

Credit Analysis

Italy

Ratings

Foreign Currency	
Long-Term IDR	AA-
Short-Term IDR	F1+
Local Currency	
Long-Term IDR	AA-
Country Ceiling	AAA

Outlooks

Foreign-Currency Long-Term IDR	Stable
Local-Currency Long-Term IDR	Stable

Financial Data

Italy	
USDbn	2008
GDP	2,302.8
GDP per head (USD 000)	39
Population (m)	59
International reserves	105.8
Net external debt (% GDP)	31.7
Central government total debt (% GDP)	99
CG foreign-currency debt	5
CG domestically issued debt (EURbn)	1,488.8

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Related Research

- *Major Western European Banks' Exposure to Eastern Europe and the CIS: Downside Risk Contained? (April 2009)*
- *Financial-Sector Support by High-Grade Sovereigns – an Update (May 2009)*
- *Global Economic Outlook (June 2009)*
- *Guide to Sovereign Credit Report (October 2008)*
- *Sovereign Rating Methodology (October 2007)*
- *Bank Systemic Risk Report (May 2009)*

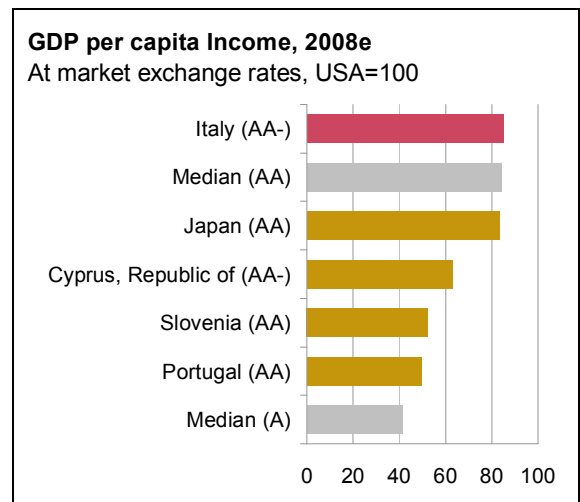
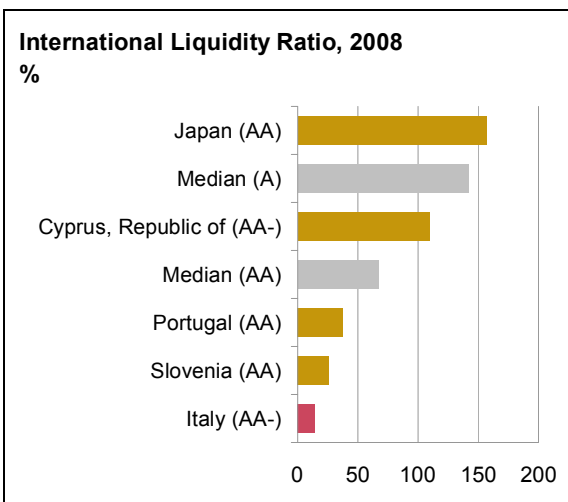
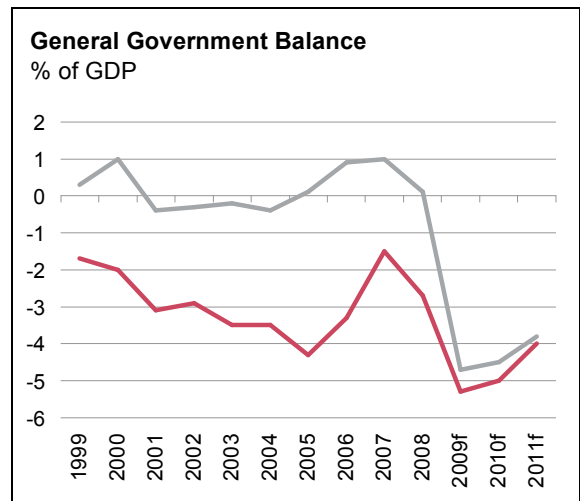
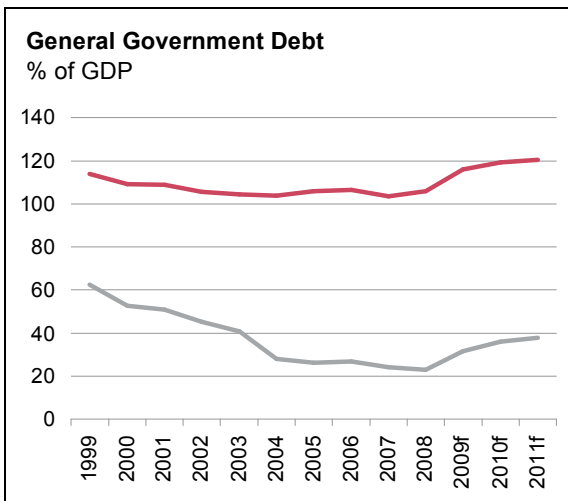
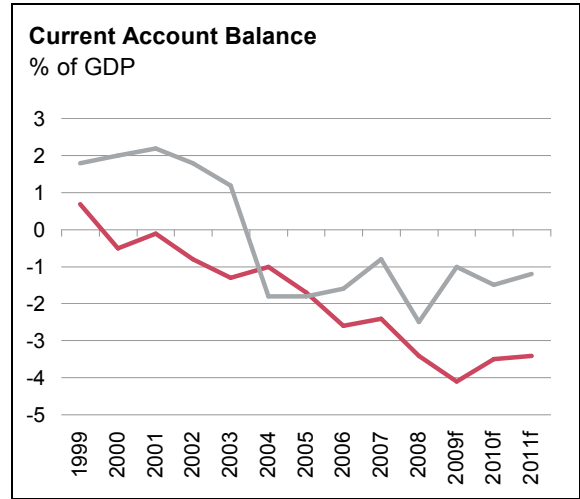
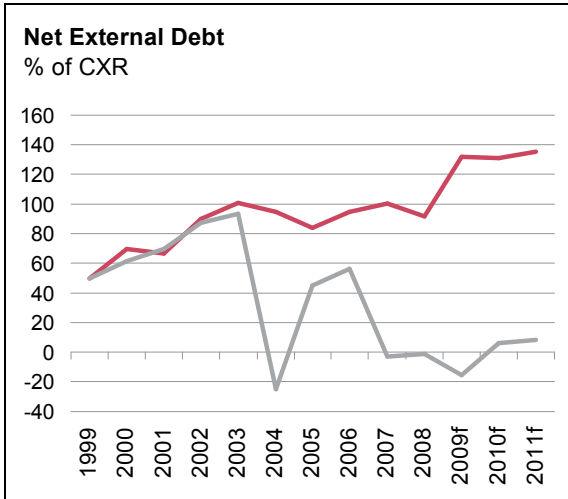
Rating Rationale

