ITALY

Rating Analysis - 10/25/10
Debt: EUR1,763.6B, Cash: EUR80M

EJR Sen Rating(Curr/Prj) BBB/ N/A
EJR CP Rating: A2
EJR's 1 yr. Default Probability: 2.0%

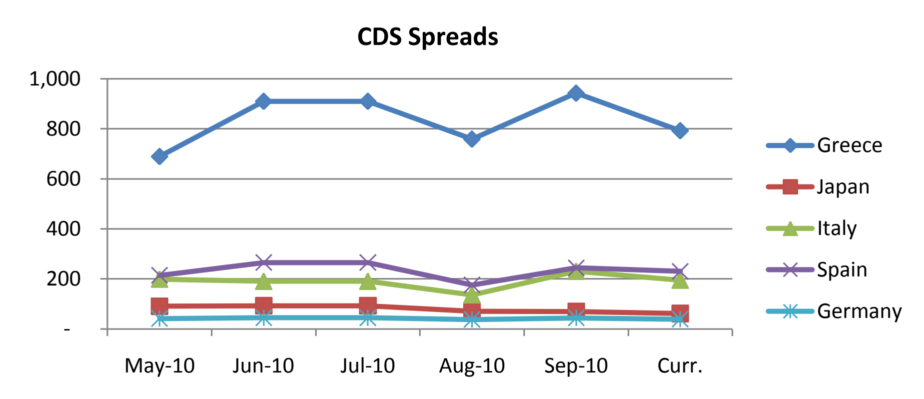
Italy has begun to show slight signs of economic recovery due in large part to floating trends on exports. The economy expanded 0.5% SA QoQ (1.3% YoY) in Q2, half the pace of the average euro area growth. The OECD has forecast GDP will *contract* by 0.3% (annualized QoQ) in the third quarter. Meanwhile, industrial output has failed to meet forecasts, rising only slightly by 0.1% in July. Household spending continues to decrease, reflecting a decline in consumer confidence. Annual inflation fell from 1.8% in July to 1.6% in August. Imports increased 0.8% (8.2% YoY) while exports were up 3.3% (9.2% YoY). Italy's current outstanding public debt of €1.8 trillion is expected to rise to 118% of GDP by Q4 2010. Still, the country is relatively healthy in terms of its annual budget. The 5.3% deficit-to-GDP ratio is below the European average of 6.6%. Furthermore, Italy has made significant progress in cutting regulatory costs. Direct investment flows inward are currently 1.36% of GDP (up from 0.75% in 2009). Unemployment, meanwhile, has risen to 8.5% Q2 (its highest rate since 2003) and continues to rise. Overall, we believe Italy shows signs of continued yet slowed economic recovery though it maintains poor competitiveness, high government inefficiency and rising debt.

Italy's CDS spreads have fallen in recent months. Still, they are trading at more than three times their target price, indicating a good buy opportunity.

	Annual Ratios					
INDICATIVE CREDIT RATIOS	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13
Debt/ GDP (%)	101.0	116.5	120.9	125.4	130.2	135.1
Govt. Sur/Def to GDP (%)	-2.7	-5.3	-5.6	-5.6	-5.6	-5.6
Adjusted Debt/GDP (%)	106.0	122.0	126.5	131.2	136.0	141.1
Interest/ Taxes %	17.7	15.9	20.0	20.9	21.2	21.4
GDP Growth (%)	-3.3	-2.8	1.0	1.0	1.0	1.0
Foreign Reserves/Debt (%)	1.1	1.4	1.4	1.3	1.3	1.3
Implied Sen. Rating	BBB-	BB+	BBB-	BB	BB	BB

INDICATIVE CREDIT RATIOS	B	BB	BBB	A	AA	AAA
Debt/ GDP (%)	120.0	80.0	60.0	50.0	40.0	30.0
Govt. Sur/Def to GDP (%)	-5.0	-2.0	0.5	3.0	5.0	9.0
Adjusted Debt/GDP (%)	125.0	85.0	65.0	55.0	45.0	35.0
Interest/ Taxes %	22.0	15.0	12.0	9.0	7.0	5.0
GDP Growth (%)	-1.0	1.0	2.0	4.0	5.0	6.0
Foreign Reserves/Debt (%)	9.0	12.0	15.0	20.0	25.0	30.0

PEER RATIOS	S&P Sen.	Debt as a % GDP	Govt. Surp. Def to GDP (%)	Adjusted Debt/ GDP	Interest/ Taxes %	GDP Growth (%)	Ratio-Implied Rating*
Greece	BB+	115.6	-13.6	118.8	25.8	-2.5	BB-
Italy	A+	116.5	-5.3	122.0	15.9	-2.8	BB
Japan	AA	251.5	-2.7	257.6	14.6	-4.1	B
Spain	AA	53.6	-11.1	57.2	9.6	-3.0	BBB+
Germany	AAA	73.4	-3.0	80.2	10.7	-2.0	BBB-



