Rapporto annuale Standard § Poor's

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Rationale

The ratings on Italy are supported by the country's relatively prosperous and well-diversified economy, with GDP per capita remaining close to the 'AA' median. Italy also benefits greatly from membership of EMU, which has led to plummeting borrowing costs and protects Italy from potential balance-of-payments pressures. Nevertheless, the effectiveness of the European Stability and Growth Pact (SGP) as a policy anchor has deteriorated steadily.

The very high general government debt and interest burdens will continue to greatly limit policy flexibility in the long term. Furthermore, despite low borrowing costs, the interest burden accounts for more than 11% of spending at the general government level and 20% for the central government. Not only is the debt-to-GDP ratio one of the highest among rated sovereigns, but its decade-long slow decline is also now reversing. Government debt is expected to rise toward 109% of GDP in 2005, more than 2x the 'AA' median (42% of GDP). This follows several years during which only unsustainable one-off measures engineered a moderate and decelerating decline in the debt ratio. The structural weakness of Italy's public finances will lead to general government budget deficits of more than 3% of GDP until at least 2008, unless a more vigorous policy of current expenditure control is effectively implemented.

The economy's growth potential is low and the international competitiveness of Italian companies has been on a declining trend for a decade. This is due to obstacles in the areas of physical and institutional infrastructure, regional inequalities, and structural rigidities, especially in the labor market. In the long term, growth prospects could dim further, as Italy has one of the most adverse demographic profiles among rated sovereigns.

Outlook

The negative outlook reflects the increasing downside risks to Italy's public finances in an environment of low growth and weakening peer pressure through the SGP. Compounded by weak potential output growth, which the government estimates at 1.3% per year, the debt ratio will peak at 110% of GDP in 2007. The government's expectation of rapid structural budgetary improvements, and projections of revenues of about 1% of GDP per year raised through asset sales, appear optimistic. Consequently, the resulting officially targeted debt ratio of 101% of GDP by 2009 also seems difficult to achieve, with a ratio of 107% of GDP for that year looking more plausible.

A general election will be held in April 2006 and neither of the two main political groupings has presented a cohesive medium- to long-term strategy to address Italy's structural budgetary imbalances. The current government's medium-term financial plan stops short of outlining any concrete measures to deal effectively with Italy's fiscal crisis. As both the center-left and the center-right suffer from deep internal divisions, any post-electoral consolidation strategy is likely to be modest.

The outlook could revert to stable if structural measures were implemented that would ensure the resumption of a clear, significant, and sustainable downward trend of the government debt ratio. Conversely, the long-term rating could be lowered within the next year if no signs of a sustainable and coherent debt reduction strategy emerge after the April 2006 elections.

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Comparative Analysis

Italy has one of the highest debt-to-GDP ratios of any investment-grade sovereign rated by Standard & Poor's.

Italy's larger fiscal deficits, limited fiscal flexibility, and dependence on one-off transactions set its fiscal consolidation strategy apart from that of other EMU sovereigns.

Italy has a prosperous and diversified economy, although regional disparities are much larger than in its peers, and both the record and outlook for growth compare unfavorably with the 'AA' median.

Italy's peer group includes sovereigns rated in the 'AA' category, such as the Kingdom of Belgium (AA+/Stable/A-1+), as well as the Republics of Portugal, Slovenia, and Iceland (all rated foreign currency AA-/Stable/A-1+). The Hellenic Republic (Greece; A/Stable/A-1) is also a peer, as it has similar debt ratios and dynamics to Italy. Like many sovereigns in the 'AA' category, Italy has a highly developed and diversified economy, but is struggling to contain fiscal, labor market, and regional development imbalances.

Italy is less prosperous than Belgium, and especially Iceland, while income levels remain comparable with the 'AA' median (see chart 1). Italy's per capita income remains well ahead of Greece, Portugal, and Slovenia, where the levels are more than one-third lower. At the same time, the Italian average conceals the extraordinary differences between the prosperous northern part of the country and the relatively underdeveloped south. The regional disparities are more pronounced in Italy than in any other Western European society. Only the Federal Republic of Germany (AAA/Stable/A-1+) comes near the Italian level of regional economic heterogeneity, due to the legacy of reunification.