- Italy has been relatively insulated from the direct fall-out of the global financial crisis. Italian banks' heavy reliance on retail funding, low leverage ratios and traditional commercial banking approach helped them weather the subprime shock, although asset quality is now deteriorating due to the recession and exposures in eastern Europe. Support for the banking sector has been limited to post-Lehman liquidity measures, a small-scale re-capitalisation programme and guarantee programmes that have not been used.
- The projected widening in the fiscal deficit is significantly less than for other high-grade sovereigns and can be attributed nearly entirely to the economic cycle. The authorities have announced discretionary policy easing measures to the tune of 1.8% of GDP, but these are offset fully by tax increases and expenditure cuts elsewhere. This fiscally neutral approach to policy easing may weigh on short-term economic growth but is fiscally responsible in light of the constraints posed by high debt levels.
- Nevertheless, the Italian economy has been hit hard by the global recession and the shock will exacerbate long-standing weaknesses in growth, competitiveness and the public finances. Six consecutive quarters of negative growth since mid-2007 have seen Italy suffer the largest cumulative GDP loss among the G7 with the exception of Japan. Fitch Ratings expects public debt to rise to close to 120% of GDP by the end of next year, taking it back to levels last seen in the mid-1990s, before Italy joined EMU.
- Lower interest costs and longer debt maturities – thanks to EMU membership and effective public debt management – mean that the burden of servicing public debt will remain substantially below that in the mid-1990s. In addition, there has recently been some progress in improving product market competitiveness (a factor that has played a large part in Italy's weak growth performance over the last five to 10 years), strengthening medium-term fiscal planning and laying the groundwork for expenditure consolidation.
- But structural fiscal weaknesses remain and it will be crucial to see medium-term consolidation plans reinvigorated in the aftermath of the global crisis. The latest Economic and Financial Planning Document (DPEF June 2009) shows only a modest pace of structural fiscal tightening from 2011, significantly weaker than set out in earlier plans despite higher projected debt levels. And while important groundwork has been done on expenditure consolidation, the government has yet to demonstrate success in reducing current primary expenditure, necessary to secure lasting fiscal improvements.
- Italy's creditworthiness remains supported by its wealthy, high-income and diversified economy; a large and stable tax base; the authorities' substantial financing flexibility, thanks to a deep and liquid bond market; and low and stable inflation, enhanced by EMU membership.

Key Rating Drivers

- It will be necessary to reinvigorate medium-term fiscal consolidation plans in the aftermath of the global economic crisis
- Demonstrable progress in implementing public expenditure rationalisation and medium-term growth performance will be key for public debt dynamics and the outlook for creditworthiness.

Peer Comparison



— Italy

— Medians

Rating Factors

Peer Group

Rating	Country
AA	Hong Kong
	Japan
	Kuwait
	Portugal
	Slovenia
AA-	Italy
	Cyprus
	San Marino
	Saudi Arabia
A+	China
	Czech Republic
	Korea
	Malta
	Slovakia
	Taiwan

Rating History

Date	Long-Term Foreign Currency	Long-Term Local Currency
19 Oct 2006	AA-	AA-
17 Jun 2002	AA	AA
14 July 1998	AA-	AA-
26 Oct 1995	AA-	AAA
23 Feb 1995	AA-	-
10 Aug 1994	AA	-

Summary: Strengths and Weaknesses

Rating factor	Macroeconomic	Public finances	External finances	Structural issues
Status	Neutral	Weakness	Neutral	Weakness
Trend	Stable	Negative	Stable	Stable

Note: Relative to 'AA' category
Source: Fitch

Strengths

- The Italian economy is wealthy and income per capita is high
- The industrial base is sophisticated and diversified
- Inflation is low and stable and economic growth, while weak, has been steady
- EMU membership has enhanced external stability, anchored inflation expectations and provided banks access to the European Central Bank (ECB) as lender of last resort
- The government bond market is large, deep and liquid, enhancing the authorities' financing flexibility

Weaknesses

- Public debt is high
- Economic growth has been the lowest among high-grade sovereigns over the last five years
- Poor productivity performance has contributed to deteriorating labour cost competitiveness and sizeable loss of export market shares
- Product and labour market rigidities persist, despite recent improvements
- Italy scores worse than the 'AA' median (sovereigns rated 'AA+', 'AA' or 'AA-') on four out of six of the World Bank's Governance Indicators (used to help inform Fitch's qualitative judgements of political risk) including government effectiveness, rule of law, control of corruption and political stability

Local Currency Rating

For euro area sovereigns, Fitch sets equal Local-Currency (LC) and Foreign-Currency (FC) Ratings (at 'AA-' in the case of Italy). This reflects the absence of factors that would usually lead the LC Rating to be higher than the FC Rating. Firstly, euro area sovereigns have limited ability to monetise their domestic debt stock and lack preferential access to domestic capital markets. Secondly, the EUR's status as a reserve currency makes the prospect of a currency crisis very unlikely. This implies that, even though Italy earns the bulk of its income in EUR, there is no significant difference in the sovereign's ability to service FC or LC (ie EUR) debt.

Country Ceiling

Fitch assigns a single 'AAA' Country Ceiling for all 16 euro area members. These sovereigns lack preferential access to foreign exchange and are unable to impose capital controls. Therefore the risk that a resident entity will be unable to transfer funds to a non-resident creditor due to an inability to convert EUR into FC – transfer and convertibility (T&C) risk – is considered independent of the host sovereign's default risk. The 'AAA' ceiling reflects this euro-area-wide T&C risk.

Outlook and Key Issues

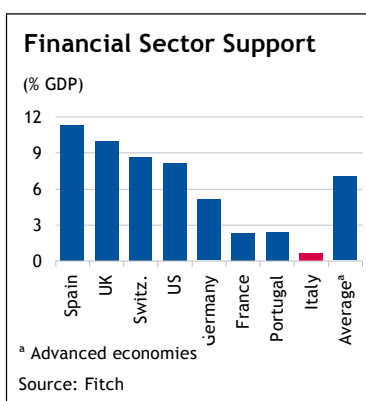
While Italy has been relatively insulated from the direct fall-out of the global financial crisis, it has been hit hard by the global recession and the shock will exacerbate long-running fiscal and growth weaknesses. The authorities' discretionary fiscal response to the crisis has been appropriately limited in light of fiscal constraints, but the deficit will nevertheless rise to its highest level since the mid-1990s this year, with Fitch projecting public debt to rise to 120% of GDP by 2011, close to the peaks reached in the years prior to EMU entry. The burden of servicing this debt will remain well below mid-1990s levels thanks to lower interest rates and effective debt management policies, but projected debt levels amplify the need to re-invigorate consolidation plans after the global crisis.

