Rating reactions to the pandemic in Europe

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- The pandemic crisis is a challenge for the rating agencies. In 2020, downgrades were mainly confined to sovereigns with high credit risk, while in Europe only the UK was downgraded, also due to Brexit concerns. This marks a key difference to the way in which rating agencies reacted in the past, for example to the sovereign debt crisis.
- In 2021, when last year's economic and fiscal damage will be factored in, and based on our analysis of Moody's methodology, we anticipate a deterioration in some key elements of credit profiles across European countries. On the back of more pronounced fiscal weakness, Italy will remain under close scrutiny, while the UK will probably be shielded by its reserve-currency status.
- However, we expect Italy's rating to remain unchanged this year and next, given the bold support from the ECB and the EU, as well as improved prospects for reform under Prime Minister Mario Draghi. In the medium term, we see potential for an upward rating drift for Italy, while we consider an affirmation of current ratings as the most likely outcome for the UK.

An overview of rating actions during the pandemic

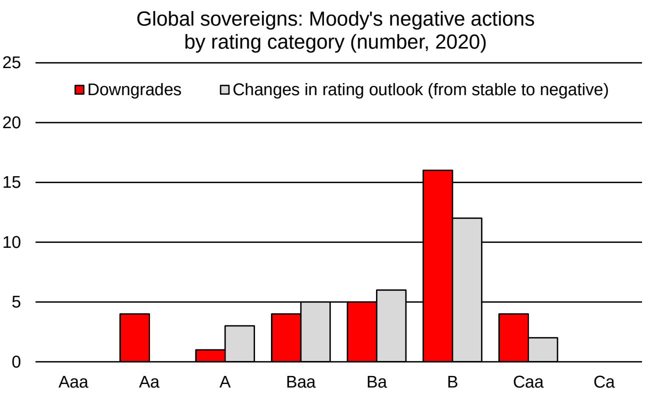
The crisis induced by the global pandemic has taken its toll on the ratings of several sovereigns. While the economic shock appears to have affected GDP and the fiscal outlook of different countries similarly, the assessment of each country's credit profile is not absolute, but reflects the extent to which individual countries prove to be more exposed to the effects of the pandemic, due to their economic structure or existing weaknesses, relative to the average. This represents a challenge for the rating agencies in assessing the credit risk of sovereigns.

In this note, we examine rating-agency reactions, with a general focus on sovereigns in Europe and a more specific (re)assessment of the credit profiles of the UK and Italy, the two European countries that have experienced a downward drift in rating in recent years and that lead Moody's concerns in Europe. The UK, which signed a Brexit trade deal at the end of 2020, is now rated "Aa3" by Moody's, the lowest level considered high grade, with stable outlook. Italy – which suffered a government crisis at the start of 2021, resulting in the formation of a government headed by Mario Draghi – is rated "Baa3", one notch above non-investment grade (with a stable outlook). While its approach is different, sovereign ratings get a broadly similar outcome from Fitch, while S&P rated both countries one level higher, probably reflecting a more balanced emphasis on the economic strengths and fiscal weaknesses.

We focus our analysis on Moody's, which we refer to as "the rating agency" throughout. Of 141 sovereign countries rated by Moody's, there were 34 sovereign downgrades in 2020[1], more than double that in 2019 (14) and 2018 (16). These downgrades were in addition to Moody's 28 negative changes in rating outlook (from stable to negative) last year (see Chart 1).

The negative rating actions[2] were concentrated in low-rated categories, countries in which the negative impacts of the pandemic shock likely exacerbated pre-existing, profound weaknesses. The highest number of negative rating actions was related to countries with sub-investment grade ratings, particularly those seen as "speculative, with high credit risk" (B-category, about 50% of the total), as was the case with the downgrade of Turkey in September 2020.

CHART 1: NEGATIVE RATING ACTIONS SO FAR IN THIS CRISIS



Source: Bloomberg, UniCredit Research

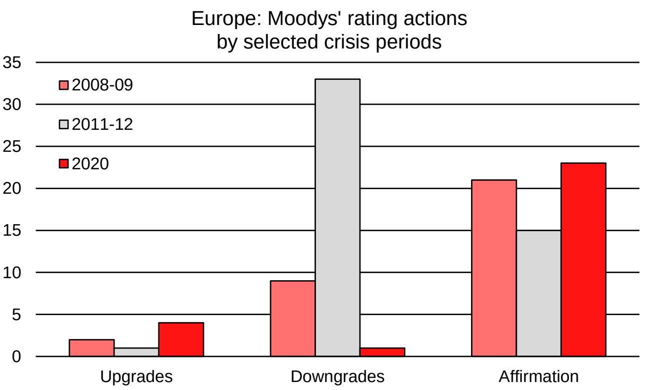
While the UK was subject to a downgrade[3], the credit profiles of EU countries were relatively immune in 2020. Last year, Moody's affirmed the sovereign ratings of the majority of EU countries, and a few of them (Greece, Croatia, Bulgaria and Slovenia) were even upgraded, most likely as a result of progress made before the pandemic (see Chart 2). Currently, the ratings of European countries are mostly above the "speculative, high credit risk" category: Greece (Ba3), Cyprus (Ba2) and Croatia (Ba1) in the Ba category; and Hungary, Italy, Portugal, Romania (Baa3), Bulgaria and Spain (Baa1) in the Baa category.

[1] As opposed to 5 upgrades in 2020.
[2] We mainly consider downgrades and changes to negative outlook.
[3] Moody's downgraded the UK to "Aa3" in October 2020, with stable outlook. The UK was previously downgraded by Fitch in March 2020, to "AA-"; outlook is negative.

Therefore, despite the pandemic shock, Europe has not experienced a real change of pace with respect to the rating assessment of the previous two years, when the main downgrade was specifically related to Italy's crisis in 2018.

