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Research Update:

Ratings On Italy Lowered To 'BBB-/A-3'; Outlook Stable

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Overview

- We have revised our average real and nominal GDP growth projections for Italy over the 2014-2017 forecast horizon down to 0.5% and 1.2%, respectively, from 1.0% and 1.9%, as persistently low inflation and a difficult business environment continue to weigh on Italy's economic prospects.
- In our opinion, Italy's weak real and nominal economic prospects have undermined public debt dynamics more than we forecast in our June 6, 2014 report. In absolute terms, we now estimate Italian general government debt will be €2.256 trillion by year-end 2017, which is €80 billion higher (or 4.9% of estimated 2014 GDP) than we forecast in June.
- Under our criteria, such a large increase in debt, combined with consistently low growth and eroded competitiveness, are not commensurate with a 'BBB' rating.
- We are therefore lowering our long- and short-term sovereign credit ratings on Italy to 'BBB-/A-3' from 'BBB/A-2'.
- The stable outlook reflects our expectation that the government will gradually implement comprehensive and potentially growth-enhancing structural and budgetary reforms, and that household balance sheets will remain strong enough to absorb further increases in public debt. We also assume the European Central Bank's monetary policy stance will continue to support a normalization of inflation in Italy and its key eurozone trading partners.

Rating Action

On Dec. 5, 2014, Standard & Poor's Ratings Services lowered its unsolicited long- and short-term foreign and local currency sovereign credit ratings on the Republic of Italy to 'BBB-/A-3' from 'BBB/A-2'. The outlook on the long-term ratings is stable.

Rationale

The downgrade reflects the recurrent weaknesses we see in Italy's real and nominal GDP performance, including its eroded competitiveness, which are undermining the sustainability of its public debt. Since our last report (see " Ratings On Italy Affirmed At 'BBB/A-2'; Outlook Remains Negative," published June 6, 2014 on RatingsDirect), we have revised our average real and nominal 2014-2017 GDP growth projections for Italy down to 0.5% and 1.2%, respectively, from 1.0% and 1.9%.

We expect the Italian economy to exit recession in early 2015, although we forecast only a modest GDP recovery of about 0.2%, compared with our previous forecast of 1.1% for next year (see "Credit Conditions: The Eurozone Crawls Into 2015 With Weak Momentum," published Dec. 3, 2014). By contrast, according to its Draft Budgetary Plan 2015, the government expects average real and nominal GDP growth of 0.7% and 1.9% in 2014-2017. Compared with the government's view, we forecast weaker recovery in private consumption and gross fixed capital formation. We believe that consumption will be constrained by a difficult labor market situation, with unemployment at a historically high level, and gradual budgetary consolidation. At the same time, we expect investment activity to remain subdued due to uncertainty regarding the outlook for demand, including weaker economic growth prospects in Italy's main trading partners in Europe and the rest of the world, and a challenged monetary transmission mechanism that impedes a faster improvement in credit conditions. Our forecast also reflects our view of Italy's weak domestic fundamentals, including its difficult business environment and competitiveness challenges.

As a result of weaker real and nominal economic growth prospects, as well as delayed budgetary consolidation according to the revised Draft Budgetary Plan 2015, we now project Italian general government debt--excluding European Financial Stability Facility (EFSF) guarantees--to peak at above 133% of GDP in 2016, with net general government debt at about 127% of GDP. We believe net general government debt will then stabilize at about 127% (see "S&P Clarifies Its Approach To Accounting For EFSF Liabilities When Rating The Sovereign Guarantors," published Nov. 2, 2011). In absolute terms, we now estimate Italian general government debt will be €2.256 trillion by year-end 2017, which is €80 billion higher (or 4.9% of estimated 2014 GDP) than we previously forecast.

During 2014-2017, we forecast an average annual general government deficit of 2.7% of GDP, higher than our previous forecast of 2.5% of GDP as well as the government's average deficit target of 2.1% during the same period (according to the revised Draft Budgetary Plan 2015). Our projection of a higher-than-targeted general government deficit for the period 2014-2017 reflects our forecast of underlying weaker real and nominal GDP growth. Our forecast for 2015 takes account of the Italian government's steps to contain the deficit, including extending the freeze on public-sector wages, announced in 2013. At the same time, we estimate a slight increase in primary expenditure (government spending excluding interest payments) for 2014 and 2015, as the government aims to reduce the fiscal drag on the economy until external demand and local credit conditions normalize.

