REPUBLIC OF ITALY

Rating Analysis - 7/11/11
Debt: EUR1,843.0B, Cash: EUR93.3B

EJR Sen Rating(Curr/Prj) BB+/ N/A
EJR CP Rating: A3
EJR's 1 yr. Default Probability: 2.7%

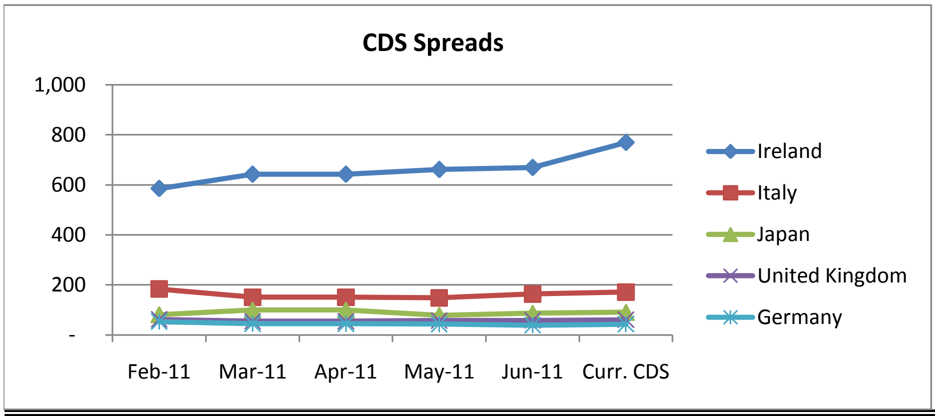
Slipping - the concerns about Greece are spreading to Italy with the upshot being a case where an issuer is guilty until proven innocent. In the case of Italy, our calculation of debt to GDP of 120% or more, and a government deficit of 4+% provides little comfort. Unfortunately, as a result of the problems in Greece, Italy will have to provide additional support to its banks and will see some pressure on its economy. The most immediate concern is that Italy's cost of funding is causing additional pressure. We expect that Italy's banks will be turning to the ECB for deposit support.

On July 14, the Italian Treasury is planning on the sale of €7B in multiple maturity bonds (5 year and 10 year issues) with average interest rates of 3.75% to 4.5%. Spreads on Italian debt have increased to over 4% and are expected to widen as the crisis continues. Italy's CDS spreads compared to the German benchmark are now at 300bps. Italy's 10 year bond yield is now near 5.64%.

	Annual Ratios					
INDICATIVE CREDIT RATIOS	Jun-09	Jun-10	Jun-11	Jun-12	Jun-13	Jun-14
Debt/ GDP (%)	107.9	122.6	125.1	127.7	130.1	132.5
Govt. Sur/Def to GDP (%)	-5.4	-4.6	-0.5	-0.1	-0.1	-0.1
Adjusted Debt/GDP (%)	115.1	130.4	133.1	135.8	138.3	140.9
Interest Expense/ Taxes (%)	15.7	15.4	16.6	18.0	18.8	19.6
GDP Growth (%)	-3.0	1.5	-2.0	-2.0	-1.8	-1.8
Foreign Reserves/Debt (%)	1.4	1.3	1.3	1.2	1.2	1.2
Implied Sen. Rating	BB+	BB	BB	BB	BB	BB

INDICATIVE CREDIT RATIOS	AA	A	BBB	BB	B	CCC
Debt/ GDP (%)	40.0	50.0	60.0	80.0	120.0	150.0
Govt. Sur/Def to GDP (%)	5.0	3.0	0.5	-2.0	-5.0	-9.0
Adjusted Debt/GDP (%)	45.0	55.0	65.0	85.0	125.0	155.0
Interest Expense/ Taxes (%)	7.0	9.0	12.0	15.0	22.0	26.0
GDP Growth (%)	5.0	4.0	2.0	1.0	-1.0	-5.0
Foreign Reserves/Debt (%)	25.0	20.0	15.0	12.0	9.0	7.0