Banking Sector Has Shown Relative Resilience, Economy Has Not

Italy's banking sector has fared comparatively well through the global banking crisis. No large or medium-sized banks have failed or fallen short of regulatory minimum capital requirements; to date banks have not resorted to issuing state-guaranteed debt; and the overall size of state injections of capital has been small. Exposure to subprime-related toxic assets and the freeze in global interbank markets in late 2008 was limited by a large retail funding base (both in the form of deposits and retail bonds), heavy focus on traditional commercial banking business, relatively low leverage and strong regulatory provisions. In addition, low levels of private-sector debt and modest rates of real-estate price inflation have left the Italian banking sector as a whole less vulnerable to household debt problems evident in some other European economies.

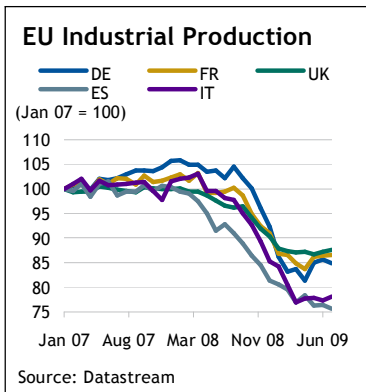
Nevertheless, asset quality is deteriorating, with Banca d'Italia (BdI) data showing a rise in banks' non-performing loans (NPLs) to 5.7% of total loans at end-2008 from 4.6% at end-2007, with further increases this year. The recession and rising unemployment are likely to contribute to a further rise in domestic NPLs, with the real-estate development and SME sectors particular sources of concern. Furthermore, the two largest banks – UniCredit S.p.A. (Long-Term IDR 'A'/Negative Outlook) and Intesa Sanpaolo ('AA-'/Stable) – have significant exposures to economies in eastern Europe and the Commonwealth of Independent States suffering deep recessions. UniCredit's Long-Term IDR was downgraded from 'A+'/Negative in April due largely to its exposure to eastern Europe.¹

As elsewhere, significant sovereign support was deemed necessary to maintain the stability of the Italian banking sector following the collapse of Lehman Brothers. On the liquidity front, the authorities established a temporary new bank debt guarantee programme, a swap facility whereby banks can swap non-ECB-eligible collateral for government bonds and a guarantee arrangement for banks' borrowing ECB-eligible collateral from third parties (including non-banks). In addition, the government issued a guarantee to the relatively generous deposit protection scheme, which insures deposits up to a maximum of EUR103,291 per depositor. A state recapitalisation scheme in the form of hybrid convertible bonds was also announced. While no maximum aggregate amount has been specified, indications suggest that around EUR10bn or 0.7% of GDP is expected. To date only one bank (Banco Popolare; 'A-'/Rating Watch Negative) has received capital (of EUR1.45bn), but four others are in the process of receiving capital. However, with banks to date not having issued state-guaranteed debt and the scale of the government bond swap scheme limited to EUR40bn (2.5% of GDP), it is clear that the fiscal implications of measures taken to support the financial sector are modest by the standards of other high-grade sovereigns (see "Financial Sector Support" chart).²

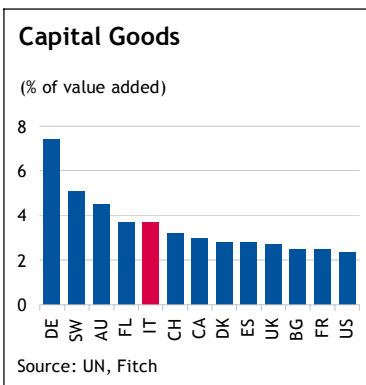


¹ "Major Western European Banks' Exposure to Eastern Europe and the CIS"; see Related Research on page 1 of this report

² "Financial-Sector Support by High-Grade Sovereigns - an Update"; see Related Research on page 1 of this report



The relative resilience of the banking sector has not been matched by the performance of the Italian economy (see “EU Industrial Production” chart). Despite lower exposure to private-sector deleveraging and a much smaller export sector compared with Germany, real GDP was down by 6% in the year to 09Q2, a sharper decline than in the US, UK or Germany. Italy has experienced six quarters of negative growth since the middle of 2007, compared with five in the US, UK and the euro area as a whole. The cumulative loss of output since Q207, at 6.3%, has only been exceeded, among the G7, in Japan. To some extent this underperformance may reflect the industrial orientation of the economy, whereby capital-goods industries – which were hit particularly hard at a global level by the collapse in world trade from late 2008 – make up a high share of value-added relative to other advanced economies (see “Capital Goods” chart). However, it also likely reflects the weak starting base for growth – GDP grew at just 1% a year over 2004-2008, the lowest rate among all countries rated in the ‘AA’ and ‘AAA’ categories by Fitch.



Nevertheless, high-frequency data suggest that the economy may be close to bottoming out: purchasing managers indices have picked up to pre-Lehman levels, car registrations are rising by nearly 9% annually thanks to the scrapping scheme, industrial production has shown some recent signs of stabilisation, and business sentiment has recovered from lows seen in March. Fitch expects a very shallow recovery to take hold from around the turn of the year, in line with a wider euro area expansion, with growth averaging 0.5% in 2010 as a whole. While fiscal policy will be less supportive than elsewhere, private-sector deleveraging pressures will be less intense and will be softened by the decline in interest rates, given that two-thirds of mortgages pay interest at variable rates.

Constrained Discretionary Stimulus, But Debt Will Reach 15-Year High

The authorities have strived hard to provide fiscal support to the economy within the constraints imposed by high public debt levels. Two sets of stimulus measures have been presented: the main package, announced in November 2008 and extended in early 2009 worth EUR27bn (or 1.8% of GDP) in gross terms over 2008-2011 and a subsequent stimulus package tabled in July 2009 (Decree Law 78) worth a further EUR11.4bn (0.7% of GDP) over 2009-2012. But both sets of measures are intended to be fiscally neutral, with easing measures offset by spending cuts or tax increases elsewhere. The largest of the main measures include cuts in corporate tax rates, a strengthening of the SME guarantee fund, “green” subsidies for car purchases and the scrapping of older cars, an income support bonus for the lowest-income families and strengthened unemployment benefits. Decree Law 78 entails tax breaks on investment, further enhancements of unemployment benefits, wage subsidies and training measures. In addition state-owned postal savings bank Cassa Depositi e Prestiti (‘AA-’/Stable) is expanding its lending to support investment.