Country (EJR Rtg)	Current CDS	Targeted CDS
Greece (BB)	793	350
Japan (BB+)	62	300
Italy (A)	195	75
Spain (A+)	230	60
Germany (AA)	39	30

Main Economic Indicators

Italy has one of the most developed economies in the world, resulting in high standards of living. Its per capita GDP of US$35,360.86 is higher than the EU average. The Italian economy is exceedingly diversified with a highly developed industrial north and a less developed, welfare-dependent agricultural south. Overall, the economy is driven in large part by the manufacture of high-quality consumer goods.

The country fell into recession during Q2 2008 with -0.7% GDP growth after nearly 12 consecutive quarters of positive economic growth. The economy did not begin to recover until Q3 2009. Now, eight quarters after having initially slipped into recession, Italy has begun to show slight signs of economic recovery due in large part to floating trends on exports and the resilience of household consumption. Q1 2010 GDP increased 0.4% SA over the prior quarter. GDP rose 0.5% during Q2, only half the pace of growth throughout the eurozone in the same period, due mainly to a 3.3% increase in exports.

Italy is currently Europe's most heavily indebted country, which is only enhanced by its slow growth. This year, public debt as a percentage of GDP is expected to rise 3% to 118%. Italy's outstanding public debt is €1.7 trillion euros, seven times the size of Greece. The country's outstanding debt is exceedingly difficult to reduce, and failure to do so will weigh on the economy over the long term. Despite these levels, markets have deemed Italy less risky than other Southern European nations. Italy levies a relatively high tax and social security burden on labor income. On average, single taxpayers take home less than 55% of total labor costs.

Fiscal 2010 Data

Eurozone	Deficit-to-GDP Ratio	Debt-to-GDP Ratio
Austria	-3.40	69.30
Belgium	-6.00	97.60
Cyprus	-6.10	56.20
Finland	-2.20	44.00
France	-7.50	77.50
Germany	-3.30	72.10
Greece	-13.60	113.40
Ireland	-14.30	57.70
Italy	-5.30	115.20
Luxembourg	3.20	14.50
Malta	-2.20	69.10
Netherlands	-5.30	62.20
Portugal	-9.40	76.90
Slovakia	-2.23	35.70
Slovenia	-0.19	35.90
Spain	-11.20	53.20

Source: Bloomberg

Despite massive outstanding debt, Italy is relatively healthy in terms of its annual budget. Its deficit, equivalent to 5.3% of GDP in 2009, is below the EU average of 6.3%. Furthermore, Italy has made significant progress in reducing regulatory costs. Such progress, if continued, will speed up its recovery and make its economy more competitive in the process.

Further Indicators: Inflation, Population and Unemployment

July inflation in Italy rose 1.80% as compared to the year prior. The National Consumer Price Index for the whole nation CPI rose by 0.4% compared to the previous year. The EU Harmonized Index of Consumer Prices declined by 0.9% compared to the previous month, yet rose 1.8% in comparison to the same month of the previous year.

Italy's unemployment rate rose to a seasonally adjusted 8.5% during Q2 2010 from seasonally adjusted 8.4% during Q1 2010. Economists had predicted a rate of 8.6% (seasonally adjusted) for the second quarter.

Population by employment status: June 2010 provisional sstimates (seasonally adjusted)

Absolute values in thousands and changes in thousands and percentages.

	Absolute Values	Changes from the previous month		Changes from the same month of the previous year	
		Absolute	Percentage	Absolute	Percentage
Employed	22929.00	7.00	0.00	-126.00	-0.50
Unemployed	2129.00	-24.00	-1.10	166.00	8.5*
Inactive (aged 15-64)	14876.00	5.00	0.00	103.00	0.70

*Total: 8.5%; Males: 7.7%; Females: 9.6%.

Source: Istat, *Employment and Unemployment: Provisional Estimates June 2010* , July 2010.

Export Dependent Economy

Italy is the world's seventh-largest exporter. Over 60% of its trade is conducted with fellow EU partners. During the most recent quarter of 2010, exports of €38,005 million exceeded imports of €37,872 million.

Throughout the first half of 2010, trade increased by 12.6% for exports (12.2% for EU countries and 13.2% for non EU countries) and by 18.5% for imports (16.2% for EU countries and 21.6% for non EU countries) as compared with the first quarter of 2009. Overall, the trade balance presented a deficit of 14.2 billion euro during the first half of 2010. Foreign trade with non-EU countries presented a surplus (excluding energy) of 14,266 million euros.