PEER RATIOS	S&P Sen.	Debt as a % GDP	Govt. Surp. Def to GDP (%)	Adjusted Debt/ GDP	Interest Expense/ Taxes %	GDP Growth (%)	Ratio-Implied Rating*
United Kingdom	AAA	98.8	-11.4	121.1	10.3	-4.9	B
Federal Republic Of Germany	AAA	87.8		95.5			BB+
Government Of Canada	AAA	18.2	-5.5	18.2	14.3	0.3	BBB+
Japan	AA-	266.6	-8.7	273.0	14.6	-1.5	CC
Republic Of Ireland	BBB+	91.6	-32.4	105.9		-0.2	BB-



Country (EJR Rtg*)	Current CDS	Targeted CDS
Ireland(BB)	769	400
Italy(BB+)	171	333
Japan(BB+)	91	333
United Kingdom(AA)	61	30
Germany(AA)	43	30

* Projected Rating

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$35,300 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 manufacturing 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, Italy has begun to show slight signs of economic weakness is likely to be manifested along with the increased funding costs. For the most recent quarter, GDP seaasonally adjusted rose a rather tepid .7%. which tops the 1.8% decline recorder a year ago. A major driver of the gain was the 4.1% rise in exports and a recovery in investments from a 12% decline a year ago to a 5% gain for the first quarter. However, we expect weakness.

Italy is currently among the world's most heavily indebted countries, which is only enhanced by its slow growth. This year, public debt as a percentage of GDP is expected to rise 3% to 125%. 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 pay.

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%. Italy successfully narrowed its deficit in the third quarter of 2010, leaving the economy on track to meet the government austerity target of 5% of GDP in 2010. Italy is targeting a public deficit of 3.9% in 2011 and 2.7% in 2012. The country 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 and Unemployment
In November 2010, Italy's National CPI remained unchanged from October 2010 and rose 1.7% in comparison to the same month of the previous year. Meanwhile, the EU's Harmonized Index of Consumer Prices (HICP) rose by 1.9% in comparison to the same month of the previous year.

Unemployment has also increased in recent months. In the first quarter of 2011, the total number of unemployed persons in Italy increased by 200,000 to 2.05 million people, raising the unemployment to 8.17%. During the same quarter, the employment rate decreased to 56.7% from 57.5% in the third quarter of 2009. Italy's statistics office estimates that a total of 22.8 million persons were employed in the third quarter of 2010.

Export Dependent Economy
Italy is the world's seventh-largest exporter. Overall, more than 60% of its trade is conducted with fellow EU partners. 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.

In first quarter 2011, total exports increased by 4% over the prior year. while imports increased by 5.2% YoY. Italy has positives net exports but the expectation is for some deterioration because of problems of other Meditereanean countries. Austerity measures and increased taxes will hurt.

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.

The World Bank Group - Doing Business 2010 Survey: Italy

Ease of…*	2011 Rank	2010 Rank	Change in Rank
Doing Business	**80**	**76**	**0**
Starting a Business	68	74	**-5**
Dealing with Construction Permits	92	85	**0**
Registering Property	95	97	**-1**
Getting Credit	89	87	**0**
Protecting Investors	59	57	**0**
Paying Taxes	128	128	**0**
Trading Across Borders	59	54	**0**
Enforcing Contracts	157	157	**0**
Closing a Business	30	29	**0**

* 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 2011.

Assumptions for Projections

	Peer Median	Issuer Average	Base Case Yr 1&2	Base Case Yr 3,4,5
Income Statement				
Taxes Growth%	0.0	1.0	**(3.0)**	**0.5**
Social Contributions Growth %	0.0	0.5	**0.5**	**0.5**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	0.0	0.0		
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	0.0	0.9	**(2)**	**(1.8)**
Compensation of Employees Growth%	2.3	0.5	**0.5**	**0.5**
Use of Goods & Services Growth%	1.0	0.4	**0.4**	**0.4**
Social Benefits Growth%	0.1	2.1	**3.0**	**3.0**
Subsidies Growth%	0.0	3.9		
Other Expenses Growth%	0.0	0.0	**3.0**	**3.0**
Special Items (millions EUR)	0.0	0.0		
Balance Sheet				
Currency and Deposits Growth%	(24.6)	16.5	**1.0**	**1.0**
Securities other than Shares LT Growth%	16.8	8.4	**1.0**	**1.0**
Loans Growth%	5.1	6.3	**2.0**	**2.0**
Shares and Other Equity Growth%	1.0	(5.3)	**2.0**	**2.0**
Insurance Technical Reserves Growth%	0.0	4.2	**4.2**	**4.2**
Financial Derivatives Growth%	(56.3)	0.0		
Other Accounts Receivable LT Growth%	0.0	0.5	**(3.0)**	**(3.0)**
Monetary Gold and SDR's Growth %	0.0	0.0	**5.0**	**5.0**
Other Accounts Payable Growth%	0.0	NMF		
Currency & Deposits Growth%	(24.6)	(57.7)	**0.5**	**0.5**
Securities Other than Shares Growth%	16.8	(98.7)	**2.0**	**2.0**
Growth%	0.0	0.0		
Loans Growth%	5.1	(57.9)	**0.5**	**0.5**
Insurance Technical Reserves Growth%	0.0	0.0		
Financial Derivatives Growth%	(50.0)	0.0		
Addl debt. (1st Year) million EUR	0.0	0.0		