There is still a striking difference when we compare the current reaction with what happened during the previous global financial and especially sovereign debt crises. As Chart 2 reminds us, the sovereign debt crisis triggered 33 downgrades[4] in Europe in about two years and there were nine during the global financial crisis. In addition, for several European countries, during the sovereign debt crisis in particular, the downgrades were associated with multiple changes in a country's rating level. For example, Portugal's sovereign rating moved from "A1" to "Ba3", while Spain moved from "Aa1 to Baa3", with the deterioration even more devastating for countries such as Cyprus and Greece.

CHART 2: MOODY'S REACTIONS TO DIFFERENT CRISES[5]



Source: Bloomberg, UniCredit Research

As we are still navigating this crisis, we explore what this shock might imply for sovereign ratings in Europe, what we think will be the key variables and what trends will be under close scrutiny and might trigger rating revisions in the next few years. In the next section, we start by identifying possible fundamental drivers of the rating action, looking at evidence from previous crises. Then, we analyze the methodology used by Moody's to assess the scorecard-indicated outcome for sovereign rating.

The fundamental drivers of rating actions in Europe

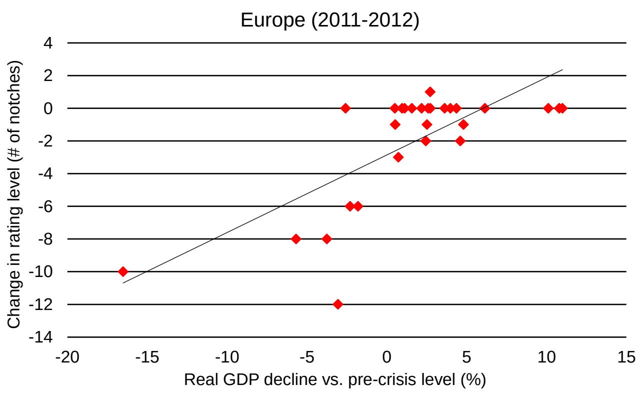
To start identifying the fundamental drivers of changes in a country's rating level, we analyze annual key indicators for the countries in Europe across selected crisis periods (2008-09, 2011-12 and 2020).

Here we show the results for the sovereign debt crisis, which appears to be relatively more informative for the eurozone countries; the findings for the global financial crisis move broadly in line with those of the sovereign debt crisis.

Our correlation analysis reveals the following drivers of change in the rating level[6]:

- **The size of the GDP shock** is positively related to downgrades. Countries suffering higher GDP declines saw a more significant deterioration in their credit profile during the sovereign debt crisis. Chart 3 illustrates this for the countries in Europe in the period 2011-12. We plot the change of rating levels against the change in the country's real GDP compared to its pre-crisis level (in 2010).

CHART 3: **GDP SHOCK AND RATING CHANGES (2012)[7]**



Source: EC's AMECO database, Bloomberg, UniCredit Research

The annual change in real GDP observed in 2020 in Europe was a decline of around 6.0% on average, ranging between -2.8% for Poland to -11.0% for Spain. Such a GDP shock would be a compelling trigger for changes in the rating level. However, this correlation has completely broken down during the current crisis, at least until now.

- **The government budget balance** is also positively related to the change in rating levels. The collapse in GDP during a crisis results in a widening of the general government budget deficit, due to both the cyclical impact and the discretionary fiscal response (if any). Such a deterioration of the budget deficit might weaken a country's fiscal position and could be a catalyst of change in the rating assessment. Chart 4 clearly shows this positive relationship graphically for the sovereign debt crisis.

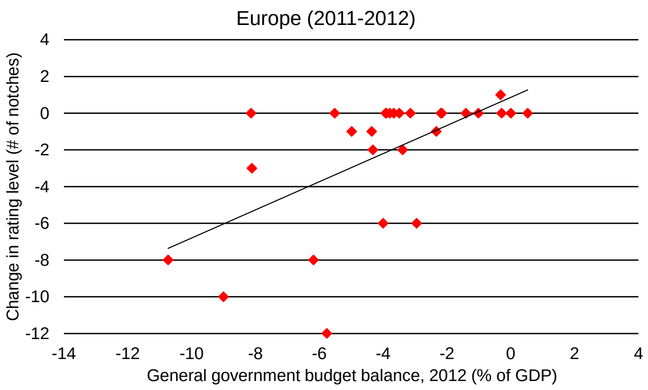
[4] These downgrades affected twelve countries.

[5] We report here the total number of downgrades regardless of the change in the rating level that occurred for each country. In our analysis, Europe refers to EU27 countries and the UK.

[6] In our analysis, we refer to the European Commission (EC)'s AMECO database and EC's *Autumn 2020 Economic Forecast*, published in November 2020, as well as the EC's *Winter 2021 Economic Forecast*, published on 11 February, which updated the real GDP and inflation forecast.

[7] The line denotes the linear prediction.

CHART 4: BUDGET BALANCE AND RATING CHANGES (2012)

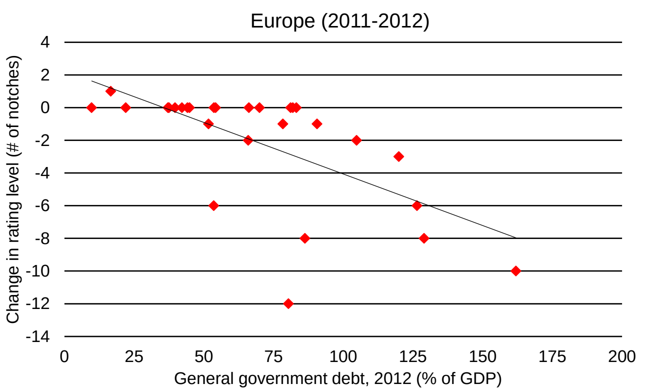


Source: EC's AMECO database, Bloomberg, UniCredit Research

With regard to the current crisis, while concerns about a higher budget deficit/GDP could be consistent with the UK downgrade, and a lower budget deficit a probable factor behind Bulgaria's upgrade (improvements that were antecedent to the crisis), the sizeable increase in budget deficits observed last year still did not impact the credit assessment of most of the countries in Europe.

