MOODY'S RATINGS

CREDIT OPINION

6 June 2024

Update

Government of Italy – Baa3 stable

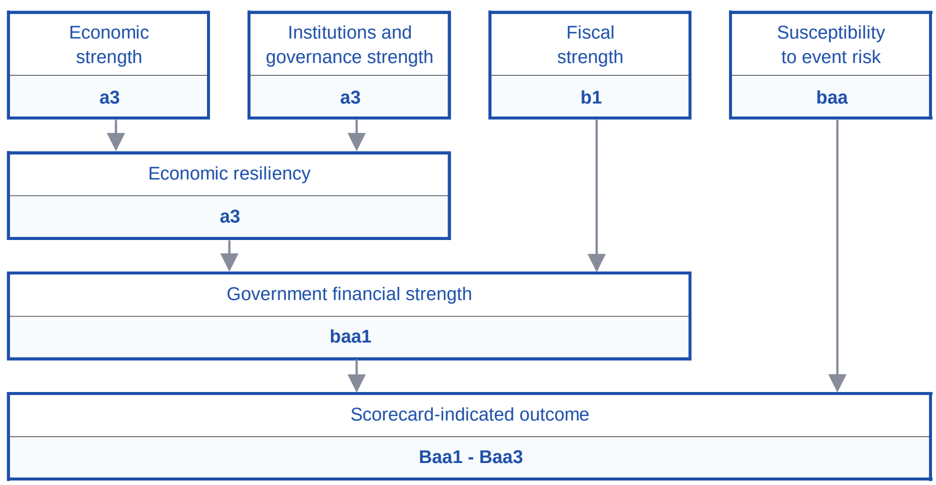
Regular update

Summary

Our credit view of Italy balances the economy's large size, large household wealth, low private-sector indebtedness, solid external position and economic diversification against the country's weak growth potential and elevated public debt levels. In the context of higher interest rates, raising economic growth potential and running primary fiscal surpluses will be key to prevent debt from significantly rising.

Exhibit 1

Italy's credit profile is determined by four factors



Source: Moody's Ratings

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Credit strengths

» Large and diverse economy with high household wealth and low private-sector debt;

» Professional management of the large public debt burden and manageable (though weakening) debt affordability metrics;

» Solid external position with expectations of ongoing current-account surpluses.

Credit challenges

» Weak growth potential driven by demographics and a lack of structural reforms in a number of areas;

» High public debt increases vulnerability to shocks, limits fiscal room for manoeuvre;

» Importance of investor confidence given high borrowing needs.

Rating outlook

The stable outlook for Italy reflects interrelated considerations that relate to the country's economic strength and debt dynamics. Cyclical growth prospects continue to be supported by the implementation of Italy's NRRP, and risks to energy supplies have abated, in part due to strong policy action by the government. Improvements in the banking sector are also supportive of cyclical economic growth.

However, structural economic improvements from the implementation of reforms and investments such as those contained in the NRRP will likely be insufficient to materially lift Italy's growth potential and put debt on a stronger and sustained downward trajectory, in part due to institutional challenges in formulating and implementing an effective plan. Higher interest rates and a moderation in growth towards potential of around 0.8% will require a large fiscal adjustment to achieve debt-stabilising primary surpluses, and these may prove politically difficult to implement.

Factors that could lead to an upgrade

Upward pressure on the ratings would develop if there was evidence that the economy could grow at a sustainably stronger pace beyond the cyclical stimulus provided by the EU recovery funds. An improvement in growth potential would support putting debt on a clear downward trajectory given the higher interest rate environment and the significant fiscal pressures that Italy faces from its ageing population.

Factors that could lead to a downgrade

We would likely take negative rating action on Italy's sovereign rating if we were to anticipate a significant weakening of Italy's economic and fiscal strength. Indications that growth was going to be weaker over a sustained period of time would put downward pressure on the ratings because of its importance for future debt dynamics. Signs that the debt was likely to start significantly trending upward, either as a result of materially weaker growth prospects, a further spike in interest costs or lower-than-expected improvements in the primary balance, would be negative for the outlook, and ultimately, the ratings. Evidence of increased geopolitical risks, including the ones stemming from Russia's war in Ukraine, would be negative for the outlook or ratings.

