REPUBLIC OF ITALY

Rating Analysis - 11/28/11
Debt: EUR1,842.8B, Cash: EUR93.3B

EJR Sen Rating(Curr/Prj) BB/ N/A
EJR CP Rating: A3
EJR's 1 yr. Default Probability: 3.0%

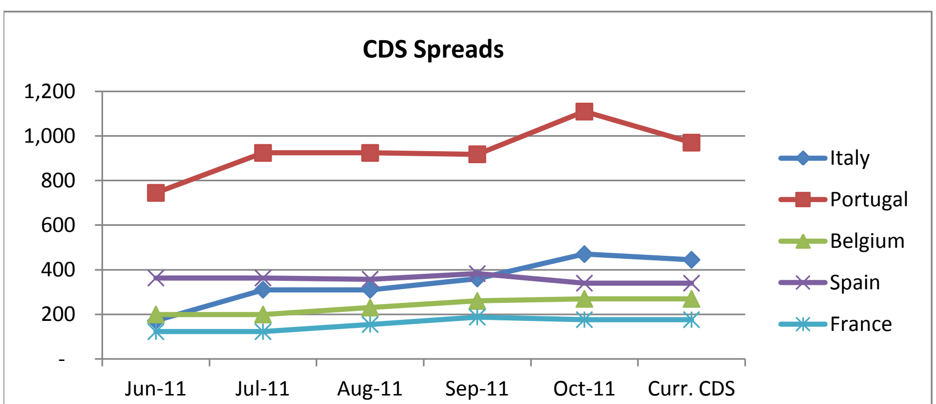
La Acido Vita - from La Dolce Vita, life in Italy has become sour of late; even without the concerns about Greece, Italy is in miserable shape. Over the past 3 fiscal years, total debt has grown by 14.3% while GDP has shrunk by 2.4%. The annual government deficit of EUR68B and the debt to GDP of 119% place additional pressure on credit quality. Furthermore, Italy will probably have to provide additional support to its banks and will see some pressure on its economy. We expect that Italy's banks will continue turning to the ECB and Italy for support.

In 2012, the Republic of Italy needs to finance EUR320B of debt and is likely to experience increasing yields and restricted access without external intervention. As of this weekend the yields on the 6 month notes were 6.5%; rates have been rising despite ECB purchases. The major issue is whether the IMF will become involved and if so, whether the face value of the debt will be cut. Italy cannot support all of its debt.

	Annual Ratios					
INDICATIVE CREDIT RATIOS	Jun-09	Jun-10	Jun-11	PJun-12	PJun-13	PJun-14
Debt/ GDP (%)	110.9	119.2	127.0	135.5	145.9	156.9
Govt. Sur/Def to GDP (%)	-5.4	-4.6	-0.5	-0.1	-0.1	-0.1
Adjusted Debt/GDP (%)	119.8	128.4	136.1	144.5	154.9	165.8
Interest Expense/ Taxes (%)	15.7	15.4	23.0	24.9	26.3	27.8
GDP Growth (%)	-3.0	1.5	0.9	0.9	0.4	0.5
Foreign Reserves/Debt (%)	1.4	1.3	1.2	1.1	1.0	0.9
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*
French Republic	AAA	82.5	-7.1	102.0	9.6	1.4	BB-
Kingdom Of Spain	AA-	60.5	-9.3	70.0	9.7	0.7	BB
Kingdom Of Belgium	AA	96.0	-4.1	121.5	12.1	2.1	BB-
Republic Of Italy	A	119.2	-4.6	128.4	15.4	1.5	B+
Portugal Republic	BBB-	93.6	-9.8	103.5	13.6	1.1	B+



Country (EJR Rtg*)	Current CDS	Targeted CDS
Italy(BB-)	445	500
Portugal(BB-)	970	500
Belgium(BBB-)	269	267
Spain(BBB+)	340	158
France(A+)	176	60

* 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 seasonally adjusted rose a rather tepid .8% although we expect growth will turn negative. A major driver of the gain was the 9.5% rise in exports although the 14.0% rise in imports more than offset the gain. The Balance of Trade has been negative over the past several years and has become increasingly negative. recently.

Italy is currently among the world's most heavily indebted countries, which is exacerbated 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 historically 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.

Additional 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 remains a problem for Italy and is likely to record further increases as austerity measures are implemented. Over the past three quarters, reported unemployment rose from 7.5% to 8.6%. We would not be surprised to see the real unemployment to reach 9.5% within a year as a result of the sluggishness in the EU periphery countries.

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 9.5% over the prior year. while imports increased by 14.0% YoY. Increased energy costs have increased the import number. The expectation is for some deterioration because of problems of other Mediterranean countries. Austerity measures and increased taxes will also hurt.

Ease of Doing Business

The Italian government has attempted to cut regulatory costs, in an effort to enhance productivity and stimulate economic growth. However, as can be seen in the below scale, Italy has slipped in the DB Survey.