- **The general government debt**. We find a negative relationship between the changes in countries' rating levels and the level of public debt/GDP reached at the apex of the sovereign debt crisis (see Chart 5). This is not a big surprise: the risk of a downgrade tends to be higher for countries with higher levels of public indebtedness.

CHART 5: PUBLIC DEBT AND RATING CHANGES (2012)



Source: EC's AMECO database, Bloomberg, UniCredit Research

The pandemic shock will leave a significant legacy in terms of the public debt/GDP ratio. Already, in 2020, for about two-thirds of the countries in Europe, the ratio will probably be more than 10pp above the 2019 level, and for a third of those, it will be well above 15pp higher. This was still not sufficient for the rating agency to sound the alarm.

- **Interest payments**. Lastly, interest obligations also played a role in assessing the country's credit profile in previous crises. Sovereigns that experienced multiple reductions in their rating level, especially during the sovereign debt crisis, were characterized by the highest interest burdens, as measured by the ratio of interest expenditure to total revenue. This metric was meant to simultaneously capture the potentially higher cost of servicing public debt and the diminished room for maneuver for stimulating growth.

From 2012-13, there was a downward trend in the interest burden for governments. While in 2012, 60% of European sovereigns allocated more than 5% of their revenue to interest payments (with the highest interest/revenue ratio above 12%), this share is now down to 25%, with the ratio capped at 7.5%. We expect, therefore, interest payments to go from being considered a negative factor in a country's creditworthiness to a more supportive one. Moreover, such a benign trend in the interest burden for countries will probably lead the rating agencies to progressively reduce the relevance of metrics that mix stock and flow (as is the case for the public debt/GDP ratio), while increasing the role of "flow-flow" metrics (related to interest payments) in their credit risk approach.

An assessment of credit profile based on rating agency methodology

So far, our analysis has shown the difference in the way the rating agency has reacted to the pandemic compared to the sovereign debt crisis. Such a difference is most likely explained by the way in which the main features of the current crisis are perceived (global in nature and more symmetric), its economic consequences (dependent on temporary COVID-19 restrictions rather than fundamental imbalances) and the very bold and coordinated monetary and fiscal policy response, to name a few. Still, at some point the deterioration in key macroeconomic indicators – starting from historical 2020 data and updated projections for the coming years – will inevitably go through the quantitative assessment of countries' credit profiles, which could, in theory, trigger rating revisions down the road. How might the rating assessment change? To answer this question, in this section, we will mainly focus on the credit profiles of the UK and Italy, compared to other large eurozone countries. The main aim is to understand the extent to which the impact of the pandemic might exacerbate the two countries' existing weaknesses, according to Moody's methodology[8].

Moody's methodology is mainly based on a scorecard of many historical and a few forward-looking indicators, integrated with other (mainly, forward-looking) rating considerations.

[8] See references, Moody's (2019).

The four main blocks or factors that are considered are: **1.** economic strength; **2.** institutions and governance strength; **3.** fiscal strength; and **4.** susceptibility to event risk. In order to score such factors, several sub-factors are analyzed and scored. Moreover, factor 1 and 2 are combined to measure a sovereign's "economic resiliency", which, combined with factor 3, provides a score of "government financial strength". The latter is then associated with factor 4 to get the scorecard-indicated outcome for sovereign rating. We examine some of the main determinants of these factors, using the most recent data available.

1. Economic strength: Starting with the latest assessment[9] of the factor of economic strength, the UK's score is "a1" and Italy's score is "a3". These are relatively high scores, which are mainly supported by the two "aaa" scores for the UK and "aaa" and "aa1" scores for Italy, attributed to the sub-factors "scale of the economy" and "national income", respectively. The relevance of these two sub-factors has recently increased in Moody's methodology due to the decreased weighting of the "growth dynamics" sub-factor, which is good news for both countries[10]. The "growth dynamics" sub-factor is calculated from **1.** a ten-year average of real GDP growth (so far, 2015-24) and **2.** the volatility in real GDP growth. Both of these components see (and would see) Italy, the UK and the majority of rated sovereigns penalized, and will be under particular scrutiny.

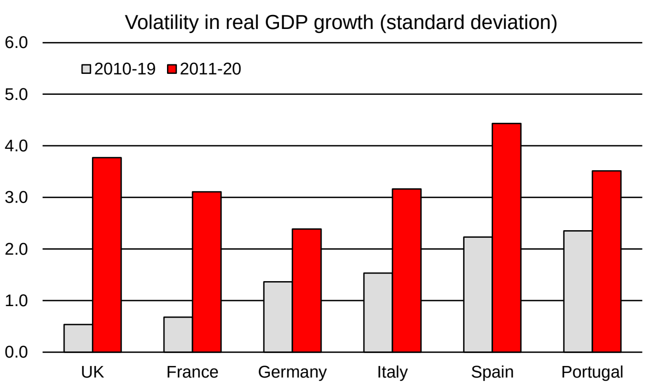
In the latest assessment, Italy's average real GDP growth sub-factor was 0.9%, based on the rating agency's expectations of 5.6% growth in 2021 (2020: -9.0%), probably followed by more moderate growth (of 2-3%) in the following three years. According to the agency's methodology, such average growth represents the lower bound of a "b3" score (0.9-1.1%), implying that lower-than-expected GDP growth might trigger, for example, a move to a "caa1" score for this sub-factor (0.7-0.9%). An identical outcome and risk characterizes the UK: the sub-factor ten-year average of real GDP growth equaled 1.0%, and therefore a "b3" score, like Italy. Still, this was underpinned by strong 7.1% growth in 2021 (2020: -10.1%), followed by a pace of real GDP growth probably below the UK's 2.0% trend growth until 2024.