The government is relying on these measures providing a boost to spending by targeting support on groups with a particularly high marginal propensity to consume or on areas of expenditure hit particularly hard by the global recession and credit crunch, including capital goods and consumer durables. The government estimates that the main measures will boost GDP by 0.6% in 2009 and 0.4% in 2010. However, given that the measures are being offset euro for euro by cuts in spending elsewhere or tax increases, the net effects on demand are, in Fitch’s opinion, likely to be significantly smaller. Offsetting savings identified in the main package include accounting changes to asset valuations that will increase corporate taxes, other procedural changes to tax collection and assessments, as well as cuts in capital and current expenditure budgets, including the Local Development Fund. Decree Law 78 introduced a tax amnesty on Italians repatriating offshore savings, changes to the system of tax offsets and the release of gaming concessions. The decree also proposed a measure to tax capital gains on Bdl’s gold holdings, but the ECB has objected to this on the basis that it would impair Bdl’s financial and institutional independence.

The lack of discretionary easing in net terms means that most of the anticipated deterioration in the deficit can be explained by cyclical factors. Moreover, the anticipated increase in the deficit over 2007 to 2009, at 3.8pp of GDP, is just half the average across all 'AA' or 'AAA' sovereigns, thanks also to the fact that property taxes make up a significantly lower share of GDP than in some other advanced economies. Nevertheless, the combination of a deficit of 5.3% of GDP, the financing of bank recapitalisation and a 3.6% decline in nominal GDP will see debt rise to over 115% of GDP by end-2009. With the deficit remaining wide and growth slow, Fitch projects debt to increase further to 120% by end-2010, a level last seen in the mid-1990s before Italy entered EMU.

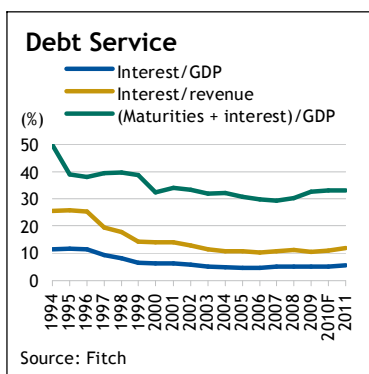
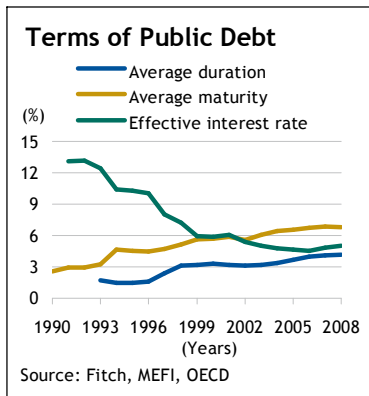
However, the credit implications of this projected rise in debt need to be seen in the context of a major improvement in the terms of the debt and the debt service burden. EMU membership and effective debt management policies have allowed the government to reduce the average cost of its debt dramatically – a trend that has been maintained through the crisis, with 10-year bond yields remaining in the 4%-5% range despite the rise in spreads over bunds – and to increase its maturity and duration sharply (see “Terms of Public Debt” chart). Consequently Fitch projects the debt service burden to remain sharply lower than in the mid-1990s, both in terms of interest payments and refinancing. In particular, interest payments are projected to remain below 12% of revenue in the next two to three years compared with over 25% in the mid-1990s (see “Debt Service” chart).

The rise in duration – partly related to a sharp decline in reliance on Treasury bill issuance compared with the mid-1990s – has also significantly reduced the sensitivity of the interest burden to shocks to interest rates. The government estimates that a 100bp rise in interest rates across the yield curve would now add 0.37% of GDP to the interest burden after two years. Fitch estimates that with the duration of public debt in the mid-1990s less than two years, the impact of the same interest shock would, at that time, have been around three times as large. These improvements in the terms of Italian public debt are reflected in the government’s status as a large, regular and liquid issuer in euro area sovereign debt markets with a weight of around 22% in the major global fixed-income indices. This has helped the government navigate a period of high volatility in euro sovereign bond markets with exceptional levels of issuance across the currency bloc.

Medium-Term Consolidation Plans Will Need Re-Invigoration

However, while the expected fiscal deterioration may look moderate relative to some other advanced economies this has to be seen in the context of the medium-term consolidation plans previously in place. Both the current government and the previous Prodi administration had set out ambitious goals for public debt reduction which have now been suspended. The June 2008 Economic and Financial Planning Document (DPEF 2008) established a goal of balancing the budget in 2012 (and the structural budget in 2011), a path which put the debt/GDP ratio on a projected firm downward trend of 3%-4% a year from 2009. By contrast, DPEF 2009 shows not only that this year’s discretionary stance has been revised to a neutral one, but the pace of tightening over the medium term is much slower, with deficits throughout and no return to structural balance even by 2013 (see table below).

Significant budgetary reforms have recently been implemented with a view to supporting consolidation and rationalisation in primary spending, including: the adoption for the first time of multi-year budget targets in DPEF 2008; a comprehensive review of public expenditure entailing zero-based budgeting; and stronger controls on local government finances and healthcare spending.



Official Medium-Term Projections for Borrowing and Debt

(% GDP)	2008	2009f	2010f	2011f	2012f	2013f
DPEF 2009 - Deficit	2.7	5.3	5.0	4.0	2.9	2.4
DPEF 2009 - Debt	105.7	115.3	118.2	118.0	116.5	114.1
DPEF 2008 - Deficit	2.5	2.0	1.0	0.1	0.0	-0.1
DPEF 2008 - Debt	103.9	102.7	100.4	97.2	93.6	90.1
Memo items						
GDP growth - DPEF 2009	-1.0	-5.2	0.5	2.0	2.0	2.0
GDP growth - DPEF 2008	0.5	0.9	1.2	1.3	1.5	1.5
Structural deficit ^a - DPEF 2009	3.4	3.1	2.8	2.5	2.1	2.2
Structural deficit ^a - DPEF 2008	2.3	1.7	0.6	-0.3	-0.2	-0.2

^a Cyclically adjusted budget deficit excluding one-offs

Source: MEFI - Economic and Financial Planning documents 2009-2013 and 2010-2013

But while these measures give some confidence that a strong consolidation agenda will re-emerge, there has been little progress to date in reducing primary spending and it is hard to see how this can be achieved without addressing public-sector compensation, given the overall degree of rigidity on the spending side. Moreover, the 2008 fiscal outturn showed a widening in the structural deficit that partly reflected discretionary policy easing following positive revenue surprises in the course of 2007. Higher debt levels as a result of the crisis also mean that a greater “fiscal effort” will be necessary to stabilise debt. For example, the primary surplus necessary to stabilise debt at 120% of GDP would be around 2.4%, some 0.5% of GDP higher than with debt at 100% (for a country with real interest rates of 3% and growth of 1%.) Admittedly, most advanced-country governments have yet to articulate fully plans for stabilising and reducing public debt in the aftermath of the global crisis. Nevertheless, the Italian authorities – despite facing a less severe fiscal shock than some – will need to set out stronger adjustment plans over the course of 2010 to reduce debt faster over the medium term and underpin the credibility of previously laid out consolidation goals.