Key indicators

Exhibit 2

Italy	2018	2019	2020	2021	2022	2023	2024F	2025F
Real GDP (% change)	0.9	0.5	-9.0	8.3	4.0	0.9	0.7	1.2
Inflation rate (% change average)[1]	1.2	0.6	-0.1	1.9	8.7	5.9	1.7	2.0
Gen. gov. financial balance/GDP (%)	-2.2	-1.5	-9.4	-8.7	-8.6	-7.4	-5.6	-4.2
Gen. gov. primary balance/GDP (%)	1.5	1.9	-5.9	-5.2	-4.3	-3.6	-1.7	-0.2
Gen. gov. debt/GDP (%)	134.5	134.2	155.0	147.1	140.5	137.3	140.7	142.4
Gen. gov. debt/revenues (%)	290.8	285.7	326.9	309.5	294.6	287.3	294.4	298.1
Gen. gov. interest payment/revenues (%)	7.9	7.2	7.3	7.4	8.9	7.9	8.2	8.4
Current Account Balance/GDP (%)	2.6	3.3	3.9	2.4	-1.6	0.5	2.0	2.3

[1] Harmonized Index of Consumer Prices (HICP)

Source: Moody's Ratings

Detailed credit considerations

We assess Italy's **economic strength** as "a3", which reflects the large size and diversification of the economy as well as the relatively low indebtedness of the private sector. Households in particular have low debt and high financial wealth, which provides some buffers against economic shocks. However, some structural challenges that have been left unaddressed for many years weigh on growth potential; these include labour market rigidities, a high tax burden and inefficiencies in the public sector. As a result, we have set the final score one notch below the initial score of "a2".

Over the coming years, the Italian economy will benefit from a sustained rate of investment as the implementation of NGEU accelerates, although the country is facing difficulties in executing on its investment plans. Progress on delivery of the milestones and targets has been good so far. However, Italy is facing difficulties spending the money it receives, and only €45.6 billion of NGEU funds were spent by end-2023 (2.2% of GDP) with approximately three times that amount needing to be spent by 2026. The implementation of policies, such as those outlined in the NRRP, are key to durably lift Italy's growth potential.

We assess Italy's **institutions and governance strength** as "a3", reflecting the benefits from EU and euro area membership in terms of transparency and policymaking. However, we assess that institutional gaps will constrain the structural improvements to growth from the implementation of reforms and investments such as those contained in the NRRP. Italy's policy effectiveness deficiencies keep its credit profile reliant on the existence of a credible backstop by the ECB. In late 2023, we lowered the score from "a2" to reflect the limited progress made in addressing structural economic challenges to sustain stronger economic growth, which is the core credit challenge of Italy.

Despite ranking better than global rating peers, Italy scores poorly compared to other Western European countries on international surveys, particularly for rule of law and control of corruption. Lengthy court proceedings and a significant backlog of cases in the judicial system remain a weakness, with negative effects on the business environment, investment decisions and the fight against corruption. The authorities have implemented a number of reforms and investments as part of the NRRP to improve the efficiency of the justice system.

Our "b1" score for **fiscal strength** mainly reflects the very elevated public debt ratio, which we forecast will stabilise at just above 140% of GDP. Successive governments managed to sustain reasonably solid primary surpluses even in periods of political volatility, giving some confidence that primary surpluses will reemerge in coming years. In spite of these primary surpluses, though, weak growth has prevented the authorities from making large reductions in the public debt ratio over the last two decades. The debt trajectory is highly sensitive to assumptions on growth, interest and the fiscal balance and even a small deviation from our current baseline could place the debt burden on more pronounced upward trajectory.

Although Italy has an average debt maturity of around 7 years, which slows the pass-through from higher interest rates to the interest burden, a high debt load as well as higher cash borrowing needs will feed through relatively quickly through weaker debt affordability in coming years. Interest costs absorbed 7.9% of revenue in 2023 down from 8.9% in 2022 due to lower payments on inflation-linked debt but we forecast them to increase to reach 10.5% by 2028, broadly returning to their 2013 levels. The fiscal strength score also reflects Italy's comparatively high level of debt associated with state-owned enterprises.

Our “baa” assessment of **susceptibility to event risk** is driven by banking sector risks.

Our “baa” score for **political risk** reflects both domestic and geopolitical risks. On the domestic side, our view is that the political dynamics in Italy tend to be a bigger source of volatility than in many other advanced economies. Italy has a history of short-lived and unstable coalition governments, often comprising several parties with diverging policy agendas which complicates the formulation and implementation of structural reforms that would bring benefits only over the medium term. While the current coalition's parties do have some divergent policy priorities, the fragmentation of the opposition increases the likely longevity of the government.