Base Case

ANNUAL REVENUE AND EXPENSE STATEMENT (MILLIONS EUR)

	Jun-08	Jun-09	Jun-10	PJun-11	PJun-12	PJun-13
Taxes	455,911	441,112	445,416	432,054	419,092	421,187
Social Contributions	215,908	213,542	214,508	215,478	216,453	217,432
Grant Revenue	0	0	0	0	0	0
Other Revenue	0	0	0	0	0	0
Other Operating Income	0	0	0	0	0	0
Total Revenue	723,380	707,017	713,032	647,532	635,545	638,620
Compensation of Employees	169,650	171,026	171,905	172,789	173,677	174,569
Use of Goods & Services	85,606	91,202	91,600	92,000	92,401	92,804
Social Benefits	319,963	336,443	343,608	353,916	364,534	375,470
Subsidies	15,001	15,435	16,040	16,042	16,043	16,045
Other Expenses	0	0	0	0	0	0
Grant Expense	0	0	0	0	0	0
Depreciation	28,985	29,850	31,166	31,166	31,166	31,166
Total Expenses	619,205	643,956	654,319	665,912	677,821	690,054
Operating Surplus/Shortfall	104,175	63,062	58,713	-18,380	-42,276	-51,434
Interest Expense	80,718	69,242	68,379	71,798	75,388	79,157
Net Operating Balance	23,457	-6,180	-9,666	-90,178	-117,663	-130,592

ANNUAL BALANCE SHEETS (MILLIONS EUR)

ASSETS	Jun-08	Jun-09	Jun-10	PJun-11	PJun-12	PJun-13
Currency and Deposits	67,726	80,032	93,271	94,204	95,146	96,097
Securities other than Shares LT	15,698	18,296	19,825	20,023	20,223	20,426
Loans	53,593	54,600	58,019	59,179	60,363	61,570
Shares and Other Equity	129,256	130,664	123,779	126,255	128,780	131,355
Insurance Technical Reserves	1,502	1,543	1,608	1,676	1,746	1,820
Financial Derivatives						
Other Accounts Receivable LT	129,585	130,889	131,522	127,576	123,749	120,037
Monetary Gold and SDR's						
Additional Assets	0	0	0	0	0	0
Total Financial Assets	397,360	416,024	428,024	428,913	430,007	431,305

LIABILITIES	Jun-08	Jun-09	Jun-10	PJun-11	PJun-12	PJun-13
Other Accounts Payable			131,522	131,522	131,522	131,522
Currency & Deposits	211,159	220,713	93,271	1,709,936	1,828,289	1,959,766
Securities Other than Shares	1,403,490	1,526,520	19,825	20,222	20,626	21,038
Loans	135,369	137,662	58,019	58,019	58,019	58,019
Insurance Technical Reserves			1,608	1,608	1,608	1,608
Financial Derivatives						
Other Liabilities	56,225	57,091	1,657,516	131,522	131,522	131,522
Liabilities	1,806,243	1,941,986	1,961,761	2,052,828	2,171,586	2,303,475
Net Financial Worth	(1,408,883)	(1,525,962)	(1,533,737)	(1,623,915)	(1,741,579)	(1,872,170)
Total Liabilities & Equity	397,360	416,024	428,024	428,913	430,007	431,305

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