While the second and third waves of COVID-19 infections have lowered GDP growth forecasts for 2021, compared to previous expectations of the rating agency, it will most probably be followed by stronger growth in 2022 in most countries in Europe. That said, any idiosyncratic response in terms of the ability to recover to pre-pandemic levels at the end of 2022 will be important to assess countries' average GDP growth and reaffirm current scores.

Our expectation is that the vast majority of economies in Europe should be able to reach pre-pandemic levels in the second half of 2022, and a few particularly exposed countries (including Italy) at the beginning of 2023. For Italy, the focus will also be on what can guarantee better medium-term growth, particularly real GDP growth of at least 2.0%, on average, in 2023-25.

In contrast, the sub-factor of historical volatility in real GDP growth is one of the quantitative indicators that is most likely to deteriorate significantly for all countries due to the pandemic shock. Should the methodology be applied to Italy, an increase in the standard deviation of GDP growth from 1.53 to slightly above 3 (see Chart 6) could potentially trigger a negative change from the current score of historical volatility of "aa3" to "b1": a significant downgrade of around 10 notches for this component. This could contribute to a downward move in Italy's economic-strength score, despite the weighting of the volatility sub-factor being relatively low.

CHART 6: SIGNIFICANT INCREASE IN GROWTH VOLATILITY



Source: Eurostat, EC, UniCredit Research

As Chart 6 shows, such a deterioration could be even more pronounced for the UK and other eurozone countries traditionally characterized by a relatively stable rate of GDP growth, leading to a widespread severe deterioration in the economic-strength factor. In detail, the score related to historical volatility could change from "aaa" to "caa1" in the UK, and from "aaa" to "b1" in France. All other things remaining equal, in theory, this could imply a two-notch reduction in the UK's economic strength factor (from "a1" to "a3"). We believe that the risk related to the increase in GDP volatility is not likely to have an immediate impact on country ratings as it might be considered a tolerable, generalized negative effect of an unprecedented global shock to ratings.

As a last step, the economic strength factor might be further adjusted downward in order to capture structural weakness, mainly on the supply side. The pandemic crisis might amplify some of these weaknesses.

[9] See Moody's (October 2020) and Moody's (November 2020).
[10] This is captured by the higher weighting currently attached to these two sub-factors, compared to the previous version of the methodology: 65% in total vs. 50% previously. In contrast, the weighting of the sub-factor "growth dynamics" was lowered from 50% to 35%, currently divided into 25% for the average real GDP growth and 10% for the volatility in real GDP growth.

For Italy, such an adjustment factor to the economic strength already implied a change of an initial score of “a2” to a final score of “a3”[11]. Therefore, any further concern could still be captured in the additional deterioration already assumed. In contrast, for the UK, the impact of this adjustment factor to economic strength is currently nil.

Looking forward, the risks appear mainly related to the following: **1.** the emergence of an idiosyncratic response to a deeper crisis than that assumed so far (delaying the recovery to pre-pandemic levels); **2.** the ability to build a credible strategy to anchor medium-term GDP growth expectations (2023-25); **3.** the implied increase in GDP growth volatility; and **4.** the exacerbation of structural weaknesses.

When we update the economic strength factor with 2020 data for Italy, in theory this might move towards a negative adjustment of one notch to “baa1” from “a3”. However, the expected stimulus from EU recovery funds, as well as the commitment to fixing long-lasting structural issues, promoted by the Next Generation EU Program – as hinted at by Prime Minister Mario Draghi in his speech before the Senate[12] – are very difficult to ignore, and should represent a mitigating and supportive factor for the economy, leaving the assessment of the economic strength factor at least unchanged, in our view. An update with the latest evidence available might also call for a deterioration in the UK’s economic strength factor, triggered by the country losing its ability to guarantee the same stable and high rates of growth it has managed in the past. Here, in addition, increasing concerns related to structural weakening in trade, investment and productivity in the coming years, as a result of Brexit, might become consistent with a “negative” adjustment factor.

2. Institutions and governance strength. The second key factor is represented by institutions and governance strength. It is built up of two main sub-factors: “quality of institutions” and “policy effectiveness”, with weightings of 40% and 60%, respectively.

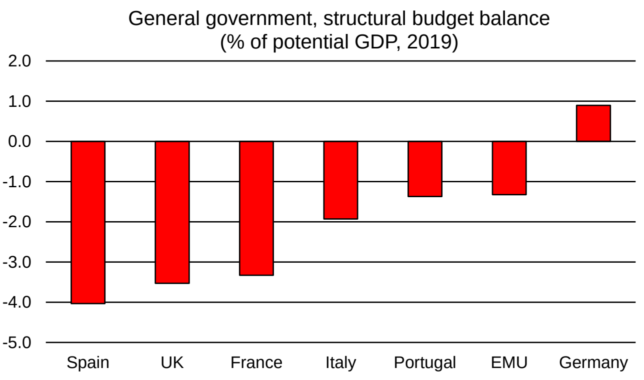
With regard to the “quality of institutions”, the UK and Italy benefit from strong checks and balances in their institutional setup, and Italy, in particular, like other eurozone countries, from belonging to the European Monetary Union, which also devises and sets fiscal standards. Still, in terms of quantitative indicators, the “quality of institutions” is mainly captured by the World Bank’s worldwide governance indicators (WGI, 2019) for “regulatory quality” and “government effectiveness”, as well as “rule of law” and “control of corruption”. Given the weak performance of the country in terms of these indicators, Italy’s score (“a”) is lower than that of the UK and the main eurozone countries.