Although Italy's NATO membership is ultimately a guarantor of national security, the country also faces contagion risks from the Russia-Ukraine war as it is bound by NATO's Article 5 collective defense clause, which treats an attack on any NATO member as an attack on all treaty signatories. The EU's Mutual Defence Clause (Article 42.7 of the Lisbon Treaty) would also apply if the war (Russia-Ukraine) involved an EU country. The commitment to bring defence spending to the NATO 2% target (from 1.5% in 2023) will create additional fiscal pressures for Italy. While this is not our base case because of the deterrent effect of these clauses, there is a heightened risk that these treaty obligations could ultimately result in Italy needing to use armed force to restore and maintain stability in Europe. The probability of such risks materialising have increased in light of the ongoing war between Russia and Ukraine.

We consider susceptibility to **government liquidity risk** as “baa”. Investor confidence is important given Italy's large gross borrowing requirements at around 20% of GDP each year. Although the ECB's bond purchase programmes have ensured favourable funding conditions, monetary policy normalisation will leave Italy more exposed to investor confidence at a time when the government needs investors to play an increased role in the Italian debt market. We do not expect the reinvestment of maturing debt under the Pandemic Emergency Purchase Programme (PEPP) and the Transmission Protection Instrument (TPI) will be a panacea against rising yields in all circumstances. In our view, the ECB will be less likely to activate TPI quickly if the rise in yields is unambiguously triggered by domestic policy choices.

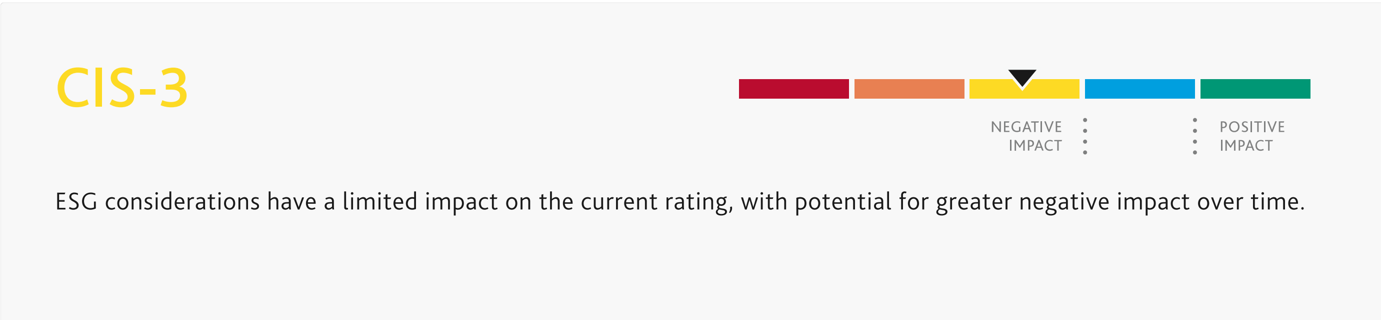
We assess Italy’s susceptibility to **banking sector risk** as “baa”, which mainly reflects the risks the Italian banking sector poses to the government's balance sheet. We have recently moved the score from “ba” because the system now has stronger capital and liquidity buffers to withstand shocks than it did before the global financial crisis. The steady improvement in the sector's asset quality has been facilitated by the government's *Garanzia sulla Cartolarizzazione delle Sofferenze* (GACS) guarantee program, at the expense of higher contingent liabilities worth 0.5% of GDP as of mid-2023. Interlinkages between the sovereign and banks remain material because of the large holdings of Italian government bonds on banks' balance sheets.

We assess **external vulnerability risk** as “aa”, reflecting the strong improvement in Italy's external position since the euro area debt crisis. Persistent current-account surpluses and valuation effects have supported a restoration of Italy's net creditor position, which stood at 7.4% of GDP in 2023. That said, higher energy prices and the larger import content of investment have pushed the current account into a small deficit of 1.6% of GDP in 2022 for the first time since 2012 and we expect current-account surpluses will remain lower than historically, reflecting higher energy prices and continued NGEU investment.

ESG considerations

Italy's ESG credit impact score is CIS-3

Exhibit 3
ESG credit impact score



Source: Moody's Ratings

Italy's ESG Credit Impact Score is moderately negative (**CIS-3**), reflecting a combination of moderate exposure to environmental risks, high exposure to social risks and, like many other advanced economies, very strong governance and in general strong capacity to respond to shocks.

