REPUBLIC OF ITALY
Rating Analysis - 7/25/12
Debt: EUR1,897.2B

EJR Sen Rating(Curr/Prj) CCC+/ C+
EJR CP Rating: C
EJR's 1 yr. Default Probability: 22.0%

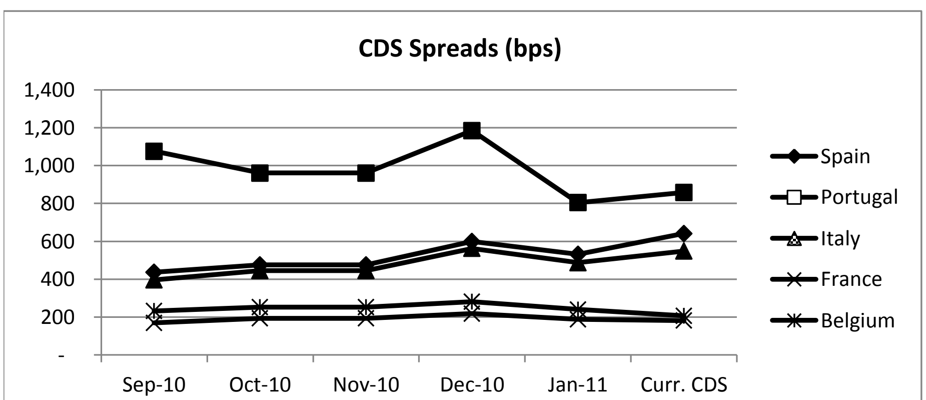
Losing credibility - from 2007 to 2011 Italy's debt to GDP rose from 103% to 120% and with an annual deficit (as a percentage of GDP) near 4.0%, we expect debt to GDP to exceed 125% by the end of 2012. From 2007 to 2011, debt rose 18.4% while during the same period GDP rose only 1.7%. Italy will probably have to provide additional support to its banks and will see some pressure on its economy. Italy's independent ability to support its banks is questionable given the country's and banks' weak condition. The rise in funding costs exacerbates credit pressures.

Italy and its regional governments need to rollover approximately EUR183B in 2012 and EUR214B next year and is likely to experience increasing yields and restricted access without external intervention. Yields on the 10 year bonds are near 6.5%; rates have been rising despite prior ECB purchases. Future intervention by the ECB and IMF will provide some liquidity but might subordinate existing creditors. Italy cannot support all of its debt if the EU economy falters. Debt/GDP will continue to rise and the country will remain pressed. We are downgrading from "B+" to "CCC+", with a neg. watch.

	Annual Ratios (source for past results: IMF)					
INDICATIVE CREDIT RATIOS	2009	2010	2011	P2012	P2013	P2014
Debt/ GDP (%)	116.0	118.7	120.0	129.0	138.7	150.3
Govt. Sur/Def to GDP (%)	-5.4	-4.6	-3.9	-6.6	-7.0	-7.8
Adjusted Debt/GDP (%)	116.0	131.2	132.3	141.9	152.2	164.6
Interest Expense/ Taxes (%)	15.8	15.5	16.7	20.6	21.0	21.8
GDP Growth (%)	-3.5	2.3	-0.5	-4.5	-4.5	-5.0
Foreign Reserves/Debt (%)	1.4	1.3	1.4	1.4	1.3	1.3
Implied Sen. Rating	B	B+	B+	B	B	CCC+

INDICATIVE CREDIT RATIOS	AA	A	BBB	BB	B	CCC
Debt/ GDP (%)	45.0	55.0	75.0	85.0	95.0	145.0
Govt. Sur/Def to GDP (%)	4.0	1.0	-2.0	-5.0	-8.0	-10.0
Adjusted Debt/GDP (%)	40.0	50.0	60.0	80.0	120.0	150.0
Interest Expense/ Taxes (%)	7.0	9.0	12.0	15.0	22.0	26.0
GDP Growth (%)	4.0	3.0	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*
Federal Republic Of Germany	AAA	81.4	-1.0	92.3	11.4	2.0	BBB-
French Republic	AA+	88.9	-5.2	115.3	9.5	1.2	B+
Kingdom Of Belgium	AA	102.1	-3.7	102.1	11.9	1.2	BB
Kingdom Of Spain	BBB+	68.5	-8.5	84.0	12.3	0.3	BBB-
Portugal Republic	BB	106.8	-4.2	118.4	13.0	-2.9	BB-



