2 | 119.3 | 119.1 | 118.2 |
| GG interest/GG revenues | 10.8 | 11.2 | 9.9 | 9.7 | 10.6 | 12.0 | 13.0 | 13.7 |

**Table 3**

| Italy (Republic of) -- Negative Scenario Assumptions (cont.) | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Dom. credit private & NFPEs/GDP | 107.1 | 111.9 | 117.6 | 119.5 | 118.6 | 118.6 | 119.1 | 119.3 |
| CPI (% chg) | 2.1 | 3.5 | 0.7 | 1.7 | 2.4 | 1.8 | 1.8 | 1.8 |
| Current account balance/GDP | (3.0) | (3.0) | (2.0) | (3.0) | (4.0) | (4.0) | (4.0) | (4.0) |
| Narrow net ext. debt/CARs | 223.4 | 192.3 | 276.8 | 247.0 | 238.4 | 225.1 | 226.0 | 224.6 |

e--Estimate. f--Forecast. GG--General government. CARs--Current account receipts.

## Related Criteria And Research

- Italy Unsolicited Ratings Lowered To 'A/A-1' On Weaker Growth Prospects, Uncertain Policy Environment; Outlook Negative, Sept. 19, 2011
- Sovereign Government Rating Methodology And Assumptions, June 30, 2011
- Credit FAQ: Why We Revised The Outlook On Italy To Negative, May 23, 2011
- Research Update: Republic of Italy Outlook Revised To Negative On Risk Of Persistent High Debt Ratio; 'A+/A-1+' Ratings Affirmed, May 20, 2011
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

| **Ratings Detail** (As Of September 19, 2011)* | |
|---|---|
| **Republic of Italy (Unsolicited Ratings)** | |
| Sovereign Credit Rating | A/Negative/A-1 |
| Transfer & Convertibility Assessment | AAA |
| Senior Unsecured (3 Issues) | AAA |
| **Sovereign Credit Ratings History** | |
| 19-Sep-2011 | A/Negative/A-1 |
| 20-May-2011 | A+/Negative/A-1+ |
| 19-Oct-2006 | A+/Stable/A-1+ |

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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