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Economic growth will remain slower than in most peers

The regional differences contribute to Italy's below-par output growth. Overall unemployment (8% in 2005) is broadly in line with rates in many EMU sovereigns. The northern part of the country, however, is characterized by near-full employment, with unemployment rates below 4%, whereas joblessness in the south is among the most severe in Europe, affecting more than 15% of the labor force. When demand picks up, this imbalance leads relatively quickly to inflationary pressures, especially in sheltered services sectors, limiting the growth potential of the economy.

In the past, output growth in Italy has underperformed the 'AA' median, and this situation is likely to continue. Among Italy's direct peers, even the wealthier Belgium will be outgrowing Italy, although by a narrower margin than Slovenia and Greece (see chart 2). Potential growth is stunted by a significant and sustained loss of competitiveness due to moribund productivity growth (see chart 3). Italian producers have been losing world market share for a decade.

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Finally, with growth and competitiveness in the doldrums, membership of EMU is increasingly seen as a cause rather than a mitigant of Italy's economic woes. In no other EMU member state has any noteworthy political party questioned Eurozone membership. Nevertheless, simulations suggest that in terms of creditworthiness, Italy would have more to lose than any other Eurozone member bar Greece if it were to reintroduce a national currency (see chart 4). This is due to its relatively higher public debt and the strength of the real appreciation since the 1990s (see commentary article "Breaking Up is Hard To Do: Rating Implications Of EU States Abandoning The Euro", published on RatingsDirect, Standard & Poor's Web-based credit analysis system, on Nov. 24, 2005).

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In the long term, Italy's growth potential is threatened by its very unfavorable demographic profile. Although certain of its peers face similarly adverse population trends--especially Greece and Portugal--the shrinkage of Italy's working-age population is expected to set in much earlier than elsewhere, thereby undermining the growth potential earlier. The fiscal challenges that aging will bring are highlighted by the fact that Italy already spends 14.4% of GDP on public pensions (2003 data). The country is also engaged in a battle to keep burgeoning health care costs under control. At 8.4% of GDP in 2003, these are still low compared with its peers, which spend between 9.6% (Belgium and Portugal) and 10.5% (Iceland) of GDP on health care. In contrast, pension spending in Italy's peers tends to account for a much lower 8%-9% of GDP. Similarly to the Greek pension reform of 2002, the 2004 Italian pension reform postponed real structural changes well into the future. The comparatively underdeveloped state of Italy's social welfare system (in particular, unemployment insurance) sets it apart from its peers and could bring further social spending pressures in the medium term, especially as labor markets are liberalized and the severance payment scheme is diverted into building up a funded pension pillar.

A towering debt burden

General government debt, estimated at more than 108% of GDP for 2005, still compares very unfavorably with most of Italy's 'AA' rated peers, as does the country's minimal primary surplus relative to debt levels. Only lower-rated Greece displays comparable fiscal numbers. Japan (AA-/Stable/A-1+) has a higher--and still rapidly increasing--debt burden. Net of financial assets, however, Japan's and Italy's debt ratios are comparable (see chart 5). Furthermore, the Japanese government's debt is in its own currency, meaning that if debt dynamics were to become truly unsustainable, reducing the real debt burden through the creation of surprise inflation would be an option. This "painless" resolution of unfavorable debt dynamics does not exist in the case of EMU members such as Italy or Greece.

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The debt ratio of Greece is similar to Italy's and the lack of progress in reducing it led to a lowering of the ratings on the sovereign by one notch in 2004, mirroring the Italian experience. The lack of consolidation progress in Greece, however, has occurred on the back of buoyant economic expansion, in contrast to the Italian slow-growth environment. Thanks to sizable primary surpluses of about 4% of GDP, Belgium is now firmly embarked on a fast downward debt trend; its debt ratio fell below the 100% mark in 2003 for the first time in two decades. Early in the next decade, Belgium's debt ratio may resemble that of Portugal more closely than that of Italy or Greece, a testament to dogged Belgian determination to compress the public debt.