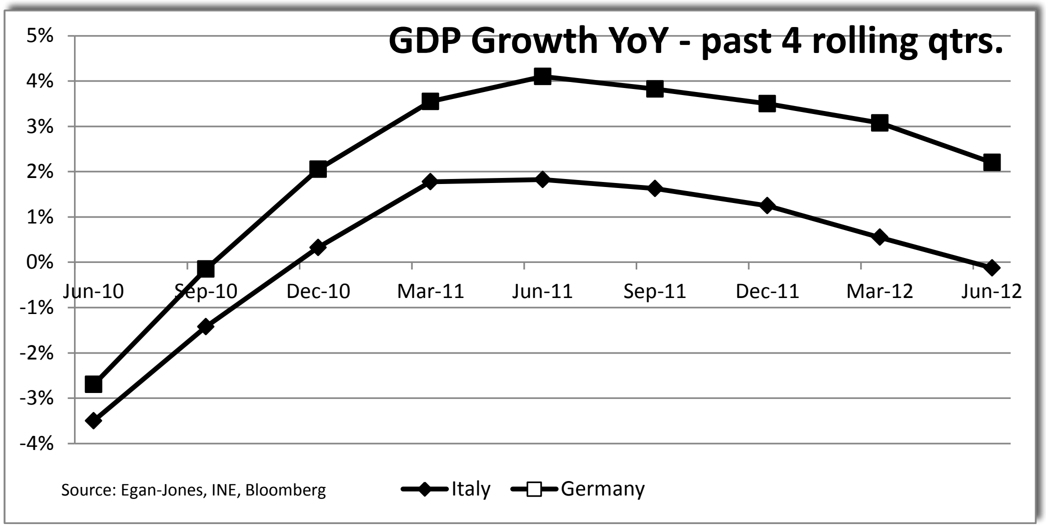
Country (EJR Rtg*)	Current CDS	Targeted CDS
Spain (C)	641	5,000
Portugal (CCC+)	858	1,500
Italy (C+)	550	4,300
France (BBB-)	183	400
Belgium (BBB-)	207	400

* Projected Rating
* EJR's targeted CDS based on rating

Economic Growth

No growth - Italy was hobbled by the global financial crisis of 2007 and did not show signs of a recovery until Sept. of 2010. The country is currently in a recession with economic contraction over the last couple of quarters. For the March 2012 quarter, Italy's GDP declined .6% according to ISTAT (and the second quarter also weak).

As can be seen from the below chart, the Italy's rolling four quarter GDP growth has been negative; Italy is currently shrinking while Germany has recorded growth near 2%. A large portion of Italy's economy is geared to the tourism and light manufacturing industries. The continued weakness in the EU limit's growth in the economy. (Note, the high debt to GDP further depresses growth.)



Fiscal Policy

Italy's deficit to GDP of 3.9% is not comforting and is likely to grow over the next couple of years. From FYE 2009 through 2011, total sovereign revenues rose 1.5% while expenses excluding interest rose 0.4% The major problem for Italy is its high Debt to GDP and support needed for its banks. As can be seen from the chart to the right, none of the listed countries have a worse Debt to GDP than the Italy. Italy's attempts to implement austerity measures and provide real bank relief are likely to fall short and will increase debt.

	Deficit-to-GDP (%)	Debt-to-GDP (%)	5 Yr. CDS Spreads
Italy	3.9	120.0	488
Germany	1.0	70.6	102
France	5.2	74.7	189
Belgium	3.7	85.3	240
Italy	3.9	104.3	488
Portugal	4.2	93.6	805

Sources: Bloomberg and IFS

Unemployment

The Italy's unemployment rate of 9.1% is higher than Germany's and Belgium's as indicated in the chart at right. Furthermore, as of the March 2012 quarter, the rate rose to 9.8%. The weak level of employments will impede the government's attempts to reduce the budget deficit. We expect unemployment to remain high and to climb over the next year.