In our view, the success of the government's aim to lower the tax burden on labor and capital will hinge on further permanent spending cuts along the lines of measures it proposed in its recent spending review. The review highlights €32 billion (2.0% of GDP) in potential cumulative savings over 2014-2016. In its 2014 Stability Programme, the government stated that these savings were to be used to reduce the tax wedge on labor. The tax wedge is the difference between the employers' cost of hiring an employee, including social security contributions, payroll taxes, and salary, and the net income that the employee actually receives.

We view the Italian government's ability to raise revenues--beyond the already-high tax burden and existing government revenues of an estimated 47.7% of GDP this year--as relatively limited. At 42.3%, the implicit tax rate on labor is the second highest in the EU. The government has committed to reducing currently high tax pressures and making spending cuts to compensate for the resulting revenue loss; however, in our view, the plans for these spending cuts lack detail over the medium term, and we believe implementation risks exist.

Although we recognize the arguments in favor of countercyclical stimulus, we view Italy's fiscal flexibility as increasingly limited. This view takes into consideration our forecasts of weak nominal GDP growth and the fact that Italy shares the same currency with most of its trading partners. Membership of the eurozone (European Economic and Monetary Union) provides Italy with a strong monetary anchor and access to funding at low nominal interest rates. Nevertheless, we believe that membership in a monetary union increases the onus on member governments to support competitiveness through fluid labor, product, and services markets, and to build up fiscal buffers against future shocks. This is more the case now than in June, given that the European Central Bank (ECB) is undershooting its medium-term price stability target of close to, but lower than, 2% for the eurozone as a whole. The harmonized indices of consumer price inflation (CPI) in Italy showed an inflation rate of 0.2% in October, year on year, while core CPI was 0.6% year on year. In this context, restoring fiscal buffers could prove difficult.

We currently assess Italy's product and labor markets as relatively inflexible. Despite rising unemployment, hourly labor costs in Italy's non-farm sector have increased by more than 12% between 2008 and 2014. Wage increases also reflect the disproportionate share of job losses incurred by younger, lower-paid workers on temporary contracts. The European Commission's cost competitiveness indicators, based on unit labor costs and wages, show Italy significantly underperforming the rest of its eurozone and EU peers, and indicate ongoing erosion of cost competitiveness. In our view, persistent erosion of cost competitiveness, compared with that of Italy's peers, points to the magnitude of a potential downward labor cost adjustment, which could negatively affect already-weak household consumption. At the same time, such an adjustment could help restore the economy's competitiveness, in line with what we have observed for other eurozone sovereigns, such as Spain or Portugal.

We note that Italy's prime minister, Mr. Matteo Renzi, has made some progress with his Jobs Act, which aims to tackle the duality of the Italian labor market by relaxing restrictions to dismissing employees on open-ended contracts and reducing incentives for hiring employees on temporary contracts. This duality has, in particular, generated high youth unemployment (43.3% as of October 2014). We would view the passage of an undiluted labor reform as an important sign of the government's determination to pursue policies suited to a member of a monetary union that includes some of the world's most competitive exporters. We would also view as a rating positive the removal of obstacles--created by tax and labor laws--to companies growing beyond legally specified employee-number thresholds. However, we see a risk that the secondary legislation, which specifies the implementation of provisions in the Jobs Act, could be weakened. We believe this could happen if the government encounters increased opposition from constituencies adversely affected by its policies, particularly given a backdrop of persistently low economic growth. Moreover, we understand that the extension of decentralized wage bargaining between the employers and trade unions from the industry sector to other sectors in the economy--from the national sector level to the individual company level or other measures that could improve the responsiveness of wages to underlying economic conditions--is not part of the current reform efforts. We believe that, in light of the low inflation outlook, the existing wage-setting process is impeding the restoration of Italy's competitiveness.

In the near term, increased labor market flexibility could, in our view, likely accelerate a wage adjustment and reduce the pace of job-shedding. At the same time, we do not believe the labor reform measures will create net employment in the near term. As a consequence, the already high unemployment rate could worsen until a sustainable economic recovery sets in. Over the medium term, however, we believe the measures, if put in place by secondary legislation, would be supportive of employment growth. Were Italy's labor market to improve more rapidly and more sustainably than we currently expect, such a development would be a credit positive.