Forecast Summary

	2005	2006	2007	2008	2009f	2010f	2011f
Macroeconomic indicators and policy							
Real GDP growth (%)	0.8	2.1	1.5	-1.0	-5.0	0.5	1.3
Consumer prices (annual average % change)	2.2	2.2	2.0	3.5	1.1	0.7	0.7
Short-term interest rate (%) ^a	2.0	2.8	3.8	3.9	1.3	1.0	1.5
General government balance (% of GDP)	-4.3	-3.3	-1.5	-2.7	-5.3	-4.9	-4.0
General government debt (% of GDP)	105.8	106.4	103.5	105.8	115.4	118.4	120.1
EUR per USD (annual average)	0.8	0.8	0.7	0.7	0.7	0.7	0.7
Real effective exchange rate (2000 = 100)	117.1	118.8	119.7	122.5	122.9	123.1	124.1
External finance							
Current account balance (USDbn)	-29.7	-48.0	-51.0	-78.0	-82.7	-79.0	-83.3
Current account balance (% of GDP)	-1.7	-2.6	-2.4	-3.4	-3.9	-3.6	-3.7
Current account balance plus net FDI (% of GDP)	-2.9	-2.8	-4.9	-4.8	-4.9	-4.5	-4.5
Net external debt (USDbn)	458.0	579.4	732.1	729.1	845.9	887.9	937.2
Net external debt (% of GDP)	25.8	31.1	34.6	31.7	40.3	39.9	41.4
Net external debt (% of CXR)	83.8	94.8	100.3	91.5	132.0	130.8	135.1
Official international reserves including gold (USDbn)	60.6	73.3	83.3	105.8	111.0	111.5	107.0
Official international reserves (months of CXP cover)	1.3	1.3	1.3	1.5	1.8	1.8	1.7
External interest service (% of CXR)	10.0	10.0	11.7	13.6	17.0	17.0	17.0
Gross external financing requirement (% int. reserves)	578.3	608.0	610.9	664.4	524.0	529.5	541.0
Memo: Global forecast summary							
Real GDP growth (%)							
US	3.1	2.7	2.1	0.4	-3.1	1.3	1.7
Japan	1.9	2.0	2.3	-0.7	-6.9	0.9	1.5
Euro area	1.8	3.1	2.7	0.6	-4.6	-0.3	1.9
World	3.3	3.9	3.6	1.7	-3.3	1.4	2.5
Commodities							
Oil (USD/barrel)	54.4	65.4	72.6	97.0	55.0	65.0	70.0

^a ECB short-term repo-rate (annual average)

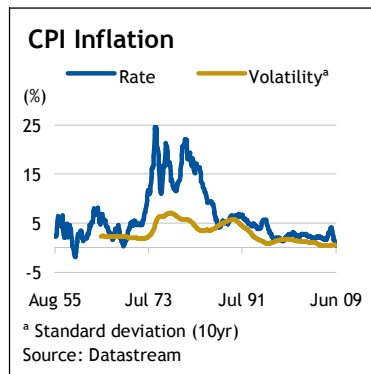
Source: Fitch

Comparative Analysis: Macroeconomic Performance and Policies

Italy

	2008						
	Japan 'AA'	Portugal 'AA'	Slovenia 'AA'	Cyprus 'AA-'	Italy 'AA-'	'AA' median	'A' median
Real GDP (5yr average % change)	1.7	1.2	5.0	4.0	0.9	3.6	5.2
Volatility of GDP (10yr rolling SD)	1.3	1.5	1.3	1.0	1.3	1.4	2.0
Consumer prices (5yr average)	0.3	2.6	3.6	2.5	2.4	2.8	3.2
Volatility of CPI (10yr rolling SD)	0.7	0.7	2.5	1.3	0.5	1.1	1.8
Years since double-digit inflation	33.0	17.0	12.0	27.0	24.0	n.a.	n.a.
Unemployment rate	4.0	7.6	4.4	3.7	6.8	4.4	5.1
Type of exchange rate regime	Floating	EMU	EMU	EMU	EMU	n.a.	n.a.
Dollarisation ratio	-	9.0	2.6	52.0	n.a.	22.2	11.6
REER volatility (10yr rolling SD)	8.7	1.9	2.3	5.5	3.7	3.7	5.2

Source: Fitch



Strengths

- Euro area membership has ushered in a period of low and stable inflation unprecedented in Italy's post-war history.
- Membership of the euro area has lowered interest rates, anchored inflation expectations, removed the threat of a currency crisis and given Italian banks access to hard-currency liquidity support from the ECB.
- Low household debt and stable property prices leave the economy less exposed to household sector deleveraging than some other large EU countries.
- GDP growth, while weak, has been more stable than the 'AA' average over the last five years.

Weaknesses

- Economic growth has been weaker than not only the 'AA' median but also the (lower) 'AAA' median over the last five years.
- The unemployment rate is higher than the 'AA' median, although it remains significantly lower than in the 1980s and 1990s following significant reforms.
- High government debt levels have constrained the authorities' ability to take aggressive counter-cyclical fiscal policy measures to support the economy.
- Poorer and slower growing regions in the south have weighed on national growth performance.

Commentary

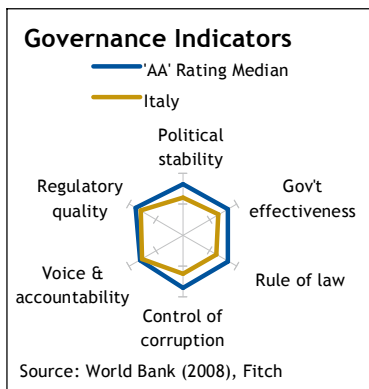
The Italian economy has not suffered from the private-sector excesses witnessed in some other large high-grade sovereigns and is hence less exposed to the painful deleveraging and economic adjustment dynamics underway elsewhere. However, it headed into the crisis with a weak underlying growth rate and it has been hit hard by the global trade shock at the end of 2008. Moreover, the government has not had the luxury of using aggressive fiscal stimulus measures to support the economy, which will likely weigh on short-term recovery prospects. Meanwhile, competitiveness concerns leave it less well placed than Germany to benefit from any bounce-back in world trade. That said, it is hard to deny the benefits Italy has accrued from EMU membership in terms of broader macroeconomic stability, including low and stable inflation and low interest rates.