[11] According to Moody’s (November 2020), “structural challenges remain large and have been left unaddressed for many years, resulting in very low growth potential of the Italian economy, labour market rigidities, a lack of competition in domestic product and services sectors, high tax rates and an inefficient public sector and judicial system”.

[12] See *Le dichiarazioni programmatiche del Presidente Draghi, Governo Italiano*, 17 February 2021.

The other “policy effectiveness” sub-factor is broken down into “fiscal policy effectiveness” and “monetary and macroeconomic policy effectiveness”. In terms of “fiscal policy effectiveness”, in particular, Italy stands to be penalized by the slow adjustment in the public debt trajectory during recovery phases, with the public debt/GDP ratio broadly stabilizing at a high level compared to its peers. On the other hand, Italy’s score for this sub-factor (“a”) has thus far been supported by a relatively low structural budget deficit (1.9% of GDP in 2019, see Chart 7), as well as the high degree of transparency of the government’s accounts and the quality of its debt management. The opposite is true for the UK, where a relatively high structural budget deficit (3.5% in 2019) probably contributed to triggering a “fiscal policy effectiveness” score of “baa”.

CHART 7: STRUCTURAL BUDGET BALANCE



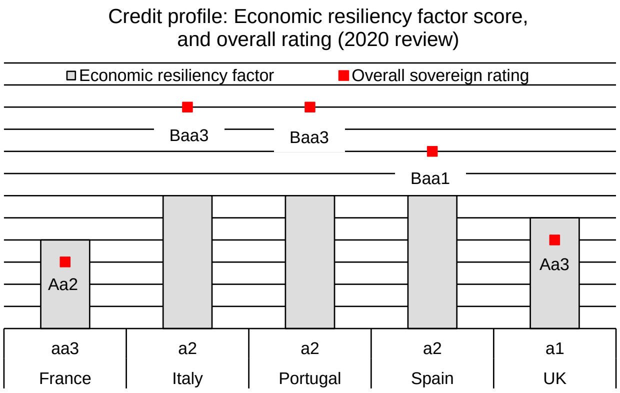
Source: EC’s Ameco database, UniCredit Research

The current crisis will inevitably lead to a significant deterioration of the country’s structural and budget balance once 2020 data is included. This will be another driver under particular scrutiny and will represent another challenge for the rating agency’s assessment this year amid what is likely to prove a widespread deterioration across the main European countries, and will require more time to detect differences in the effectiveness of governments’ management of fiscal policy responses. If one assumes that it is unlikely that there will be a deterioration of the “fiscal policy effectiveness” sub-factor triggered by the recent increase in the structural budget deficits, negative changes to the institutions and governance strength score do not look likely in the short term.

In the medium term, for Italy and the other eurozone countries, the opportunity offered by the Next Generation EU program to improve the prospects of the European integration, the targeted reform of EU fiscal rules and the ECB’s bold monetary policy response might support a potential shift in the “policy effectiveness” sub-factor for the better rather than the worse. The UK will be under scrutiny as a slow adjustment from a high structural deficit might reinforce concerns that the predictability and effectiveness of policymaking might be lower than in the past.

The economic and institutions and governance strengths (factors 1 and 2) are combined into a single score of a country's "economic resiliency". In the latest assessment, Italy's "economic resiliency" score was similar to that of Spain and Portugal, one (alphanumeric) notch lower than the UK, which in turn was one notch below France (see Chart 8).

CHART 8: RANKING BEFORE THE PANDEMIC: ECONOMIC RESILIENCY[13]

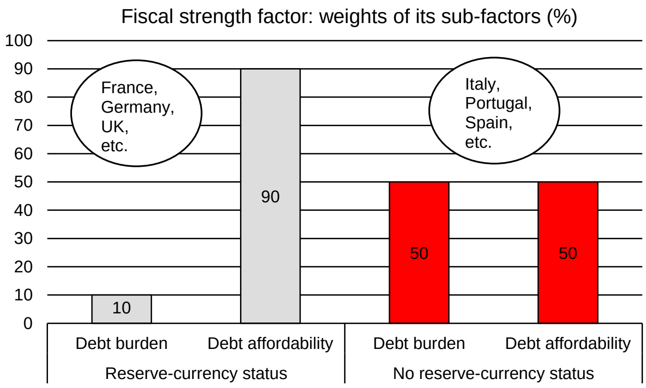


Source: Moody's, UniCredit Research

3. Fiscal strength. A sovereign's fiscal strength is defined by Moody's as a "direct indicator of the sustainability of the sovereign's debt burden". The pandemic shock inevitably led to a significant deterioration in the public finances of all countries in Europe. The factor of fiscal strength comprises two relevant quantitative sub-factors, "debt burden", consisting of general government (GG) debt/GDP and GG debt/revenue; and "debt affordability", comprising GG interest payments/revenue and GG interest payments/GDP.

According to the rating agency's methodology, the relative weights of the two sub-factors, "debt burden" and "debt affordability", change depending on whether the country in question has a reserve-currency status (see Chart 9). While the euro is considered a reserve currency, only the two largest member states, Germany and France, are considered to benefit from reserve-currency status. This means that their credit profiles are likely to be less affected by the increase in public debt induced by the pandemic. This is expected to mark a key divide in the reassessment of European countries' credit profiles, between, for example, the UK, Germany and France at one end of the spectrum and Spain, Italy and Portugal at the other end.