Exhibit 4
ESG issuer profile scores

Source: Moody's Ratings

Environmental

Italy's **E-3** environmental issuer profile reflects low exposure to environmental risks across most categories, though the country has a moderate exposure to physical climate and water management risks, specifically water and heat stress as well as wildfire risk. Italy is among the most exposed to heat stress in Southern Europe according to Moody's climate risk data. Although agriculture accounts for a relatively small share of GDP and employment, it is located in regions that are at higher risk of drought around the Po River and in the South. Although it generates a relatively small share of electricity supply (10.5%), hydropower is the second-largest source of energy generation and has been affected by recurring droughts.

Social

Italy's **S-4** social issuer profile score reflects high demographic risks as well as risks related to labour and income. Italy has highly adverse demographics and public social spending is heavily geared towards pensions. Health care spending and long-term care spending are also set to rise in the coming decades. Successive governments have implemented pension reforms over the past years which partially mitigate the fiscal impact of the rapidly ageing population, but aging costs will still continue to rise through 2040. Exposure to other social risks such as housing, health and safety issues and access to basic services is low or very low.

Governance

Italy's **G-1** governance issuer profile score reflects very high institutions and governance strength. In a global comparison, Italy scores well on global surveys assessing voice & accountability, regulatory quality and government effectiveness. Italy scores somewhat weaker on control of corruption and rule of law than other European countries, but in line with other similarly rated sovereigns. Provision of data is in line with EU standards. However, recent years have seen unexpected deficit overruns (relative to annual targets) due to the Superbonus scheme, which will eventually feed through to debt levels as tax credits are utilised .

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

All of these considerations are further discussed in the “Detailed credit considerations” section above. Our approach to ESG is explained in our report on how the scores depict varied and largely credit-negative impact of ESG factors and our cross-sector methodology General Principles for Assessing Environmental, Social and Governance Risks Methodology.

Recent developments

NGEU implementation will support a modest improvement in growth

Economic activity in Italy slowed in 2023 with GDP growing by 0.9% (after 4% in 2022) as growth in household consumption declined under the weight of still-elevated inflation and high borrowing costs. Investment growth also moderated after a long phase of expansion driven by the construction sector with household gross fixed capital formation growing at a much slower pace than in the previous two years. The manufacturing and services sectors stabilised, while production in the construction sector remained at the same high level from last year as it continues to benefit from projects funded under the Superbonus scheme.

Inflation decelerated substantially in the second half of 2023, with the annual rate of change in the harmonised index of consumer prices (HICP) falling below 2% in November 2023 despite a robust labour market and the unemployment rate remaining historically low at 7.2% at end-2023. However, while hourly wages increased sharply in December 2023 as a result of one-off payments to public sector employees for contracts that expired in 2021, underlying real wage growth was lower and it is expected to average 1.5% in 2024. We forecast inflation will gradually stabilise around 2% in 2024-25 from 5.9% in 2023. While exports of goods declined slightly at end-2023 compared to the previous year, we expect them to rebound in 2024 as world trade recovers and global demand for Italian goods picks up.

Gas storage is at seasonal highs and, given the substantial progress in diversifying gas supply, the risk of shortages remains low. The worsening global financial environment had a limited impact on the profitability of Italian banks, which benefitted significantly from higher net interest margins. We forecast subdued real GDP growth of 0.7% in 2024 as a result of the construction sector's diminishing support, although it will pick up pace in the second half of the year as inflation recedes and interest rates will likely start to decline. The anticipated acceleration in NGEU spending will support cyclical growth as the year continues and into 2025 and 2026. Real GDP growth will accelerate slightly to 1.2% in 2025 as consumption and investment will continue to recover on the back of a further easing of inflation and monetary policy.

NGEU execution is facing difficulties, but it is expected to markedly accelerate

The execution of Italy's NRRP has encountered some hurdles, particularly due to constraints in administrative capacity at the local government level, an issue that is not unique to Italy. Progress on the delivery of milestones and targets has been good, although slower than planned, and Italy has been the first country requesting the fifth tranche of payment (€10.6 billion) after successfully receiving the third (€18.5 billion) and fourth (€16.5 billion) tranches in 2023 for a total of €102.5 billion (4.9% of 2023 GDP) out of €194.4 billion available until 2026.