Comparative Analysis: Structural Features

Italy

	2008						
	Japan 'AA'	Portugal 'AA'	Slovenia 'AA'	Cyprus 'AA-'	Italy 'AA-'	'AA' median	'A' median
GNI per capita PPP (USD, latest)	34,600	20,890	26,640	26,370	29,850	31,595	20,680
GDP per capita (USD, mkt exchange rates)	38,576	22,792	26,960	28,929	39,034	38,805	18,450
Human Development Index (percentile, latest)	95.0	83.9	85.0	84.5	88.9	88.6	79.5
Ease of Doing Business (percentile, latest)	93.8	79.7	69.5	-	70.7	89.9	72.4
Trade openness (CXR and CXP % GDP)	21.1	51.3	77.5	78.4	36.3	n.a.	n.a.
Gross domestic savings (% GDP)	23.6	12.9	29.4	12.9	20.7	28.7	27.6
Gross national savings (% GNP)	25.9	10.5	27.4	6.7	18.2	25.0	23.8
Gross domestic investment (% GDP)	23.5	22.2	32.2	24.3	21.2	23.1	24.6
Private credit (% GDP)	149.6	147.0	85.6	235.2	105.0	142.1	92.4
BSR indicators							
Bank system CAR	-	10.3	10.5	12.0	10.8	n.a.	n.a.
Foreign bank ownership (% assets)	-	21.0	38.2	43.1	7.1	n.a.	n.a.
Public bank ownership (% assets)	-	22.0	16.4	1.1	n.a.	16.4	19.5
Default record (year cured) ^a	-	-	-	-	-	n.a.	n.a.

Source: Fitch and World Bank



Strengths

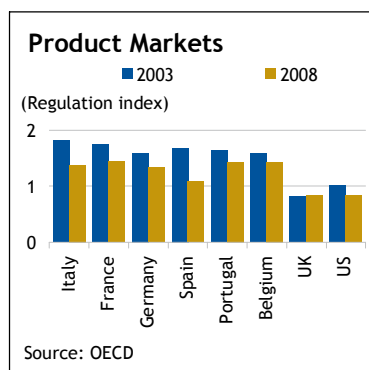
- GDP per capita is high.
- The industrial base is advanced and diversified.
- The banking sector has proved relatively robust thanks to a large retail funding base, low leverage ratios and strong regulatory provisions.
- There have been significant improvements in product market competitiveness in the last five years according to the OECD.

Weaknesses

- Productivity has been virtually stagnant over the last five years, reflecting low rates of inward FDI and R&D expenditure and product market rigidities. GDP per capita has progressively fallen behind advanced country peers.
- The product markets are still heavily regulated by OECD standards.
- Governance indicators are poor relative to 'AA' peers and the business environment is relatively weak.
- Labour market rigidities remain despite reforms in 1990s and early 2000s, contributing to low employment and participation rates, limited responsiveness of wages to productivity, and high long-term unemployment.

Commentary

Italy's supply-side performance since the early part of this decade has been poor. While significant labour market reforms were enacted in the 1990s and in 2003 – helping to lower unemployment, raise participation and facilitate greater use of temporary contracts – product market reforms have only been implemented more recently. Excessive regulation of domestic product markets has constrained the economy's capacity to restructure in the face of greater competition from emerging markets, particularly in traditional manufacturing exports. Product market rigidities – in addition to a centralised wage bargaining framework that limits the responsiveness of wages to productivity, high employment protection, a high tax wedge and uneven social safety nets – have contributed to poor labour market outcomes in terms of low employment rates, limited mobility and high long-term unemployment. However, product market reform was stepped up in 2006 with the Bersani decree, which liberalised professional services and retail trade. The OECD's latest assessment shows a strong improvement in product market competitiveness since 2003, thanks to these reforms and energy sector liberalisation.

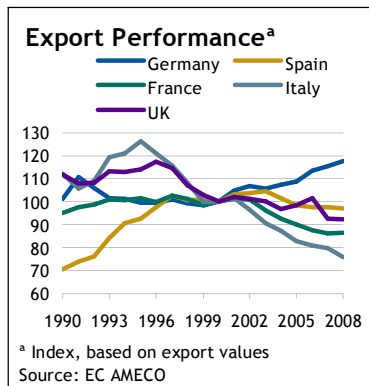


Comparative Analysis: External Finances

Italy

	2008					Last 10 years	
	Japan 'AA'	Portugal 'AA'	Slovenia 'AA'	Cyprus 'AA-'	Italy 'AA-'	'AA' median	'A' median
GXD (% CXR)	160.6	471.7	118.0	547.7	322.3	255.8	92.1
GXD (% GDP)	36.5	213.5	87.8	380.2	111.5	123.9	56.2
NXD (% CXR)	-219.6	141.5	26.0	-1.2	91.5	64.9	-17.1
NXD (% GDP)	-49.9	64.1	19.3	-0.8	31.7	22.3	-11.6
GSXD (% GXD)	29.0	26.0	21.4	3.0	42.0	16.8	11.7
NSXD (% CXR)	-58.5	82.5	5.0	10.4	107.0	4.0	-25.6
NSXD (% GDP)	-13.3	37.4	3.7	7.2	37.0	1.4	-17.2
SNFA (USDbn)	653.5	0.0	-2.0	-1.8	-847.6	0.2	7.3
SNFA (% GDP)	13.3	0.0	-3.7	-7.2	-36.8	1.7	16.2
Ext. debt service ratio (% CXR)	15.1	78.9	16.6	14.3	73.2	30.9	12.6
Ext. interest service ratio (% CXR)	2.3	20.9	4.0	13.0	13.6	10.0	3.0
Liquidity ratio (latest)	156.5	37.6	26.1	109.5	14.4	48.8	139.6
Current account balance (% GDP)	3.2	-12.2	-5.9	-18.0	-3.4	1.2	-1.3
CAB plus net FDI (% GDP)	1.0	-11.6	-5.2	-15.5	-4.8	-0.4	2.0
Commodity dependence (% CXR, latest)	-	-	-	-	10.2	8.0	19.7
Sovereign net FX debt (% GDP)	-21.0	-4.5	-2.1	3.7	-4.4	-	-

Source: Fitch



Strengths

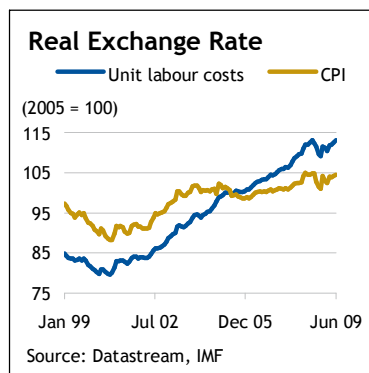
- EMU membership has eliminated the risk of an exchange rate crisis. Greater nominal exchange rate stability since EMU membership has been accompanied by lower and more stable CPI inflation and a sharp decline in inflation differentials against competitors. The real exchange rate based on relative CPI has appreciated relatively little since Italy joined the euro.
- In the context of relatively strong growth in export prices, there is some micro-based evidence of quality upgrading in traditional export sectors and success in penetrating niche high-value-added markets. Historical export volume data was revised up in 2008 and export growth improved in 2006 and 2007.
- The overall net international investment position has been broadly balanced, in contrast to some other euro area members, including Portugal. Italian spending has not been financed by rising net liabilities to foreigners, reducing a potential constraint on medium-term domestic demand growth.