Italy's gross debt ratio, by contrast, will remain in the triple digits as a percentage of GDP until the end of the current decade, in the absence of further fiscal tightening and sizable additional one-off revenues. Given that Greece joined EMU only in 2001, it can still expect savings in debt-servicing costs, which in the Italian case will now be negligible. In this regard, high-interest pre-EMU debt will fall to 7% of Italy's outstanding obligations by the end of 2006. The slow decline in Italy's debt ratio compared with Belgium's is even more striking, as Belgium's EMU-related interest savings were comparatively modest. Belgium's implicit interest rate dropped by 300 basis points in the decade to 2003, compared with 720 basis points for Italy. Finally, fiscal flexibility, both on the revenue and expenditure sides, is lower in Italy than in almost all of its peers (see chart 6). Only Belgium's budget is less flexible, which makes the superior Belgian fiscal consolidation all the more noteworthy.

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Structural fiscal adjustment has been delayed

As Italy's potential growth will remain below that of its 'AA' peers, a speedy debt ratio reduction comparable with that seen in Belgium requires a more substantial fiscal tightening. So far, however, successive Italian governments have preferred to resort to the generation of one-off receipts, such as the securitization of public assets and tax amnesties involving preferential taxation for formerly undeclared tax bases. Although Portugal (and to a lesser extent Belgium) had also resorted to one-off revenue measures in their struggles to meet their fiscal objectives, these efforts have been accompanied by more rigorous structural expenditure restraint (see chart 7). Portugal's failure to implement its own ambitious plans eventually led to its one-notch ratings downgrade in June 2005.

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The sustained reliance on large one-off revenue measures distinguishes Italy from all of its peers. In 2002-2004, these items accounted for about 1% or more of GDP each year. Italy has also been more astute in executing transactions that have led to a reduction in the general government debt burden according to European accounting rules, but have had little substantive effect. Among these, an asset swap with Banca d'Italia (the central bank, AAA/Stable/A-1+) in 2002 resulted in a debt ratio decline of 2.0% of GDP, while the de-consolidation and balance sheet management of Cassa Depositi e Prestiti SpA (CDP, AA-/Negative/A-1+) in 2003 shaved off debt worth a further 0.8% of GDP. No other peer government has performed similar transactions.

Political Environment:Elusive Consensus For Structural Reform

- The opposition center-left is leading in opinion polls ahead of the April 2006 elections, but has yet to present a coherent policy program.

- Internal disputes have prevented the Berlusconi government from proceeding with originally planned cuts to taxes and primary spending.

- Recent constitutional reform may make policy implementation even more difficult.

Despite a solid parliamentary majority, Prime Minister Silvio Berlusconi's center-right government has been unable to push through its agenda of structural and fiscal reforms, with the exception of certain moderate labor market and pension reforms. The most important reason for stagnation in other areas has been the internal fragility of the coalition. Economic policy orientation has been incoherent and subject to reversals, most notably on the question of tax cuts. Berlusconi's leadership and the dominant role of his Forza Italia party are in decline following the party's dismal showing in a string of elections since mid-2004.

A defeat of the government coalition in the April 2006 parliamentary election will lead to the departure of Berlusconi as a political player, and his Forza Italia party is likely to unravel or merge with one or both of either Alleanza Nazionale (AN) or the Christion Democratic Union (UDC), forming a de-facto "Southern League", rendering a workable center-right coalition improbable for the foreseeable future.

After winning Italy's first ever primary election, former prime minister and EU Commission president Romano Prodi will lead the center-left opposition into the general election. A potential center-left majority will lack cohesion in the same way as Berlusconi's government and would probably have to rely on the unreconstructed communist party as a coalition partner.