Unemployment (%)	2010	2011
Italy	8.3	9.1
Germany	7.4	6.8
France	9.6	9.8
Belgium	7.6	7.1
Spain	20.3	22.9
Portugal	11.1	14.0

Source: Intl. Finance Statistics

Banking Sector

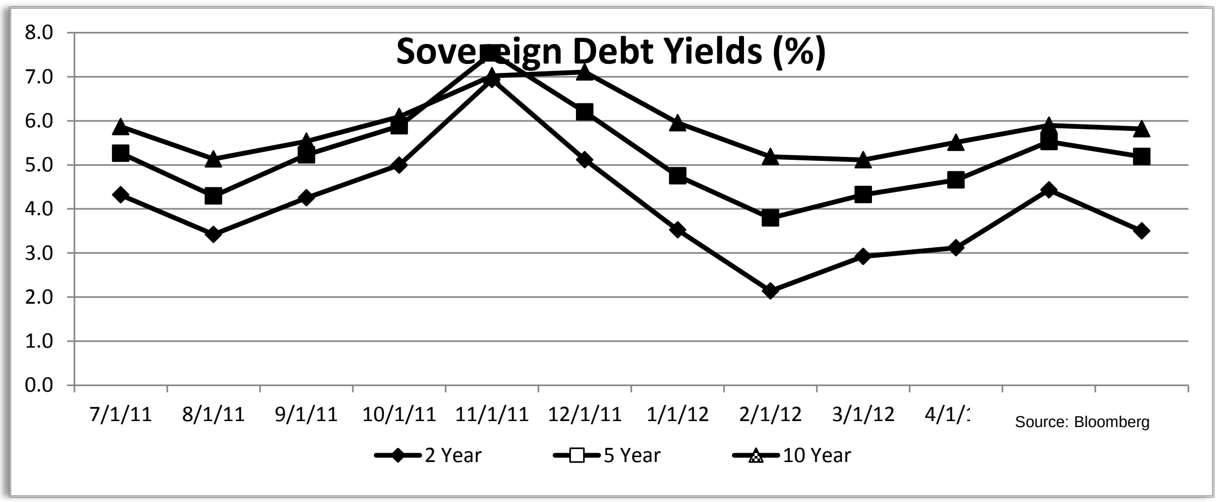
Italy has significantly exposure to its banking because the bank's large aggregate size measured in assets The top five banks have assets equal to 131% of GDP versus 125% for Germany. Italy will probably be expected to provide financial support to its banks over the next couple of quarters to ameliorate asset quality problems; banks appear to be undercapitalized and equity is severely diluted by reserve shortfalls. However, Italy's ability to support its banks is minimal.

Bank Assets (billions of local currency)

	Assets	Cap/ Assets %
UNICREDIT SPA	927	5.9
INTESA SANPAOLO	639	7.5
BANCA MONTE DEI	241	4.6
BANCO POPOLARE S	134	7.0
UBI BANCA SCPA	130	7.6
Total	2,071	
EJR's est. of cap shortfall at 10% of assets less market cap		195
Italy's GDP		1,581

Funding Costs

As a result of the waning of the ECB's LTRO and weakening of Italy's credit metrics, Italy has seen a slight rise in its funding costs over the past couple of months. As can be seen in the below graph, the bond yields have declined since Nov. 2011, but have risen recently. Other EU governments have requested that the ECB, EFSF, and IMF purchase the government's debt. Watch ECB actions to supress Italy's funding costs.



Ease of Doing Business

Major factors for growing the economy are the ease of doing business and the economic freedom; although not the sole factor for determining economic growth, a country which makes it easy for businesses to operate and provides a reasonably free environment to conduct business has a good chance for growth. The chart on the right indicates that with an overall rank of 87 (1 is best) is strong.