However, Italy is facing difficulties spending the money it receives. The latest semi-annual report from the government noted that €21.1 billion of NGEU funds were spent in 2023 (1.0% of 2023 GDP), a slight increase compared to the €17 billion spent in 2022 but significantly less than the €40.9 billion planned for the year. In total, Italy has spent €45.6 billion of NGEU funds by end-2023 (2.2% of GDP), and approximately three times that amount needs to be spent by 2026. The modest acceleration in spending in 2023 does not reflect an improvement in the public administration's spending capacity, which remains constrained, but rather a continued utilisation of pre-existing tax incentives, including the Superbonus, which account for nearly 60% of the €45.6 billion spent so far. Tax credits are the sole category where the use of NGEU funds is in line with the government's target, in contrast to all other expenditure areas which exhibit significant underutilisation.

In November 2023, the European Commission approved the revised version of Italy's NRRP that the Italian government submitted earlier in the year to accelerate execution and maximise its ability to make the most of the funds. Out of the remaining 349 milestones and targets, 144 were modified. The central government also assumed control over projects worth €13 billion, which were previously managed by local authorities, and its authority was expanded, enabling it to appoint special commissioners whenever one or more targets are in danger of not being met. Ultimately, although the Italian economy will benefit from an increase in public investment as the implementation of NGEU accelerates, we remain sceptical that Italy will see a large increase in its growth potential from this programme. Moreover, there is a risk that it will be unable to access all funds before the 2026 deadline and we see a low probability that the programme will be extended.

Stable debt trajectory will rely on narrowing deficits and continued growth

The fiscal deficit in 2023 narrowed to 7.4% of GDP from 8.6% in 2022 as a result of the termination of most energy support measures and the gradual phase-out of the Superbonus. However, the 2023 deficit significantly surpassed the government's target of 5.3%, largely due to the escalating costs of the Superbonus. The initial government estimate for the scheme was €35 billion over 15 years (1.7% of 2023 GDP), but actual spending has reached €160 billion in the four years since 2020 (7.7% of 2023 GDP). Furthermore, the total expenditure on all construction tax credits, with the superbonus making up the largest share, has amounted to roughly €219 billion so far (10.5% of 2023 GDP).

The unforeseen cost surge for the Superbonus scheme can be attributed to several factors, including a higher-than-anticipated demand for the tax relief, construction costs influenced by fluctuating variables such as material costs and significant capacity constraints and resource misallocations. The government tightened the rules around the Superbonus significantly in 2023. These changes, which included making the Superbonus tax credits non-transferable, should positively impact the government's budget balance in 2024 and beyond. The adjustments also means that the accounting classification is likely to change, with new tax credits being recorded in the deficit as they are claimed over the subsequent five years, rather than at their creation.

We forecast the fiscal deficit will fall to 5.6% of GDP in 2024, 4.2% in 2025 and 3.2% in 2026 as a result of the new accounting classification of the Superbonus and the phase out of the last remaining targeted energy support measures. That said, these reductions will be partially offset by cuts in income tax and social security contributions which, unless renewed, will expire in 2025. We incorporate some risks to the fiscal trajectory related to some of the policy objectives of the government, particularly with regard to further tax cuts which could be introduced in coming years given electoral promises such as the simplification of the income tax system towards a flat tax.

General government debt declined to 137.3% of GDP in 2023 from 140.5% in 2022, due to still-strong nominal GDP growth and a reduction in the deficit, but we forecast the debt burden will increase again to 140.7% in 2024 and 142.4% in 2025 due to expenses related to the Superbonus, as debt-creating tax credits will continue to be claimed in the coming years. Our current deficit projections suggest that Italy is likely to face an infringement procedure under the new EU fiscal rules set to be implemented from this year. Despite the new rules being more flexible than the previous ones, the Maastricht anchors that limit general government deficits to 3% of GDP and debt stocks to 60% of GDP remain the same, which means that Italy will continue to be required to maintain tight fiscal policies in the coming years. We currently anticipate a steady reduction of the deficit until 2027, but ageing costs are likely to make further deficit reduction challenging in the absence of material increases in revenue generation or cuts in government expenditure.