CHART 9: RESERVE-CURRENCY STATUS MAKES AN ENORMOUS DIFFERENCE



Source: Moody's, UniCredit Research

Based on 2019 historical data, Italy's score in terms of "debt burden" and "debt affordability" was "ba2", as a result of a combination of equally-weighted scores for the sub-metrics, ranging from "caa2", assessed for its high public debt/GDP level, to "a1" related to the interest payment/revenue ratio. This assessment was then scaled down by two additional notches (from "ba2" to "b1"), one triggered by the specific adjustment related to other features of the public debt[14] – including the debt trend, foreign-currency debt and other non-financial public debt – and the other to capture the fact that all of these sub-factors might not be sufficient to fully reflect Italy's fiscal weakness. In 2019, the UK's debt metrics were much more benign, as a relatively high score in terms of "debt affordability" ("aa3")[15], given its higher weighting, dominated the lower "debt burden" score ("ba1"), leading to an initial score of "a1". This assessment was then scaled down by two additional notches to a score of fiscal strength of "a3", due to the deteriorating debt trend[16].

Looking ahead, European countries are likely to face a deterioration in their debt burdens and debt trends, while debt affordability scores are likely to remain a more supportive factor. In the case of Italy, for example, an update of quantitative indicators this year could show changes consistent with a one-notch deterioration of the initial fiscal strength factor, mainly related to the higher debt burden last year. Moreover, any upward revision to the rating agency's public debt/GDP path in 2021-22 that could increase the debt trend outcome above 20pp (which is likely, see Chart 10), may indicate a two-notch downward adjustment to debt trend, rather than the current one-notch adjustment.

[13] See Moody's (September 2020), Moody's (July 2020) and Moody's (August 2020).

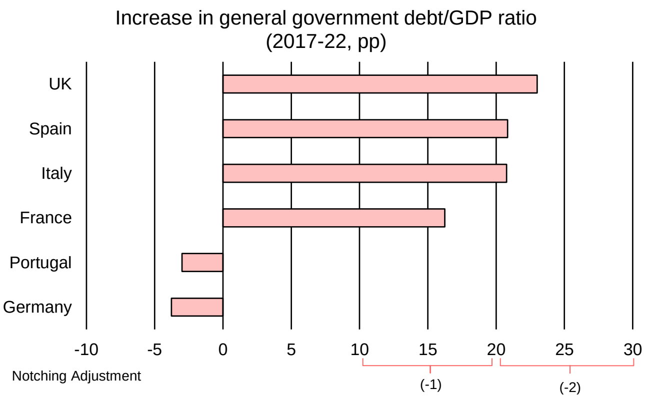
[14] The so-called debt-trend sub-factor, which was aimed to capture the increase in GG debt/GDP in the 2016-21 period, played a significant role in the downward revision related to specific adjustment.

[15] The UK's interest payment ratio was 5.5% in 2019, compared, for example, to 7.2% for Italy.

[16] The debt trend was assessed at 23.5pp for the period 2016-21, therefore already triggering a two-notch downward adjustment (see also Chart 10).

Overall, in theory, this could imply a one to two-notch deterioration of the fiscal strength factor, compared to the latest score. In contrast, for the UK, given the very low weight attributed to it, a potential two-notch downward revision in the score of "debt burden" (as of 2020 historical data) may not translate into a deterioration in the initial fiscal strength score, while a large negative effect from the debt trend (-2 notches) was already factorized into the final score of fiscal strength, which could potentially be confirmed at "a3". Therefore, Italy looks to be more exposed to a deterioration in the assessment of its fiscal strength in the coming quarters, despite starting from a cautious bias.

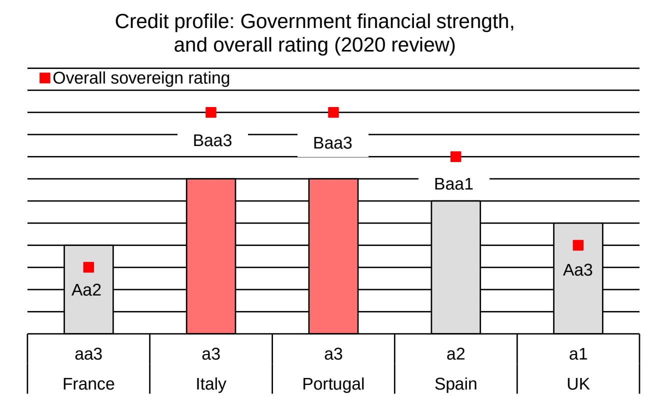
CHART 10: A COMPARISON OF THE DEBT TREND



Source: EC's Ameco database, OBR, UniCredit Research

The "government financial strength" outcome is then obtained by combining the score for economic resiliency and fiscal strength (see pink/grey bars, Chart 11).

CHART 11: RANKING BEFORE THE PANDEMIC: GOVERNMENT FINANCIAL STRENGTH



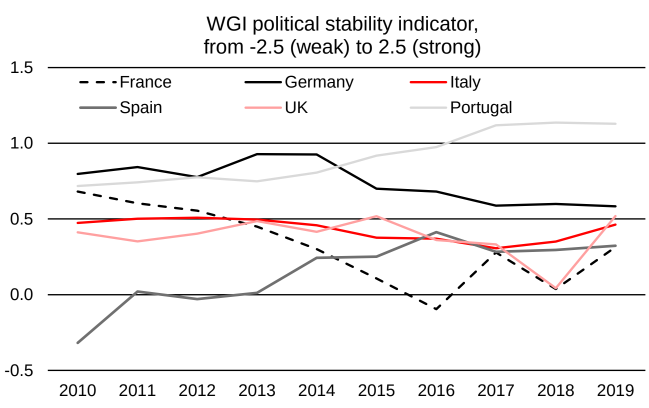
Source: Moody's, UniCredit Research

It is worth highlighting that, despite the assessment attributed before the pandemic crisis to **1.** Italy's "debt burden" and "debt affordability", **2.** the debt trend and **3.** supposed further fiscal weakness compared to its peers, the "government financial strength" alphanumeric score was still three notches above Italy's current rating ("Baa3").