The World Bank's Doing Business Survey*

	2012 Rank	2011 Rank	Change in Rank
Overall Country Rank:	**87**	**83**	**-4**
Scores:			
Starting a Business	77	67	-10
Construction Permits	96	93	-3
Getting Electricity	109	108	-1
Registering Property	84	82	-2
Getting Credit	98	96	-2
Protecting Investors	65	60	-5
Paying Taxes	134	131	-3
Trading Across Borders	63	63	0
Enforcing Contracts	158	158	0
Resolving Insolvency	30	30	0

* Based on a scale of 1 to 183 with 1 being the highest ranking.

Economic Freedom

As can be seen below, Italy is above average in its overall rank of 58.8 for Economic Freedom with 100 being best.

Heritage Foundation 2012 Index of Economic Freedom
World Rank 59*

	Rank**	2011 Rank	Change in Rank	World Avg.
Business Freedom	**77.4**	77.3	0.1	64.3
Trade Freedom	**87.1**	87.6	-0.5	74.8
Fiscal Freedom	**55.0**	55.4	-0.4	76.3
Government Spending	**19.4**	28.6	-9.2	63.9
Monetary Freedom	**82.0**	82.1	-0.1	73.4
Investment Freedom	**75.0**	75.0	0.0	50.2
Financial Freedom	**60.0**	60.0	0.0	48.5
Property Rights	**50.0**	50.0	0.0	43.5
Freedom from Corruption	**39.0**	43.0	-4.0	40.5
Labor Freedom	**43.0**	44.4	-1.4	61.5

*Based on a scale of 1-100 with 100 being the highest ranking.
**The ten economic freedoms are based on a scale of 0 (least free) to 100 (most free).
Source: The Heritage Foundation & Wall Street Journal

Assumptions for Projections

	Peer	Issuer	Base Case	
Income Statement	**Median**	**Average**	**Yr 1&2**	**Yr 3,4,5**
Taxes Growth%	4.9	1.7	**1.0**	**1.0**
Social Contributions Growth %	2.0	1.4	**1.0**	**1.0**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	12.1	5.0	**1.0**	**1.0**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	5.8	1.9	**(5)**	**(5.0)**
Compensation of Employees Growth%	2.0	(1.2)	**1.0**	**1.0**
Use of Goods & Services Growth%	4.0	1.2	**1.2**	**1.2**
Social Benefits Growth%	2.4	1.7	**1.7**	**1.7**
Subsidies Growth%	(3.8)	(6.3)		
Other Expenses Growth%	(4.4)	(4.4)	**(4.4)**	**(4.4)**
Interest Expense	0.0	4.0	**5**	**6.0**
Balance Sheet				
Currency and Deposits (asset) Growth%	(36.0)	0.0		
Securities other than Shares LT (asset) Growth%	(7.2)	9.3	**1.1**	**1.1**
Loans (asset) Growth%	30.1	14.4	**1.0**	**1.0**
Shares and Other Equity (asset) Growth%	(1.7)	(3.4)	**2.0**	**2.0**
Insurance Technical Reserves (asset) Growth%	3.0	6.2	**6.2**	**6.2**
Financial Derivatives (asset) Growth%	0.0	0.0		
Other Accounts Receivable LT Growth%	4.1	0.5	**0.5**	**0.5**
Monetary Gold and SDR's Growth %	0.0	0.0	**5.0**	**5.0**
Other Accounts Payable Growth%	0.2			
Currency & Deposits (liability) Growth%	2.8	(3.0)	**0.5**	**0.5**
Securities Other than Shares (liability) Growth%	7.6	(4.9)	**(3.4)**	**(3.4)**
Loans (liability) Growth%	7.2	3.1	**3.1**	**3.1**
Insurance Technical Reserves (liability) Growth%	0.0	0.0		
Financial Derivatives (liability) Growth%	0.0	0.0		
Addl debt. (1st Year) million EUR	0.0	0.0		

Base Case
ANNUAL REVENUE AND EXPENSE STATEMENT (MILLIONS EUR)

