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Research Update:

Long-Term Ratings On Italy Lowered To 'BBB'; Outlook Negative

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Long-Term Ratings On Italy Lowered To 'BBB'; Outlook Negative

Overview

- We have lowered our unsolicited long-term sovereign credit rating on Italy to 'BBB' from 'BBB+'.
- The rating action reflects our view of the effects of further weakening growth on Italy's economic structure and resilience, and its impaired monetary transmission mechanism.
- The outlook on the long-term rating is negative.

Rating Action

On July 9, 2013, Standard & Poor's Ratings Services lowered its unsolicited long-term sovereign credit ratings on the Republic of Italy to 'BBB' from 'BBB+'. At the same time, we affirmed the unsolicited short-term sovereign credit rating at 'A-2'. The outlook on the long-term rating is negative.

Rationale

The rating action reflects our view of a further worsening of Italy's economic prospects coming on top of a decade of real growth averaging minus 0.04%. Italy's economic output in the first quarter of 2013 was 8% lower than in the last quarter of 2007 and continues to fall. We have, moreover, lowered our GDP growth forecast for 2013 to minus 1.9%, from minus 1.4% in March 2013 and positive 0.5% in December 2011. Our expectation is that 2013 per capita GDP will be an estimated €25,000 or US$33,000, which is somewhat below 2007 levels.

In our view, the low growth stems in large part from rigidities in Italy's labor and product markets. Eurostat data suggests that wages have become misaligned with underlying productivity trends, weighing on Italy's competitiveness. As a consequence, according to Eurostat data, nominal unit labor costs have increased more in Italy than in any other major sovereign member of the European Economic and Monetary Union (EMU or eurozone). Also reflecting deteriorated competitiveness, between 1999 and 2012 Italy's share of the global goods and services market declined by about one third.

Related to Italy's recent low growth, and also a factor in the rating action, is our view of Italy's impaired monetary transmission channel; real interest rates on loans to Italy's non-financial corporations in the private sector are well above the levels of before the global financial crisis, despite a large output gap (estimated by the European Commission at 4% of potential output)

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and the European Central Bank's (ECB's) unprecedented monetary easing.

We forecast net general government debt at 129% of GDP as of end-2013 (our estimate excludes guarantees of debt issued by the European Financial Stability Facility) to be among the highest of all rated sovereigns. Our projections suggest that--at a nominal GDP growth rate of close to zero--general government debt to GDP would not start to decline unless Italy's budgetary surplus, excluding interest expenditures, approaches 5% of GDP. Risks to achieving such an outturn over the forecast horizon appear to be increasing, in our opinion. For 2013, we already see the budgetary target potentially at risk given differing approaches within the coalition government to bridging a fiscal shortfall. The shortfall is the result of the suspension of property tax on owner-occupied houses and the potential delay of a planned increase in the value-added tax.

While Italy's general government primary fiscal position has been in surplus since 2004 (except in 2009 and 2010), in our view this surplus stems from a budgetary composition that deters growth. Current expenditure is disproportionately high compared with capital expenditure; tax levels on capital and labor are higher than those on property and consumption.

In our view, the planned government payment of commercial payables, amounting to as much as €40 billion during 2013 and 2014 (2.6% of 2013 GDP), could contribute to a recovery in investment, particularly during the first half of 2014. Most of the arrears in payment will likely be financed in the market, however, adding to general government debt. As of today, we understand that the government has paid only a portion of these arrears to the private sector, but is in the process of accelerating these payments for the second half of 2013 and further into the first half of 2014.

On the external side, Italy's current account has shifted into surplus this year. Two-thirds of the improvement in Italy's current account position since 2006 has resulted from higher exports; the rest is on the back of lower imports. We project that the current account will be in a surplus of 1% of GDP in 2013, and 2% of GDP in 2014. In our view, however, much of Italy's competitiveness challenge is not directly visible in its balance of payments. Instead, it stems from high domestic costs, including energy prices that are above eurozone averages, as well as high administrative and non-wage labor costs. Italy's net external position, by itself, does not suggest a high external vulnerability. That said, domestic activity, particularly employment creation, appears to be hampered by rigidities and protections that have preserved rents for incumbents, including workers on permanent contracts.

According to the Banca d'Italia, nonperforming loans in Italy have traditionally been reported at higher levels than peers, reflecting tax disincentives for write-offs and an ineffective civil justice system. Since 2012, default rates have been rising for business loans, particularly in the construction sector. At the same time, household default rates remain low. The banking sector's systemic risk is closely tied to sovereign risk, given the banking system's large claims on the government, which represent 16% of resident total assets.