4. Susceptibility to event risk. It looks clear that a key role in the assessment of some countries' credit profiles is played by the susceptibility-to-event-risk factor. This factor has to be seen essentially as a constraint that may only lower the "government financial strength" outcome and is mainly intended to capture the negative impact of **a.** political risk, **b.** government liquidity risk, **c.** banking-sector risk and **d.** external vulnerability risk.

a. Political risk: According to Moody's methodology, this risk, stemming from domestic politics or geopolitics, "may increase a sovereign's probability of default". The score of this risk component is mainly captured by the WGI "voice and accountability" and "political stability" indicators. As Chart 12 shows, for Italy, the "political stability" indicator was 0.46 in 2019, which is within one (0 and 0.5) of the several ranges set to score political risk; while the UK was slightly above this range. This, together with a "voice and accountability" indicator slightly below 1, was consistent with a final "baa" score for the political risk component, one of the worst among Italy's main eurozone peers, and lower than the UK's "a" score, which was also supported by a better ranking for the "voice and accountability" indicator.

CHART 12: TRENDS IN POLITICAL STABILITY INDICATORS



Source: World Bank, UniCredit Research

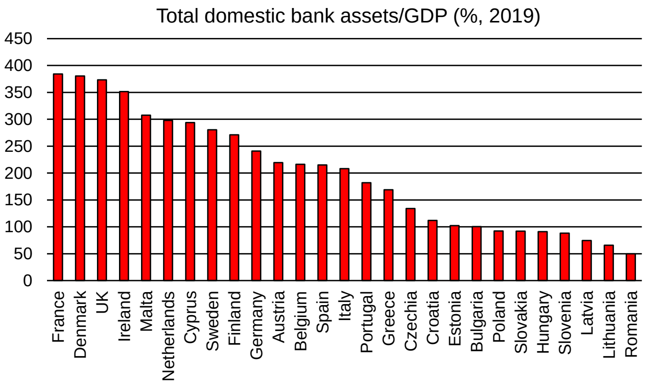
After hitting a low of 0.31 in 2017, an improving trend began (see Chart 12), which might be confirmed at a similar pace in 2020, potentially raising the level of Italy's political stability indicator above the 0.5 threshold for a better score. Should this be the case, and, above all, given the fact that the formation of Mr. Draghi's government was one of the best solutions to resolve the government crisis, with early elections unlikely to occur, an affirmation of the latest score for the political risk component currently appears much more likely than a deterioration.

b. Government liquidity risk: This risk captures: “a government’s ability to meet all its payment obligations, especially those related to debt service”. This component is related to the size of a government’s funding needs (relative to GDP over the next two years), in the context of the government’s ease of access to funding and the non-resident share of public debt. Needless to say, the pandemic shock has greatly increased the funding needs of all countries, which poses another challenge for the rating agency in calibrating its reaction.

The assessment related to this component envisages that governments whose local currency doesn’t benefit from reserve status typically receive a worse score. This places eurozone countries that do not benefit from reserve-currency status in a weaker position than France, Germany and the UK, which benefit from an “aaa” score, given that their reserve-currency status should provide a high capacity to carry debt. In the case of Italy, an initial “a” score for this component was downgraded by one notch to “baa”, based on the rating agency’s forward-looking view. For the near future, funding needs are likely to remain high in 2021, after the considerable increase in 2020, and, probably, to start to decline in 2022. However, central bank support is providing a strong backstop and, for the eurozone countries, the larger role played by the ECB, which is expected to increase its share in the bond market, is a real game changer. For Italy, for example, the share of public debt held by the ECB is expected to range from 25% to 30% in 2021, compared to 17% at the beginning of 2020. This could be considered a factor that might offset previous downward pressure on the score of this risk component, potentially opening up an improving trend.

c. Banking sector risk: In order to assess banking sector risk in terms of quantitative indicators, the methodology combines the rating agency’s index of a banking sector credit event (BSCE), which reflects the stand-alone credit profile of the domestic banking system (the so-called Baseline Credit Assessments), and the size of the domestic banking system (in terms of total domestic bank assets as a percentage of GDP). The main idea is that the larger the size of a country’s banking system, the higher the risk that it might impact on a government’s balance sheet and the economy as a whole. The UK’s banking system is very large, while Italy’s is close to the European simple average (200%), which ranges from 380% in France to 50% in Romania (see Chart 13). Therefore, Italy should not be prone to a higher-than-average risk.

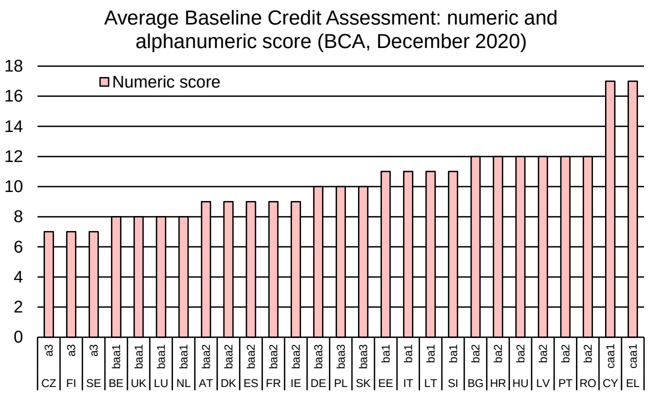
CHART 13: SIZE OF BANKING SYSTEMS



Source: ECB, Eurostat, UniCredit Research

However, the rating agency’s assessment of the domestic banking system, the BCA, penalizes many countries in Europe (see Chart 14), particularly Italy, which is scored “ba1”, indicating a sub-investment-grade status. In contrast, the UK banking sector’s risk is assessed to be very benign, probably reflecting the progress made to strengthen it over the last decade.