Moody's rating methodology and scorecard factors: Italy - Baa3 stable

Factor / Sub-Factor	Metric	Indicator Year	Indicator	Initial Factor Score	Final Factor Score	Weights
Factor 1: Economic strength				a2	a3	50%
Growth dynamics	Average real GDP growth (%)	2019-2028F	1.0	b3		25%
	MAD Volatility in Real GDP Growth (%)	2014-2023	0.6	a2		10%
Scale of the economy	Nominal GDP ($ billion)	2023	2,255.4	aaa		30%
National income	GDP per capita (PPP, Intl$)	2023	55,144.2	aaa		35%
Adjustment to factor 1	*# notches*				-1	max ±9
Factor 2: Institutions and governance strength				a3	a3	50%
Quality of institutions	Quality of legislative and executive institutions			a		20%
	Strength of civil society and the judiciary			a		20%
Policy effectiveness	Fiscal policy effectiveness			a		30%
	Monetary and macroeconomic policy effectiveness			baa		30%
Specified adjustment	Government default history and track record of arrears				0	max -3
Other adjustment to factor 2	*# notches*				0	max ±3
F1 x F2: Economic resiliency				a2	a3	
Factor 3: Fiscal strength				b1	b1	
Debt burden	General government debt/GDP (%)	2023	137.3	caa2		25%
	General government debt/revenue (%)	2023	287.3	ba3		25%
Debt affordability	General government interest payments/revenue (%)	2023	7.9	a1		25%
	General government interest payments/GDP (%)	2023	3.8	ba3		25%
Specified adjustments	*Total of specified adjustment (# notches)*			-2	-1	max ±6
	Debt Trend - Historical Change in Debt Burden	2015-2023	2.0	0	0	
	Debt Trend - Expected Change in Debt Burden	2023-2025F	5.1	-1	0	
	General Government Foreign Currency Debt/ GDP	2023	0.2	0	0	
	Other non-financial public sector debt/GDP	2023	26.4	-1	-1	
	Government Financial Assets including Sovereign Wealth Funds / GDP	2023	1.6	0	0	
Other adjustment to factor 3	*# notches*				-1	max ±3
F1 x F2 x F3: Government financial strength				a3	baa1	
Factor 4: Susceptibility to event risk				baa	baa	Min
Political risk				baa		
	Domestic political risk and geopolitical risk			baa		
Government liquidity risk				a	baa	
	Ease of access to funding			a		
Specified adjustment	High refinancing risk				-1	max -2
Banking sector risk				baa	baa	
	Risk of banking sector credit event (BSCE)	Latest available	baa3	baa3		
	Total domestic bank assets/GDP	2023	182.0	180-230		
Adjustment to F4 BSR	*# notches*				0	max ±2
External vulnerability risk				aa	aa	
	External vulnerability risk			aa		
Adjustment to F4 EVR	*# notches*				0	max ±2
Overall adjustment to F4	*# notches*				0	max -2
F1 x F2 x F3 x F4: Scorecard-indicated outcome				A3 - Baa2	Baa1 - Baa3	

Note: While information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones implied by the scorecard-indicated outcome. Thus, the rating process is deliberative and not mechanical, meaning that it depends on peer comparisons and should leave room for exceptional risk factors to be taken into account that may result in an assigned rating outside the scorecard-indicated outcome. For more information please see our Sovereign Ratings Methodology.

Footnotes: (1) Initial factor score: scorecard indicators combine with the automatic adjustments to produce an initial factor score for every rating factor, as detailed in Moody's Sovereign Ratings Methodology. **(2) Final factor score:** where additional analytical considerations exist, initial factor scores are augmented to produce a final factor score. Guidance on additional factors typically considered can be found in Moody's Sovereign Ratings Methodology; details on country-specific considerations are provided in Moody's research. **(3) Scorecard-indicated outcome:** Factor 1: Economic Strength, and Factor 2: Institutions and Governance Strength, combine with equal weight into a construct we designate as Economic Resiliency (ER). An aggregation function then combines ER and Factor 3: Fiscal Strength, following a non-linear pattern where Fiscal Strength has higher weight for countries with moderate ER and lower weight for countries with high or low ER. As a final step, Factor 4, a country's Susceptibility to Event Risk, is a constraint which can only lower the government financial strength as given by combining the first three factors. **(4) There are 20 ranking categories for quantitative sub-factors:** aaa, aa1, aa2, aa3, a1, a2, a3, baa1, baa2, baa3, ba1, ba2, ba3, b1, b2, b3, caa1, caa2, caa3, ca and 8 ranking categories for qualitative sub-factors: aaa, aa, a, baa, ba, b, caa, ca **(5) Indicator value:** if not explicitly stated otherwise, the indicator value corresponds to the latest available data.

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