	Dec-09	Dec-10	Dec-11	PDec-12	PDec-13	PDec-14
Taxes	**441,511**	**447,591**	**455,303**	**459,856**	**464,454**	**469,099**
Social Contributions	**212,555**	**213,398**	**216,340**	**218,503**	**220,688**	**222,895**
Grant Revenue	**0**	**0**	**0**	**0**	**0**	**0**
Other Revenue	**52,715**	**53,970**	**56,691**	**57,258**	**57,830**	**58,409**
Other Operating Income	**0**	**0**	**0**	**0**	**0**	**0**
Total Revenue	**706,781**	**714,959**	**728,334**	**735,617**	**742,973**	**750,403**
Compensation of Employees	**171,050**	**172,085**	**170,052**	**171,753**	**173,470**	**175,205**
Use of Goods & Services	**89,676**	**90,484**	**91,527**	**92,582**	**93,649**	**94,729**
Social Benefits	**336,211**	**344,032**	**349,721**	**355,504**	**361,383**	**367,359**
Subsidies	**16,743**	**17,786**	**16,673**	**16,675**	**16,676**	**16,678**
Other Expenses	**83,231**	**76,325**	**73,004**	**73,004**	**69,828**	**69,828**
Grant Expense	**0**	**0**	**0**	**0**	**0**	**0**
Depreciation	**30,118**	**31,359**	**31,293**	**31,293**	**31,293**	**31,293**
Total Expenses excluding interest	**710,286**	**714,285**	**715,597**	**740,811**	**746,299**	**755,091**
Operating Surplus/Shortfall	**-3,505**	**674**	**12,737**	**-5,193**	**-3,326**	**-4,688**
Interest Expense	**69,697**	**69,165**	**76,059**	**94,859**	**97,351**	**102,218**
Net Operating Balance	**-73,202**	**-68,491**	**-63,322**	**-100,052**	**-100,676**	**-106,906**

Base Case
ANNUAL BALANCE SHEETS (MILLIONS EUR)

ASSETS	**Dec-09**	**Dec-10**	**Dec-11**	**PDec-12**	**PDec-13**	**PDec-14**
Currency and Deposits (asset)	**81,951**	**93,271**				
Securities other than Shares LT (asset)	**18,298**	**21,004**	**22,957**	**23,210**	**23,465**	**23,723**
Loans (asset)	**55,045**	**58,464**	**66,876**	**67,545**	**68,220**	**68,902**
Shares and Other Equity (asset)	**130,471**	**123,357**	**119,176**	**121,560**	**123,991**	**126,471**
Insurance Technical Reserves (asset)	**1,513**	**1,456**	**1,546**	**1,642**	**1,743**	**1,851**
Other Accounts Receivable LT	**125,899**	**125,538**	**126,151**	**126,767**	**127,386**	**128,008**
Monetary Gold and SDR's						
Additional Assets	**(902)**	**(894)**	**73,242**			
Total Financial Assets	**412,275**	**422,196**	**409,948**	**340,722**	**344,805**	**348,955**
LIABILITIES						
Other Accounts Payable						
Currency & Deposits (liability)	**220,713**	**220,740**	**214,182**	**214,182**	**214,182**	**214,182**
Securities Other than Shares (liability)	**1,526,411**	**1,542,773**	**1,467,340**	**1,417,119**	**1,368,616**	**1,321,774**
Loans (liability)	**135,843**	**136,902**	**141,175**	**241,227**	**341,904**	**448,810**
Insurance Technical Reserves (liability)						
Financial Derivatives (liability)	**646**	**646**	**646**	**646**	**646**	**646**
Other Liabilities	**56,796**	**62,162**	**68,511**	**49,507**	**49,507**	**49,507**
Liabilities	**1,940,409**	**1,963,223**	**1,891,854**	**1,922,681**	**2,027,439**	**2,138,495**
Net Financial Worth	**(1,528,134)**	**(1,541,027)**	**(1,481,906)**	**(1,581,958)**	**(1,682,635)**	**(1,789,541)**
Total Liabilities & Equity	**412,275**	**422,196**	**409,948**	**340,722**	**344,805**	**348,955**

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. Note, debt levels for many sovereign issuers have increased over the past decade and has accelerated recently, effecting the implied ratings.

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