In short, political fragmentation continues to hamper policy formulation and implementation. The events surrounding the attempts of two foreign banks in 2005 to take over Italian financial institutions underlined that many political leaders are still not ready to liberalize sheltered nontradable sectors. Similarly, the generalized lament across party lines about a strong euro, alleged unfair competition from low-cost countries, or an unduly restrictive European Central Bank (ECB; AAA/Stable/A-1+) monetary stance is a potent reminder that a majority of policymakers still adhere to the pre-EMU and pre-globalization model of competitive devaluations in lieu of structural reform at home. At the same time, EMU membership has weakened market signals (such as pressure on exchange or interest rates) that could in the past have triggered painful but unavoidable adjustment measures.

Moreover, constitutional reform legislation passed by parliament in late 2005 may further complicate the challenge of implementing structural reform. The extension of powers to Italy's 20 regions and the transformation of the Senate into a federal, rather than national, chamber bears the risk of policy blockade, similar to Germany, where the opposition habitually blocked government-sponsored legislation through its control of the upper house. A reversal of the mild economic convergence of the prosperous north and the poorer south may also be a consequence, which would overshadow attempted consensus-building with divisive regional interests. The constitutional change will still need to pass a referendum after the general election to become effective, and given that the center-left opposition is strongly against the reform, the outcome of such a referendum remains uncertain. In late 2005, the Berlusconi government has also been rushing through an overhaul of the electoral system in favor of a return to full proportional representation. Although this is expected to improve the prospects of the incumbent coalition, it might also lead to (even) more political fragmentation, hampering the formation of majorities for reform.

Economic Prospects:Potential Growth Is Low And Falling

- Italy's diversified economy is characterized by a multitude of small and midsize enterprises (SMEs) boasting high but stagnant levels of productivity, but substantial regional differences persist.

- Official estimates of potential output growth put it at 1.3% per year, and demographic changes will lead to a further reduction unless labor force participation is ramped up.

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Economic structure

SMEs with low income elasticities that specialize in high-quality (but often low-tech) tradable goods are a hallmark of the Italian economy. A relatively large share of workers is employed in industry, while a number of indicators point to a widening "innovation gap". In this regard, partly as a legacy of restrictive labor market regulation, production tends to be more capital-intensive than in other developed economies, and labor participation rates remain the lowest in Europe, although they have been inching upward recently as a result of immigration and labor market reforms since 1998. In addition, a sizable shadow economy remains, as high as 26% of GDP in 2002-2003 according to one estimate, which is similar to Greece, but well above the OECD average of 16%. This is at least partly owed to bureaucracy: the OECD estimates that Italy has the most highly regulated product markets in the EU-15.

The most salient feature of Italy's economic structure is the significant gap between the prosperous north and the poorer south. Labor productivity in the south is about 15% below the national average. Although gradual convergence is occurring, the unemployment rate in the south (more than 15%) is still almost 4x that in the north (4%). Nationally, one-half of the jobless in 2004 were long-term unemployed, as a result of low regional and interpersonal wage differentiation.

Economic growth

The Berlusconi government had set out to mitigate certain of the bottlenecks holding back potential growth. The upgrading of infrastructure was intended to contribute to an improvement in productivity, while lower taxes should stimulate work incentives. In practice, however, little has been achieved on either of these fronts. The government concedes that potential growth has actually declined during its tenure to 1.3% in 2005, from 1.7% in 2001.

The rapid formal employment growth of recent years, helped by wage restraint and fiscal incentives, may not be sustained, as demand remains subdued and incentives are curtailed. In the medium term, employment growth should remain at about 0.5% per year, helped by the 2004 pensions reform restricting widespread early retirement by 2008. Further labor market liberalization (especially regional wage differentiation) could accelerate job creation, which will be required to absorb workers losing their jobs in Italy's large low-tech industrial sectors, overwhelmed by competition from low-cost countries. The downside of employment growth has been stagnant or even declining productivity. The past inflation differential with the Eurozone has led to a significant strengthening in the real exchange rate, undermining already weak export performance.

Sustained and significant increases in labor productivity would require a set of complementary (and costly) interventions. Infrastructure upgrades would have to be accompanied by an improvement in the business environment and stepped-up investment in education to bring Italy's human capital indicators in line with those of other developed societies. Finally, opening up and increasing competition in key sectors like energy and banking could help to reduce the operating costs of Italian companies. None of this should be expected to generate quick results.