Outlook

The outlook on the long-term rating on Italy is negative, indicating that we believe there is at least a one-in-three chance that the rating could be lowered again in 2013 or 2014.

According to our criteria, we may lower the rating if, in particular, we conclude that the government cannot implement policies that would keep fiscal indicators from deteriorating beyond our current expectations. Similarly, sustained delays in effectively addressing some of the rigidities in Italy's labor, services, and product markets that have been holding back growth could put downward pressure on the ratings. In accordance with our criteria, a downward revision of our view of Italy's institutional and governance effectiveness score could lead to a lowering of the rating by one notch or more, depending on the severity of the circumstances. Similarly, if Italy's external adjustment reverts, either due to renewed loss of export competitiveness or funding pressure, we may lower the rating.

On the other hand, we may revise the outlook to stable if the government implements structural reforms for the labor, product, and service markets that would likely shift the Italian economy to a higher level of growth, or if we see that other measures--such as significant asset sales and privatizations--are taken to substantially reduce the public sector debt burden.

Key Statistics

Table 1

Republic of Italy - Selected Indicators										
	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013e**	**2014f**	**2015f**	**2016f**
Nominal GDP (bil. US $)	2,127	2,307	2,111	2,057	2,197	2,012	2,024	2,037	2,074	2,112
GDP per capita (US $)	35,974	38,701	35,159	34,096	36,243	33,079	33,177	33,295	33,796	34,304
Real GDP (% change)	1.7	(1.2)	(5.5)	1.7	0.4	(2.4)	(1.9)	0.5	0.8	0.8
Real GDP per capita (% change)	1.0	(2.0)	(6.2)	1.2	(0.1)	(2.7)	(2.2)	0.2	0.5	0.5
General government balance (% of GDP)	(1.9)	(3.0)	(5.8)	(4.8)	(3.8)	(3.0)	(2.9)	(2.5)	(2.0)	(1.0)
Change in general government debt (% of GDP)	1.1	4.2	6.5	5.3	3.4	3.5	6.1	2.5	0.8	1.0
General government debt (% of GDP)	103.3	106.1	116.4	119.3	120.7	125.1	132.8	133.5	132.0	130.6
Net general government debt (% of GDP)	99.7	102.7	112.0	114.1	116.9	121.1	129.1	129.8	128.3	127.0
General government interest expenditure (% of revenues)	10.8	11.2	9.9	9.8	10.5	11.4	12.4	13.7	14.0	4.4

Table 1

Republic of Italy - Selected Indicators (cont.)										
Bank claims on resident non-govt. sectors (% of GDP)	95.6	100.7	106.5	118.0	118.1	119.4	118.6	116.9	116.0	116.2
Consumer price index (average; % change)	2.1	3.6	0.7	1.7	2.9	3.3	1.6	1.5	1.8	1.8
Gross external financing needs* (% of CARs and usable reserves)	209.7	224.0	231.6	223.4	198.7	203.7	202.7	196.2	193.9	190.7
Current account balance (% of GDP)	(2.6)	(2.9)	(2.0)	(3.5)	(3.1)	(0.5)	1.3	1.7	2.0	2.4
Current account balance (% of CARs)	(7.1)	(8.4)	(6.9)	(11.2)	(9.0)	(1.6)	3.7	4.5	5.2	6.1
Narrow net external debt (% of CARs)	223.4	191.9	276.0	248.9	194.4	224.0	234.9	236.0	230.9	221.8
Gross external debt (% of GDP)	103.7	99.6	106.4	108.1	105.8	111.6	118.7	120.1	120.3	119.1

Gross external financing needs are defined as current account outflows plus short-term debt by remaining maturity. Narrow net external debt is defined as the stock of foreign and local currency public and private sector borrowings from nonresidents (including nonresident deposits in resident banks) minus liquid nonequity external assets, which include official foreign exchange reserves, other liquid public sector foreign assets, and financial institutions' deposits with and lending to nonresidents. A negative number indicates net external lending. CAR--Current account receipts. f--Forecast. e--Estimate.

Related Criteria And Research

- 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
- Banking Industry Country Risk Assessment: Republic of Italy, Nov. 19, 2012
- Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009
- Sovereign Defaults And Rating Transition Data, 2012 Update, March 29, 2013

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 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.

Ratings List

Downgraded; Ratings Affirmed

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

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