Weaknesses

- Export shares in world markets, when measured in volume terms, have fallen sharply over the last decade or so and by more than for other advanced economies. Market shares in value terms have fallen by less but relative export price increases likely reflect cost pressures as well as quality upgrading.
- Real wage growth has outpaced productivity growth, contributing to sharp and sustained increases in relative unit labour costs over the last decade.
- Real exports of goods and services have grown much slower than in euro area peers in recent years. Strong competition from China, low inward FDI, and weak services exports corroborate the picture of a significant competitiveness problem. The current account has remained in deficit despite weak domestic demand, although this partly reflects higher oil prices.

Commentary

Italy's competitiveness challenges do not reflect its membership of EMU – before EMU, nominal exchange rate weakness was largely offset by high inflation – but rather supply-side constraints, including wage rigidities and low productivity growth. The rise in export unit values may partly reflect quality upgrading, as suggested in number of recent micro-economic studies, but also cost pressures.



Comparative Analysis: Public Finances

Italy

	2008				Last 10 years		
	Japan 'AA'	Portugal 'AA'	Slovenia 'AA'	Cyprus 'AA-'	Italy 'AA-'	'AA' median	'A' median
Budget balance (% GDP)	-2.9	-2.7	-0.9	0.9	-2.7	-0.1	-2.1
Primary balance (% GDP)	-1.9	0.3	1.7	3.7	2.4	2.5	0.3
Revenue and grants (% GDP)	32.1	43.2	42.7	44.5	46.0	39.6	35.0
Volatility of revenue/GDP ratio	4.3	2.8	0.8	11.4	2.0	3.5	7.4
Interest payments (% revenue)	8.6	7.0	3.1	6.3	11.2	5.7	5.4
Debt (% revenue)	563.6	148.8	53.5	108.4	229.9	94.1	132.8
Debt (% GDP)	180.9	64.3	22.8	48.2	105.8	45.6	34.2
Net debt (% GDP)	174.2	42.0	-0.7	35.3	102.4	41.2	22.6
FC debt (% total debt)	0.0	0.7	0.5	16.0	0.2	6.7	24.5
CG debt maturities (% GDP)	47.8	15.0	4.5	10.8	18.9	10.7	5.7
Average duration of CG debt (years)	-	3.8	4.5	6.6	4.5	4.4	3.6

Source: Fitch

Strengths

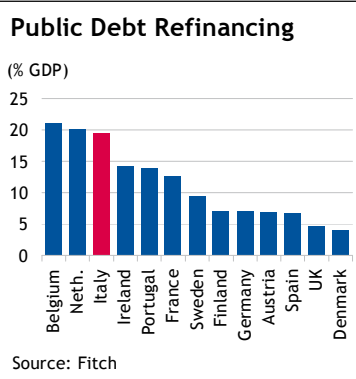
- The government bond market is deep and liquid.
- The revenue base is large and stable relative to 'AA' peers.
- There have been some recent improvements in fiscal performance and the fiscal policy framework.
- Pension reforms have limited the projected rise in pension expenditure to low levels compared with large EU peers, despite unfavourable demographics.

Weaknesses

- High public debt levels are set to increase again as a result of the global recession.
- Fiscal flexibility is limited, reflecting the high share of interest and pensions in expenditure and an already high tax burden.
- Stubbornly high primary expenditure will be hard to reduce in a recessionary environment despite the government's stated objectives. Little progress has been made to date in reducing current primary expenditure.
- Repeated tax amnesties risk undermining efforts to enhance revenue collection.
- Fiscal refinancing needs are high relative to 'AA' and European peers.
- The latest DPEF sets out weak medium-term fiscal adjustment goals.

Commentary

Progress was made in 2007 and (to a lesser extent) 2008 in reducing the fiscal deficit thanks to increased tax rates and improved tax collection. Significant enhancements have recently been made to the medium-term budgetary framework and control of local-government finances, and the government has announced a major public-sector rationalisation and efficiency drive. But the global recession has delayed the implementation of consolidation plans. While the decision to keep fiscal stimulus measures budget neutral is a fiscally responsible approach, the latest medium-term adjustment plans are significantly weaker than previous targets, despite higher public debt levels as a result of the global recession. Moreover with momentum building on plans for increased fiscal decentralisation, it will be important to ensure that greater devolution of fiscal authority does not lead to any weakening of fiscal discipline at the overall national level. The recent stabilisation in local government debt has benefitted from stronger discipline imposed from the central government over, for example, regional health budgets in structural deficit.



Fiscal Accounts Summary

(% of GDP)	2006	2007	2008	2009f	2010f	2011f
General government						
Revenue	45.3	46.4	46.0	47.0	46.6	47.2
Expenditure	48.6	47.9	48.8	52.3	51.6	51.2
O/w interest payments	4.6	5.0	5.1	5.0	5.1	5.6
Primary balance	1.3	3.5	2.4	-0.3	0.2	1.6
Overall balance	-3.3	-1.5	-2.7	-5.3	-4.9	-4.0
General government debt	106.4	103.5	105.8	115.4	118.4	120.1
% of general government revenue	234.7	223.0	229.9	245.4	253.9	254.6
General government deposits	3.7	2.8	3.4	3.6	3.5	3.4
Net general government debt	102.7	100.7	102.4	111.8	114.9	116.7
Central government						
Revenue	27.9	28.3	28.0	28.6	28.4	28.7
O/w grants	0.1	0.0	0.0	0.0	0.0	0.0
Expenditure and net lending	30.1	30.0	32.0	33.9	33.3	32.7
O/w current expenditure and transfers	27.6	27.0	28.7	29.5	29.4	29.6
- Interest	4.3	4.6	4.8	4.6	4.8	5.3
O/w capital expenditure	2.6	3.0	3.3	4.5	3.9	3.1
Current balance	0.4	1.4	-0.6	-0.8	-1.0	-0.9
Primary balance	2.9	2.9	1.5	-0.7	-0.1	1.3
Overall balance	-1.4	-1.7	-3.3	-5.3	-4.9	-4.0
Central government debt	98.9	96.3	99.0	107.6	110.7	112.7
% of central government revenue	354.4	339.8	353.1	376.0	390.1	392.1
Central government debt (EURbn)	1471.1	1487.9	1555.7	1636.5	1713.1	1776.1
By residency of holder						
Domestic	787.0	810.8	790.6			
Foreign	684.0	677.1	765.0			
By place of issue						
Domestic	1399.1	1416.1	1488.6			
Foreign	71.9	71.7	67.1			
By currency denomination						
Local currency	1460.3	1484.4	1552.0			
Foreign currency	10.7	3.5	3.6			
In USD equivalent (eop exchange rate)	14.1	5.1	5.0			
By maturity						
Less than 12 months (residual maturity)	273.4	279.0	297.2	322.5	335.8	343.6
Average maturity (years)	6.8	6.9	6.8			
Average duration (years)	4.4	4.5	4.5			
Memo						
Nominal GDP (EURbn)	1486.7	1544.8	1572.1	1520.6	1547.0	1576.7