Fiscal Flexibility:Structural Adjustment Long Overdue

- A robust expenditure consolidation strategy has yet to emerge to replace one-off receipts and to reduce the structural fiscal deficit, let alone to generate the surpluses needed to create a cushion for demographic change.

- Italy's daunting public debt ratio (about 109% of GDP in 2005) is once more on the rise, and remains vulnerable to a reversal of the interest rate cycle.

- Contingent liabilities are limited, as the banking system remains fundamentally sound.

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Revenue, expenditure, and balance performance

The government projects a 2005 general government deficit of 4.3% of GDP, which appears within reach after additional expenditure cuts were decreed in the third quarter. The official medium-term strategy is to contain spending, with the objective of bringing the deficit down to 1.5% of GDP by 2009, equivalent to a primary surplus of 3.0% of GDP. The structural balance adjustment is slightly backloaded, with a one percentage-point adjustment foreseen in the post-electoral period in 2007. As parliamentary and presidential elections are looming, scant fundamental adjustment is to be expected before the 2007 budget.

Officially, the government has reiterated its determination to completely phase out one-off measures for deficit reduction purposes by 2006. The government's 2006 deficit target of 3.8% of GDP will be hard to achieve without significant additional measures being implemented after the election. In its current form the budget probably overestimates expenditure restraint at both the central and the regional and local levels. Substantial cuts are being proposed to the institutions in charge of road and rail infrastructure, which may be hard to sustain over the medium term given the country's infrastructure needs. Anticipated extra dividend income and higher central bank transfers also appear to be of an exceptional nature. On the expenditure side fiscal pressures will mount next year, as the government is still behind schedule in the implementation of the agreed civil servant pay increases. Furthermore, a regional tax (IRAP) will have to be scrapped in its present form, as the European Court of Justice is expected to declare it too similar to VAT.

Apart from the usual intensification in their battle against tax evasion (itself encouraged by the recent extensive use of amnesties), neither the government nor the opposition has publicized any new consolidation strategies. A return to deficits of less than 3% of GDP will remain elusive without a stepped-up approach to fiscal tightening.

Government debt and interest burden

The general government debt burden remains at very high levels and would be higher were it not for repeated one-off accounting adjustments, such as deconsolidating state-owned specialized lending institution CDP or a raft of government-sponsored securitizations. About 95% of general government debt is owed by the central government. Liquid assets (deposits and minority shareholdings in quoted companies) amount to about 4% of GDP. The debt ratio will peak in 2007 at about 110% of GDP and decline only very slowly, as revenues from asset sales will fall behind government expectations of 1% of GDP per year. The plan that is currently under discussion to create an asset holding structure with the accounting effect of reducing the debt ratio would make no change to the way Standard & Poor's would look at Italy's high debt burden.

Considering adverse demographics, budgetary pressures will rise further in the next decade. Without any policy intervention, the debt ratio will reach a trough of 106% in the mid-2010s before surpassing 120% by 2030 (see footnote 1 at the end of this article).

The general government interest burden will remain high, at more than 10% of general government revenues, and more than 20% at the central government level. By year-end 2006, only about 7% of outstanding debt will still be contracted at high pre-1998 interest rates, making further interest savings contingent on reducing debt rather than refinancing. Given that about 30% of its debt is still short-term or at floating rates, Italy is highly sensitive to a rise in interest rates. A 100 basis point shift of the yield curve would increase interest outlays by 0.5% of GDP within two years.

Off-budget and contingent liabilities

The financial system remains fundamentally sound. In a reasonable worst-case scenario, the government's contingent liability from a banking crisis could amount to 18% of GDP. Bonded debt issued by majority state-owned enterprises remains small.

Notes

Footnote 1: These estimates differ from Standard & Poor's simulations quoted in the government's July 2005 medium-term financial perspective, as the latter used the cross-country standardized assumption of a fiscal starting position applying the average primary surplus over the 2000-2004 period. This surplus was substantially higher than the 2005 outcome, which is the starting point for the numbers presented above.