CHART 14: THE ASSESSMENT OF BANKING-SECTOR RISK

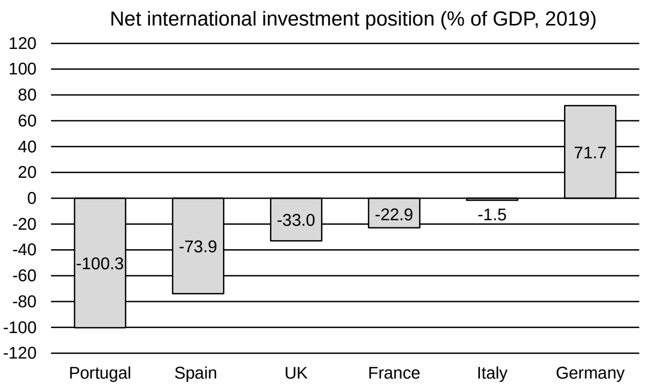


Source: Moody’s, UniCredit Research

The outlook of the European banking system is currently negative. This tends to reflect the risk that a deterioration in loan performance and profitability might undermine confidence in banks as seen in past crises, although weakness is unlikely to materialize at least while government support measures remain in place. The banking systems of Italy and Portugal are likely to be under close scrutiny in this respect. Moratorium schemes have been further extended and the share of moratorium loans is high compared to other EU countries.

d. External vulnerability risk: This captures "a sovereign's capacity to access or repay financing denominated in a foreign currency". Italy's score for this component is relatively high ("aa"), mainly reflecting the change in Italy's current account balance to sustained surpluses over the past few years (between 2.5% and 3.0% of GDP), prompting a net international investment position that is close to balanced, with further improvement ahead (see Chart 15). In the UK, the large current account deficit, which is expected to remain at 3-5% of GDP, will continue to potentially expose the country to risk, but its reserve-currency status allows the UK to maintain an "aaa" score for this component. This is unlikely to change in the short-to-medium term.

CHART 15: NET INTERNATIONAL INVESTMENT POSITION



Source: Eurostat, ONS, UniCredit Research

It is important to note that the susceptibility-to-event-risk factor is determined by the minimum score of its components, rather than the weighted average used for the other three factors. Therefore, for Italy, the latest score was the score related to the component of the "banking sector risk", that is "ba". This compares to a "baa" score (with some potential for improvement) for the "political risk" and "government liquidity risk", and the "aa" score applied to the "external vulnerability risk". The UK's susceptibility to event risk is determined by its "a" score for political risk and banking sector risk.

The "government financial strength" outcome for each country is finally combined with the sovereign's susceptibility to event risk and this determines the midpoint of the overall scorecard-indicated range for each country. In the case of Italy, this combination results in a score of "Baa2", implying scorecard-indicated range of Baa1-Baa3. Italy was then rated at "Baa3", the lower bound of this range, similar to the decision made for Spain and Portugal. In the case of the UK, the rating level was "Aa3", the upper bound of the scorecard-indicated range outcome of Aa3-A2.

Our final assessment

The main aim of this note was to shed light on the key elements that might drive rating-agency reactions to the pandemic. A look at Moody's methodology provides clear evidence that a quantitative update could affect factor scores of credit profiles for a large number of key countries in Europe. Therefore, the pandemic has put the rating agencies in a difficult spot. Moreover, our analysis shows that countries such as Italy that do not benefit from a reserve-currency status (unlike, for example, the UK) are more subject to the risk of a deterioration in their fiscal strength related to the increase in their public debt. Lastly, in countries where Moody's has already assessed the banking system performance as weak, the ability to navigate the pandemic crisis without severely damaging the banking sector outlook is likely to be very closely scrutinized.

The update of the quantitative assessment of credit profile is expected to be coupled with "other adjustments" that might exacerbate or moderate the risk of potential rating reviews. In this respect, our expectation is that the bold support of the ECB's monetary policy and/or the opportunity offered by the Next Generation EU program represent sufficient mitigating factors in supporting "government financial strength" in Europe. Moreover, in the case of Italy, the formation of Mario Draghi's government will substantially support political stability and its contribution to the finalization of Italy's Recovery and Resilience Plan will increase the probability of an efficient use of EU funds, as well as promoting an even more benign cost of debt than initially expected. In addition, a more pro-active approach to finding solutions for the most vulnerable firms might support the prospects of Italian banks. We consider all these elements as being enough to prevent any rating change this year and next, despite the deteriorating trend in quantitative assessment. In the medium term, the Next Generation EU program will likely be enough to consolidate expectations that Italy's growth trend will drift higher, while initial efforts to remove structural weakness and rigidities might improve the productivity outlook from the negative assessment taken so far. All of this will help to improve the debt trend and the banking sector assessment too. Lastly, stronger European integration has the potential to further mitigate political risk.

As we have argued[17], in terms of reforms, Mr. Draghi's focus is likely to be on reforming taxation, public administration and the civil justice system, as well as on the need to make an updated review of the degree of market competition in the country. Such interventions might repair some of Italy's structural weakness, inevitably highlighted by the rating agency, meaning that if the government delivers what is planned, then Italy's rating prospects may drift upwards in the medium term.

[17] See *Sunday Wrap*, UniCredit Research, 21 February, 2021.

The UK has just been downgraded by Moody's with a stable outlook. The change appears to be consistent with a weaker GDP growth trend in the near future, further amplified by the impact of the pandemic crisis, coupled with an upward trend in public debt. An ongoing weakening in the UK's institutions and in the effectiveness of fiscal policy complete the picture. An update of the quantitative assessment therefore doesn't seem to justify a further action in the short term, especially if the UK confirms a return to pre-crisis levels before the end of 2022. However, we do not currently see the UK's rating as being exposed to an upward drift in the medium term. There is already a high probability that the growth trend will be lower; in addition, Brexit might end up exacerbating the UK's already weak productivity, potentially triggering a negative adjustment to the country's economic strength score, while policymaking with respect to its strategy to cope with higher public indebtedness and to rebuild the country's fiscal strength will probably be under close scrutiny.

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