Much of the focus on Italy's competitiveness has been on the importance of an internal devaluation to restore competitiveness via a labor cost adjustment. That aside, we also view Italy's difficult business environment as a deterrent to job creation and to foreign investment. In our view, Italy has an unreformed services sector; a slow and costly judicial system; high nonwage employment costs, including high legal and administrative fees; and elevated severance costs for employees on permanent contracts. Foreign direct investment (FDI) inflows into Italy averaged 1.2% of GDP during the 10 years to 2013, with the stock of inbound FDI at 18% of GDP as of last year, considerably below that of other large eurozone sovereigns. Moreover, the wholesale cost of energy remains substantially higher than that of Italy's peers, partly reflecting market dominance by utility monopolies.

On the positive side, there has been an external adjustment. In 2013, Italy posted a current account surplus of 1.0% of GDP, the first current account surplus since it joined the eurozone in 1999. Since the end of 2011, much of the improvement in Italy's current account has stemmed from declining merchandise imports; in volume terms, Italian exports have reached 2007 levels. We believe that Italy's current account will remain in surplus over our 2014-2017 forecast horizon.

In October 2014, credit to the nonfinancial corporate and households sectors contracted by an estimated 3.4% year-on-year and 1.0% year-on-year, respectively (according to Banca d'Italia data). Nonperforming loans remain high, at 16.8% in June 2014, according to Banca d'Italia, but performance varies materially among banks. The distressed condition of Italy's small and midsize enterprises, which comprise about 80% of the corporate workforce and 70% of firm value added in Italy, and their traditional dependence on the banking system to finance capital expenditure, is a further obstacle to a speedier recovery of economic growth.

In conclusion, the positive or neutral elements described above are, in our view, outweighed by the recurrent weaknesses we see in Italy's real and nominal GDP performance and its eroded competitiveness, which are undermining the sustainability of its public finance position. Although we think the announced reform measures in a wide range of policy areas will ultimately help strengthen the economic fundamentals and resilience of the Italian economy, these benefits will likely not be felt in the near term. In fact, the persistently weak economic conditions could raise fiscal risks before the growth-enhancing structural reforms take root.

Our ratings on Italy are supported by the country's wealthy and diversified economy, and relatively strong international investment position in comparison with peers' rated in the 'BBB' category. The ratings also reflect our opinion that the government is gradually moving to implement several important reforms. We view the current account's shift into surplus, as of last year, as indicative of the economy's capacity to pay down net external debt levels. At an estimated 41% of GDP in 2013, net external debt is relatively moderate, in our view.

Outlook

The stable outlook reflects our expectation that the Italian government will gradually implement comprehensive and potentially growth-enhancing structural and budgetary reforms, while household balance sheets remain strong enough to absorb further increases in public debt. We also assume that the ECB's monetary policy stance will remain supportive of a normalization of inflation levels in Italy and its key eurozone partners.

According to our criteria, we could lower the ratings if we were to conclude that the government cannot implement policies to restore economic growth and strengthen public finances, leading us to revise down our assessment of Italy's institutional and governance effectiveness. This could happen if some of the rigidities in Italy's labor, services, and product markets--which have been holding back growth--persist. A deterioration in Italy's recently improved external performance could also weigh on the ratings, as could a significant negative deviation from its expected budgetary trajectory.

We could consider raising the ratings if the government fully implemented reforms to the labor, product, and service markets that led to a sustainable increase in Italy's economic growth and placed the budget deficit and government debt on a clear downward trajectory.