Regulatory Environment

The Italian government has made significant progress in cutting regulatory costs, a step which is key to enhancing productivity and, in effect, economic growth. Such reform will also aid in making Italy's economy more competitive on a global scale.

Ease of…*	2010 Rank	2009 Rank	Change in Rank
Doing Business	**78.00**	**74.00**	**-4.00**
Starting a Business	75.00	54.00	-21.00
Dealing with Construction Permits	85.00	81.00	-4.00
Employing Workers	99.00	97.00	-2.00
Registering Property	98.00	97.00	-1.00
Getting Credit	87.00	84.00	-3.00
Protecting Investors	57.00	53.00	-4.00
Paying Taxes	136.00	131.00	-5.00
Trading Across Borders	50.00	51.00	1.00
Enforcing Contracts	156.00	158.00	2.00
Closing a Business	29.00	29.00	0.00

* Measures 183 countries, based on a scale of 1 to 183 with 1 being the highest ranking.

Source: DoingBusiness - The World Bank Group

Nationwide Problems

The country continues to face a number of persistent problems including illegal immigration, organized crime, corruption, high unemployment, slow economic growth and low income in the southern regions (in comparison to the prosperous North). Italy also has widespread tax evasion and a significant underground economy which accounts for roughly 27% of GDP (2008).

The Italian government has been very active in implementing new structural reforms. They have been successful in overhauling costy entitlement programs and in effect increasing opportunities for employment. Reports show that the 2009 tax amnesty program implemented to repatriate untaxed assets held abroad has netted the federal government more than $135 billion.

Planned Austerity Measures

To date, Italy's recovery efforts have remained less successful than that of its European peers. Italy recently passed a €25 billion austerity package aimed at reducing the country's budget deficit. Over the next two years, the government will aim to bring its public deficit down to 2.7% of GDP. The deficit currently stands at 5.3% of GDP, surpassing the EU limit of 3%.

The new budget consists of cuts in transfers to local governments as well as a crackdown on tax evasion. Furthermore, the measures call for a three-year salary freeze on public workers, a three to six month delay in salary retirement dates, and a 10% cut in ministry budgets. Prime Minister Silvio Berlusconi has argued that had the austerity measure not passed, international speculation would have driven the country into an increasingly dangerous economic position. The OECD has forecast that Italy's economy will be the only one among the G7 nations to contract in Q3 2010.

Assumptions for Projections

	Peer	Issuer	Base Case	
Income Statement	**Median**	**Average**	**Yr 1&2**	**Yr 3,4,5**
Taxes Growth%	(4.8)	(3.2)	**(3.0)**	**0.5**
Social Contributions Growth %	(1.9)	(0.4)	**(1.0)**	**(1.0)**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	(7.1)	1.2	**1.0**	**1.0**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	(6.4)	(2.0)	**(2)**	**(2.0)**
Compensation of Employees Growth%	3.5	1.0	**1.0**	**1.0**
Use of Goods & Services Growth%	5.4	7.5	**5.0**	**5.0**
Social Benefits Growth%	5.5	4.9	**3.0**	**3.0**
Subsidies Growth%	0.3	0.3		
Other Expenses Growth%	11.3	11.3	**5.0**	**5.0**
Special Items (millions EUR)	0.0	0.0		
Balance Sheet				
Currency and Deposits Growth%	5.5	18.2	**1.0**	**1.0**
Securities other than Shares LT Growth%	9.9	13.0	**1.0**	**1.0**
Loans Growth%	(1.4)	2.4	**2.4**	**2.4**
Shares and Other Equity Growth%	5.2	1.1	**1.1**	**1.1**
Insurance Technical Reserves Growth%	2.8	2.8	**2.8**	**2.8**
Financial Derivatives Growth%	0.0	0.0		
Other Accounts Receivable LT Growth%	8.0	2.9	**1.0**	**1.0**
Monetary Gold and SDR's Growth %	0.0	0.0	**2.0**	**2.0**
Other Accounts Payable Growth%	9.2	NMF		
Currency & Deposits Growth%	1.4	4.5	**3.0**	**3.0**
Securities Other than Shares Growth%	8.8	8.8	**3.0**	**3.0**
Growth%	0.0	0.0		
Loans Growth%	1.7	1.7	**1.7**	**1.7**
Insurance Technical Reserves Growth(%)	0.0	0.0		
Financial Derivatives Growth%	0.0	0.0		
		0.0		
Addl debt. (1st Year) million EUR	0.0	0.0		

Base Case

ANNUAL REVENUE AND EXPENSE STATEMENT (MILLIONS EUR)