The World Bank Group - Doing Business 2010 Survey: Italy

Ease of…*	2012 Rank	2011 Rank	Change in Rank
Doing Business	**87**	**80**	**-7**
Starting a Business	77	68	**-9**
Dealing with Construction Permits	109	92	**-17**
Registering Property	84	95	**11**
Getting Credit	98	89	**-9**
Protecting Investors	65	59	**-6**
Paying Taxes	134	128	**-6**
Trading Across Borders	63	59	**-4**
Enforcing Contracts	158	157	**-1**
Closing a Business	30	30	**0**

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

Source: Doing Business - 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 costly 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. The recent removal of Prime Minister Silvio Berlusconi is unlikely to significantly improve the country's tough credit 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	Issuer	Base Case	
Income Statement	**Median**	**Average**	**Yr 1&2**	**Yr 3,4,5**
Taxes Growth%	5.2	1.0	**(1.0)**	**(0.5)**
Social Contributions Growth %	0.5	0.5	**0.5**	**0.5**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	0.0	1.4	**0.4**	**0.4**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	4.2	0.9	**1**	**0.5**
Compensation of Employees Growth%	0.5	0.5	**0.5**	**0.5**
Use of Goods & Services Growth%	3.0	0.4	**0.4**	**0.4**
Social Benefits Growth%	2.9	2.1	**2.1**	**2.1**
Subsidies Growth%	3.9	3.9	**2.0**	**2.0**
Other Expenses Growth%	(8.1)	(8.1)	**0.1**	**0.1**
Interest Expense	0.0	3.7	**6**	
Balance Sheet				
Currency and Deposits Growth%	12.5	13.8	**1.0**	**1.0**
Securities other than Shares LT Growth%	5.0	8.3	**1.0**	**1.0**
Loans Growth%	16.9	6.6	**3.0**	**3.0**
Shares and Other Equity Growth%	(2.0)	(5.4)	**2.0**	**2.0**
Insurance Technical Reserves Growth%	0.0	(3.8)	**2.0**	**2.0**
Financial Derivatives Growth%	0.0	0.0		
Other Accounts Receivable LT Growth%	3.1	0.5	**(1.0)**	**(1.0)**
Monetary Gold and SDR's Growth %	0.0	0.0	**5.0**	**5.0**
Other Accounts Payable Growth%	2.2	0.5	**0.5**	**0.5**
Currency & Deposits Growth%	0.0	0.0	**0.0**	**0.0**
Securities Other than Shares Growth%	5.3	1.1	**0.7**	**0.7**
Growth%	0.0	0.0		
Loans Growth%	18.1	0.6	**0.6**	**0.6**
Insurance Technical Reserves Growth%	0.0	0.0		
Financial Derivatives Growth%	0.0	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	440,962	436,552	434,370
Social Contributions	215,908	213,542	214,508	215,478	216,453	217,432
Grant Revenue	0	0	0	0	0	0
Other Revenue	51,561	52,364	53,108	53,320	53,534	53,748
Other Operating Income	0	0	0	0	0	0
Total Revenue	723,380	707,018	713,032	709,761	706,539	705,550
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	350,926	358,399	366,032
Subsidies	15,001	15,435	16,040	16,362	16,691	17,027
Other Expenses	74,632	81,460	74,897	81,541	74,972	81,623
Grant Expense	0	0	0	0	0	0
Depreciation	28,985	29,850	31,166	31,789	32,425	33,074
Total Expenses excluding interest	678,836	709,981	713,176	745,407	748,565	765,129
Operating Surplus/Shortfall	44,545	-2,963	-144	-35,646	-42,026	-59,579
Interest Expense	80,718	69,242	68,379	101,355	108,891	114,335
Net Operating Balance	-36,174	-72,205	-68,523	-137,002	-150,917	-173,914

ANNUAL BALANCE SHEETS (MILLIONS EUR)

ASSETS	Jun-08	Jun-09	Jun-10	PJun-11	PJun-12	PJun-13
Currency and Deposits	67,682	81,951	93,271	94,204	95,146	96,097
Securities other than Shares LT	15,749	18,348	19,878	20,077	20,278	20,480
Loans	53,691	54,832	58,467	60,221	62,028	63,888
Shares and Other Equity	129,224	130,501	123,518	125,988	128,508	131,078
Insurance Technical Reserves	1,502	1,513	1,456	1,485	1,515	1,545
Financial Derivatives						
Other Accounts Receivable LT	129,585	130,889	131,522	130,207	128,905	127,616
Monetary Gold and SDR's						
Additional Assets	0	0	0	0	0	0
Total Financial Assets	397,433	418,034	428,112	432,182	436,379	440,705

LIABILITIES						
Other Accounts Payable	129,585	130,889	131,522	132,158	132,797	133,439
Currency & Deposits	211,158	220,713	220,740	278,981	421,852	587,761
Securities Other than Shares	1,403,681	1,526,418	1,542,702	1,554,222	1,565,829	1,577,522
Loans	135,781	136,794	137,604	137,604	137,604	137,604
Insurance Technical Reserves						
Financial Derivatives	646	646	646	646	646	646
Other Liabilities	(74,345)	(74,877)	(70,677)	(3)	(3)	(3)
Liabilities	1,806,506	1,940,583	1,962,537	2,103,608	2,258,722	2,436,963
Net Financial Worth	(1,409,073)	(1,522,549)	(1,534,425)	(1,671,427)	(1,822,343)	(1,996,258)
Total Liabilities & Equity	397,433	418,034	428,112	432,182	436,379	440,705

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