

Rating Action: Moody's downgrades Italy's government bond rating to Baa2 from A3, maintains negative outlook

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Frankfurt am Main, July 13, 2012 -- Moody's Investors Service has today downgraded Italy's government bond rating to Baa2 from A3. The outlook remains negative. Italy's Prime-2 short-term rating has not changed.

The decision to downgrade Italy's rating reflects the following key factors:

1. Italy is more likely to experience a further sharp increase in its funding costs or the loss of market access than at the time of our rating action five months ago due to increasingly fragile market confidence, contagion risk emanating from Greece and Spain and signs of an eroding non-domestic investor base. The risk of a Greek exit from the euro has risen, the Spanish banking system will experience greater credit losses than anticipated, and Spain's own funding challenges are greater than previously recognized.
2. Italy's near-term economic outlook has deteriorated, as manifest in both weaker growth and higher unemployment, which creates risk of failure to meet fiscal consolidation targets. Failure to meet fiscal targets in turn could weaken market confidence further, raising the risk of a sudden stop in market funding.

At the same time, Moody's notes that the sovereign's current Baa2 rating is supported by significant credit strengths relative to other euro area peripheral economies, including (1) maintenance of a primary surplus, (2) large and diverse economy that can act as an important shock absorber in the current crisis, and (3) substantial progress on the structural reforms which, if sustained in the coming years, could improve the country's competitiveness and growth potential over the medium-term.

RATINGS RATIONALE

The first key driver underlying Moody's two-notch downgrade of Italy's government bond rating is Italy's increased susceptibility to event risk. As discussed in a recent Special Comment, "European Sovereigns: Post-Summit Measures Reduce Near-Term Likelihood of Shocks, But Integration Comes at a Cost", Moody's believes that the normalisation of sovereign debt markets could take a number of years, with political event risk and the risk of sovereign defaults increasing as the crisis persists. Moreover, events in Greece have deteriorated materially since the beginning of 2012, and the probability of a Greek exit from the euro area has materially increased in recent months. Likewise, an increased likelihood that Spain might require further external support against the backdrop of economic weakness and increased vulnerability to a sudden stop in funding. In this environment, Italy's high debt levels and significant annual funding needs of €415 billion (25% of GDP) in 2012-13, as well as its diminished overseas investor base, generate increasing liquidity risk.

The 29 June euro area summit advanced the idea of allowing European Financial Stability (EFSF) and European Stability Mechanism (ESM) funds to be used to stabilise sovereign funding markets, which implicitly recognises that these tools may be necessary to sustain Italy's access to affordable credit. However, given the size of the Italian economy and the size of the government's debt load, there is a limit to the extent to which these support mechanisms can be used to backstop such a large, systemically important sovereign. However, Italy benefits from its systemic importance for the euro area, giving it leverage in the political process as reflected in the results of the 29 June euro area summit.

The second driver of today's rating action is the further deterioration in the Italian economy, which is contributing to fiscal slippage. Moody's is now expecting real GDP growth to contract by 2% in 2012, which will put further pressure on the country's ability to meet its fiscal targets, which were scaled back when the country published its Stability Programme in April. Although its goal of achieving a structural budget balance in 2013 has not changed, the government now expects to achieve a nominal balanced budget in 2015, two years later than it expected when adopting a package of fiscal adjustment measures in December 2011. More broadly, Moody's believes that Italy's fiscal goals will be challenging to achieve, particularly given the more adverse macroeconomic environment.

The current government's strong commitment to structural reforms and fiscal consolidation has moderated the downward pressure on Italy's government bond rating. Moody's recognises that the government has proposed,

and is legislating, a reform programme that has the potential to materially improve Italy's longer-term growth and fiscal prospects. As part of this programme, the authorities implemented three fiscal consolidation packages, strengthened the pension system, and approved a structural balanced budget rule that will be effective from 2014 onwards. Moreover, in early July the government approved additional spending cuts in order to postpone a VAT hike that was due to take effect in October 2012, and which would have placed additional downward pressure on domestic demand.

The negative outlook reflects our view that risks to implementing these reforms remain substantial. Adding to them is the deteriorating macroeconomic environment, which increases austerity and reform fatigue among the population. The political climate, particularly as the Spring 2013 elections draw near, is also a source of implementation risk.

WHAT COULD MOVE THE RATING UP/DOWN

Italy's government debt rating could be downgraded further in the event there is additional material deterioration in the country's economic prospects or difficulties in implementing reform. A further deterioration in funding conditions as a result of new, substantial domestic economic and financial shocks from the euro area crisis would also place downward pressure on Italy's rating. Should Italy's access to public debt markets become more constrained and the country were to require external assistance, then Italy's sovereign rating could transition to substantially lower rating levels.

A successful implementation of economic reform and fiscal measures that effectively strengthen the growth prospects of the Italian economy and the government's balance sheet would be credit positive and could lead to a stable outlook. Upward pressure on Italy's rating could develop if the government's public finances were to become less vulnerable to volatile funding conditions, should that be accompanied by a reversal in the upward trajectory in public debt and the achievement of lower debt levels.

COUNTRY CEILINGS

As a consequence of the rating action on the sovereign, Moody's has also lowered the maximum rating that can be assigned to a domestic issuer in Italy, including structured finance securities backed by Italian receivables, to A2 from Aaa. The lower ceiling reflects the increased risk of economic and financial dislocations. The short-term foreign currency country and deposit ceilings remain Prime-1.

Italy's new country ceiling reflects Moody's assessment that the risk of economic and financial instability in the country has increased. The weakness of the economy and the increased vulnerability to a sudden stop in funding for the sovereign constitute a substantial risk factor to other (non-government) issuers in Italy as income and access to liquidity and funding could be sharply curtailed for all classes of borrowers. Further deterioration in the financial sector cannot be excluded, which could lead to potentially severe systemic economic disruption and reduced access to credit. Finally, the ceiling reflects the risk of exit and redenomination in the unlikely event of a default by the sovereign. If the Italian government's rating were to fall further from its current Baa2 level, the country ceiling would be reassessed and likely lowered at that time.

The principal methodology used in these ratings was Sovereign Bond Ratings Methodology published in September 2008. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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