Key Statistics

Table 1

Republic of Italy - Selected Indicators	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Nominal GDP (bil. US$)	2,204	2,392	2,186	2,129	2,281	2,092	2,150	2,159	2,008	2,010	2,057
GDP per capita (US$)	37,853	40,782	37,052	35,963	38,428	35,217	36,023	35,814	33,217	33,152	33,818
Real GDP growth (%)	1.5	(1.0)	(5.5)	1.7	0.6	(2.3)	(1.9)	(0.2)	0.2	0.8	1.1
Real GDP per capita growth (%)	1.2	(1.8)	(6.0)	1.4	0.3	(2.3)	(2.4)	(1.2)	(0.1)	0.4	0.8
Change in general government debt/GDP (%)	1.1	4.0	6.3	5.1	3.2	3.6	4.5	4.7	3.8	2.6	2.3
General government balance/GDP (%)	(1.5)	(2.7)	(5.3)	(4.2)	(3.5)	(3.0)	(2.8)	(3.1)	(2.9)	(2.4)	(2.3)
General government debt/GDP (%)	99.7	102.3	112.5	115.3	116.2	120.6	125.7	130.1	133.2	133.4	132.7
Net general government debt/GDP (%)	93.3	96.4	106.0	108.7	111.2	115.0	120.0	123.9	127.0	127.4	126.8
General government interest expenditure/revenues (%)	10.5	10.9	9.6	9.4	10.2	10.9	10.1	10.0	10.1	10.1	10.6
Other dc claims on resident nongovernment sector/GDP (%)	92.3	97.1	102.8	114.4	113.8	115.2	111.9	111.6	111.5	111.8	111.4
CPI growth (%)	2.1	3.5	0.7	1.6	2.9	3.3	1.3	0.2	0.3	0.9	1.2
Gross external financing needs/CARs plus usable reserves (%)	211.0	226.3	234.9	225.5	209.9	211.6	213.7	218.0	224.0	221.6	215.0
Current account balance/GDP (%)	(1.4)	(2.8)	(1.9)	(3.5)	(3.1)	(0.5)	1.0	1.5	1.4	1.5	1.7
Current account balance/CARs (%)	(4.2)	(8.7)	(7.0)	(11.7)	(9.7)	(1.5)	3.1	4.6	4.0	4.2	4.6
Narrow net external debt/CARs (%)	232.7	195.5	281.3	253.9	200.6	229.4	252.0	248.7	259.1	251.9	238.5
Net external liabilities/CARs (%)	85.5	41.5	65.8	47.9	29.1	37.7	51.3	45.4	41.8	35.0	26.8

The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources. The data reflect revisions to the historical time series of Italy's national accounts as well as government finance statistics as per recently introduced ESA 2010 methodology by Eurostat as well as revisions to balance of payments and international investment position data per the IMF's BPM6 standards, as published by the Banca d'Italia. For this reason, the data is not strictly comparable with data published by Standard & Poor's on June 6, 2014, or in Sovereign Ratings Indicators, published on Sept. 22, 2014, and June 9, 2014. Other depository corporations (dc) are financial corporations (other than the central bank) whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private-sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Republic of Italy - Ratings Score Snapshot	
Key rating factors	
Institutional and governance effectiveness	Neutral
Economic structure and growth	Neutral
External liquidity and international investment position	Neutral
Fiscal flexibility and performance	Neutral
Debt burden	Weakness
Monetary flexibility	Neutral

Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional and governance effectiveness; (ii) economic structure and growth prospects; (iii) external liquidity and international investment position; (iv) the average of government debt burden and fiscal flexibility and fiscal performance; and (v) monetary flexibility. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of Standard & Poor's "Sovereign Government Rating Methodology And Assumptions," published on June 24, 2013, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Sovereign Government Rating Methodology And Assumptions, June 24, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Defaults And Rating Transition Data, 2013 Update, Sept. 17, 2014
- Credit Conditions: The Eurozone Crawls Into 2015 With Weak Momentum, Dec. 3, 2014
- The Eurozone Crisis Is Still Not Over Yet, Oct. 23, 2014
- A Parting Of The Ways In The Global Economy, Oct. 1, 2014
- Ratings On Italy Affirmed At 'BBB/A-2'; Outlook Remains Negative, June 6, 2014
- S&P Clarifies Its Approach To Accounting For EFSF Liabilities When Rating The Sovereign Guarantors, Nov. 2, 2011

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that the external liquidity and international investment position score improved, while fiscal flexibility and performance score and monetary flexibility score deteriorated. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Italy (Republic of) (Unsolicited Ratings)		
Sovereign Credit Rating	BBB-/Stable/A-3	BBB/Negative/A-2
Transfer & Convertibility Assessment	AAA	

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