Italy-X-Press

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S&P Downgrade Brings Rating In Line With Fundamentals

Event

On Tuesday, July 9th, 2013, Standard & Poor's Ratings Services (S&P) lowered Italy's long-term foreign-currency credit rating from "BBB+" to "BBB" (two notches above speculative grade), maintaining a "negative" outlook.

Significance

The rating revision reflects the sharp deterioration in Italy's economic outlook and debt trajectory — and those for the euro area as a whole — over the last six months. After a period of relative financial market calm and declining bonds yields in the peripheral countries lasting from last summer through April, funding pressures have once again intensified. As the euro area enters a new phase of heightened volatility and political instability, the implementation of structural reforms at the national level and tangible progress on the European banking union are becoming ever more crucial for an economic recovery in the region.

Market Reaction

Although the relative adjustments were far from dramatic, financial markets did react to the news on Tuesday. The most noticeable movement of the day was in the euro (EUR), which extended its recent depreciating trend versus the US dollar (USD). Although mostly attributable to dovish comments by a European Central Bank official, the S&P announcement prompted some further weakening, taking EURUSD to a low of 1.2755. The currency closed the session at 1.2781, down 0.7% from Monday and its lowest level since late March. The Italian fixed income and equity securities also sold off, though both markets have already seen a partial retracement. The 10-year government bond yield (currently trading around 4.4%) picked up 10 basis points on the news, while the benchmark FTSE MIB stock index initially shed roughly 1.5%.

Analysis and Outlook

S&P's decision was predicated on Italy's worsening economic environment (the agency lowered its growth projection for 2013 to –1.9% from –1.4% at its last assessment) and still weak financial system. The firm noted that growth has stagnated for a decade due to labour and product market rigidities. The International Monetary Fund (IMF) also recently downgraded its 2013 forecast for the country to –1.8%.

Italy's fiscal situation is challenging. Due partly to €40 billion in government arrears payments to the private sector, the public debt is expected to top 131% of GDP this year, up from 127% in 2012. The improvement in the fiscal deficit (which fell from 5.5% of GDP in 2009 to 3% of GDP in 2012) will also slow, though the budget will maintain a primary surplus of roughly 2½% of GDP. The IMF has advised a rebalancing of the adjustment program toward more expenditure restraint and lower taxes (with a broader tax base). Although the coalition government has the official backing of all major parties, political tensions remain elevated. Contentious issues include state arrears, sales and property taxes, and the pace of austerity. Other key objectives involve tackling youth unemployment, liberalizing energy and service sectors and judicial reform.

After seven quarters of contraction, further output losses are in store; we expect real GDP to fall by nearly 2% this year, following a 2.4% drop in 2012. Output contracted 0.6% q/q (-2.4% y/y) in the January-March period, and although this represented a slight improvement on the 0.9% loss of the prior quarter, the details of the report were disappointing. All GDP components, with the exception of government spending, registered declines (including the first quarterly drop in exports since 2009 Q2). Looking ahead, domestic demand will remain constrained by record-high unemployment rates (12.2%, and almost 40% for youth), fiscal austerity and tight credit conditions. Despite the recessionary environment, interest rates on loans to small and medium-sized business (which account for 80% of total employment) are prohibitive, as the lending appetitive of banks is damped by a rising non-performing loan burden. A feeble recovery will begin to take shape in 2014, though in annual terms output will remain roughly flat.

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