	Dec-07	Dec-08	Dec-09	PDec-10	PDec-11	PDec-12
Taxes	460,574	456,237	441,857	428,601	415,743	417,822
Social Contributions	205,259	215,911	215,003	212,853	210,724	208,617
Grant Revenue	0	0	0	0	0	0
Other Revenue	51,190	51,641	52,274	52,797	53,325	53,858
Other Operating Income	0	0	0	0	0	0
Total Revenue	717,023	723,789	709,134	694,951	681,052	667,431
Compensation of Employees	163,989	169,813	171,578	173,294	175,027	176,777
Use of Goods & Services	81,016	86,241	92,718	97,354	102,222	107,333
Social Benefits	306,247	320,031	335,816	345,890	356,267	366,955
Subsidies	14,872	15,053	15,103	15,105	15,106	15,108
Other Expenses	61,166	59,511	66,239	18,050	18,569	19,103
Grant Expense	0	0	0	0	0	0
Depreciation	27,700	28,965	29,706	29,706	29,706	29,706
Total Expenses	654,990	679,614	711,160	679,398	696,896	714,982
Operating Surplus/Shortfall	62,033	44,175	-2,026	15,553	-15,844	-47,550
Interest Expense	76,753	80,545	70,163	85,627	87,083	88,563
Net Operating Balance	-14,720	-36,370	-72,189	-70,074	-102,926	-136,113

ANNUAL BALANCE SHEETS (MILLIONS EUR)

ASSETS	Dec-07	Dec-08	Dec-09	PDec-10	PDec-11	PDec-12
Currency and Deposits	58,323	67,726	80,032	80,832	81,641	82,457
Securities other than Shares LT	13,680	15,380	17,373	17,547	17,722	17,899
Loans	51,199	53,942	55,226	56,551	57,909	59,298
Shares and Other Equity	145,222	129,184	130,663	132,100	133,553	135,022
Insurance Technical Reserves	1,596	2,207	2,268	2,332	2,397	2,464
Financial Derivatives						
Other Accounts Receivable LT	127,166	130,218	134,016	135,356	136,710	138,077
Monetary Gold and SDR's						
Additional Assets	0	0	0	0	0	0
Total Financial Assets	397,186	398,657	419,578	424,718	429,931	435,218
LIABILITIES						
Other Accounts Payable	56,891	56,216	57,803	57,803	57,803	57,803
Currency & Deposits	211,987	211,158	220,713	249,186	310,152	402,964
Securities Other than Shares	1,333,030	1,403,390	1,526,630	1,572,429	1,619,602	1,668,190
Loans	138,842	133,090	135,390	135,390	135,390	135,390
Insurance Technical Reserves						
Financial Derivatives						
Other Liabilities	650	646	644	1,595	1,595	1,595
Liabilities	1,741,400	1,804,500	1,941,180	2,016,402	2,124,542	2,265,942
Net Financial Worth	(1,344,210)	(1,405,840)	(1,521,610)	(1,591,684)	(1,694,611)	(1,830,724)
Total Liabilities & Equity	397,190	398,660	419,570	424,718	429,931	435,218

Sovereign Rating Methodology

Egan-Jones takes the perspective of the investor as its primary point of view when developing the ratings it issues for sovereigns. Therefore, in the case of sovereign ratings, we attempt to take a more holistic view of credit quality to include not only analytic comparisons of various sovereign issuers but also the impact on our quantitative and qualitative analyses by current global, sovereign, governmental and market events, including the effects of government investments in speculative, volatile or other high risk investment products. For example, many sovereign issuers have taken on significant exposures of major financial institutions over the past several years. Hence, we calculate the under-funding of financial institutions and include this amount in the total indebtedness of sovereigns. (We use a base assumption that no country can afford to allow its major banks to fail and therefore we believe that there will almost always be an intervention by either a host or allied nation should financial institutions or markets require support at some measurable level.)

Generally we devise modeling calculators and do an analysis that examines the debt load of a country with respect to its GDP and other economic indicators. The analysis is then adjusted to reflect the outlook on a myriad of factors that reflect the firm’s overall view of the sovereign debt and the quality of the country’s ability to meet and thrive under such load. Some of the qualitative factors that impact our ultimate assessment of credit quality such as the flexibility, stability and overall strength of the economy, ease of tax collection, acceptance of contract law, ease of doing business, and prospects for future growth and health. The non quant issues are generally subjective and a moving target, so each rating of a sovereign may differ because of the non-quantitative nuances being addressed.

Nota Bene

History has proven that defaults on domestic public debt do occur. In fact, seventy out of three hundred twenty defaults since 1800 have been on domestic public debt (1). Egan-Jones does not view a country's ability to print its own currency as a guarantee against default. Additionally, Egan-Jones generally views cases of excessive currency devaluation as a de facto default.

1. "This Time Is Different: Eight Centuries of Financial Folly", Reinhart & Rogoff, p.111, 126