Source: Ministry of Finance, Banca D'Italia and Fitch estimates and forecasts

External Debt and Assets

(USDbn)	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Gross external debt	869.5	906.1	911.5	1123.6	1462.7	1679.8	1722.8	2124.7	2546.7	2567.7
% of GDP	72.5	82.5	81.6	92.2	97.0	97.3	96.9	113.9	120.5	111.5
% of CXR	243.0	257.8	255.1	297.9	333.0	328.3	315.2	347.5	348.9	322.3
By maturity										
Medium- and long-term	779.0	836.4	852.6	1064.4	1372.6	1589.9	1601.4	1983.9	2377.1	2359.1
Short-term	90.5	69.7	58.9	59.2	90.1	90.0	121.4	140.8	169.6	208.6
% of total debt	10.4	7.7	6.5	5.3	6.2	5.4	7.0	6.6	6.7	8.1
By debtor										
Monetary authorities	1.0	0.2	2.2	3.1	0.6	1.0	2.2	1.3	0.1	0.3
General government	437.9	446.4	438.1	553.5	729.0	817.1	828.8	947.0	1018.2	1079.2
O/w central government	424.6	431.0	422.2	521.5	692.7	760.5	762.0	900.9	996.8	1064.7
Banks	248.7	278.1	275.8	315.3	413.5	479.7	515.6	732.8	1018.7	990.5
Other sectors	182.9	181.6	197.7	254.8	320.1	383.1	378.4	444.8	509.8	498.0
Gross external assets (non-equity)	691.2	661.6	672.8	783.8	1021.0	1196.4	1264.9	1545.3	1814.6	1838.6
International reserves, incl. gold	44.4	47.6	45.8	53.0	59.0	60.1	60.6	73.3	83.3	105.8
Other sovereign assets nes	21.8	18.3	46.7	39.3	47.8	63.4	63.7	107.4	142.7	121.3
Deposit money banks' foreign assets	90.8	85.9	75.0	94.3	117.9	122.6	110.3	140.8	156.3	131.4
Other sector foreign assets	453.5	427.7	434.7	474.7	608.1	696.2	782.8	918.9	1035.3	1045.8
Net external debt	178.4	244.6	238.7	339.8	441.7	483.5	458.0	579.4	732.1	729.1
% of GDP	14.9	22.3	21.4	27.9	29.3	28.0	25.8	31.1	34.6	31.7
% of CXR	49.9	69.6	66.8	90.1	100.5	94.5	83.8	94.8	100.3	91.5
Net sovereign external debt	370.8	381.1	345.1	458.7	618.0	691.3	699.1	763.9	781.2	852.6
% of GDP	30.9	34.7	30.9	37.6	41.0	40.1	39.3	41.0	36.9	37.0
Net bank external debt	78.1	109.6	130.6	101.1	111.6	105.4	163.2	289.6	476.4	424.3
Net other external debt	-270.5	-246.1	-237.0	-219.9	-287.9	-313.2	-404.4	-474.1	-525.6	-547.8
Net international investment position	53.4	39.4	22.9	-72.0	-87.4	-100.7	-60.7	-88.3	-119.4	-283.5
% of GDP	4.5	3.6	2.0	-5.9	-5.8	-5.8	-3.4	-4.7	-5.6	-12.3
Sovereign net foreign assets	-369.5	-380.3	-343.4	-457.2	-616.4	-689.5	-695.8	-758.9	-775.4	-847.6
% of GDP	-30.8	-34.6	-30.7	-37.5	-40.9	-39.9	-39.1	-40.7	-36.7	-36.8
Debt service (principal & interest)	147.2	195.2	204.1	212.5	261.9	325.7	372.5	381.7	482.2	583.4
Debt service (% of CXR)	41.2	55.5	57.1	56.3	59.6	63.6	68.2	62.4	66.1	73.2
Interest (% of CXR)	12.8	11.2	10.3	11.1	11.2	10.0	10.0	10.0	11.7	13.6
Liquidity ratio (%)	31.0	23.3	22.3	19.8	19.1	17.7	16.0	14.5	14.9	14.4
Net sovereign FX debt (% of GDP)	-0.3	-0.4	-1.1	-1.1	-1.6	-1.4	-1.6	-3.2	-3.7	-4.4
Memo										
Nominal GDP	1199.5	1098.1	1117.3	1218.9	1508.1	1725.9	1778.2	1865.0	2114.3	2302.8

Source: NBP, IMF, World Bank and Fitch estimates and forecasts

Balance of Payments

(USDbn)	2006	2007	2008	2009f	2010f	2011f
Current account balance	-48.0	-51.0	-78.0	-82.7	-79.0	-83.3
% of GDP	-2.6	-2.4	-3.4	-3.9	-3.6	-3.7
% of CXR	-7.9	-7.0	-9.8	-12.9	-11.6	-12.0
Trade balance	-12.5	4.2	-0.1	-14.9	0.7	-1.2
Exports, fob	418.1	502.4	546.9	402.9	433.1	446.9
Imports, fob	430.6	498.1	546.9	417.7	432.4	448.1
Services, net	-1.5	-9.5	-10.9	-4.1	-8.6	-8.6
Services, credit	99.0	112.0	123.5	117.3	122.2	122.2
Services, debit	100.5	121.5	134.4	121.5	130.8	130.8
Income, net	-17.1	-26.9	-45.0	-44.9	-51.6	-54.0
Income, credit	72.4	88.1	98.5	99.8	101.9	102.9
Income, debit	89.4	115.0	143.5	144.7	153.5	156.8
O/w: interest payments	61.4	85.4	108.0	108.8	115.5	118.0
Current transfers, net	-16.9	-18.9	-22.1	-18.8	-19.5	-19.5
Memo						
Non-debt-creating inflows (net)	-14.3	-46.6	81.2	4.6	34.0	29.0
O/w equity FDI	-4.8	-48.8	-14.2	-13.4	-14.0	-14.0
O/w portfolio equity	-9.5	2.1	95.5	18.0	48.0	43.0
Change in reserves	-0.6	1.9	8.2	3.0	-3.5	-8.5
Gross external financing requirement	368.3	447.8	553.4	554.5	587.9	603.2
Stock of international reserves, incl. gold	73.3	83.3	105.8	111.0	111.5	107.0

Source: IMF and Fitch estimates and forecasts

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