

Rating Action: Moody's downgrades Italy's government bond ratings to A2 with a negative outlook

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Prime-1 ratings affirmed

Frankfurt am Main, October 04, 2011 -- Moody's Investors Service has today downgraded Italy's government bond ratings to A2 with a negative outlook from Aa2, while affirming its short-term ratings at Prime-1. The rating action concludes the review for downgrade initiated by Moody's on 17 June, 2011.

The main drivers that prompted the rating downgrade are:

- (1) The material increase in long-term funding risks for euro area sovereigns with high levels of public debt, such as Italy, as a result of the sustained and non-cyclical erosion of confidence in the wholesale finance environment for euro sovereigns, due to the current sovereign debt crisis.
- (2) The increased downside risks to economic growth due to macroeconomic structural weaknesses and a weakening global outlook.
- (3) The implementation risks and time needed to achieve the government's fiscal consolidation targets to reverse the adverse trend observed in the public debt, due to economic and political uncertainties.

The downgrade reflects the weight of these growing risks relative to some positive credit attributes. These include a lack of significant imbalances in the economy or severe pressure on private financial and non-financial sector balance sheets, as well as the actions undertaken by the government over the summer. Moody's notes that the size of the rating action is largely driven by the sustained increase in the country's susceptibility to financial shocks due to a structural shift in market sentiment regarding euro-area countries with high debt burdens. A country's susceptibility to shocks is a key factor under Moody's sovereign methodology.

The negative outlook reflects ongoing economic and financial risks in Italy and in the euro area. The uncertain market environment and the risk of further deterioration in investor sentiment could constrain the country's access to the public debt markets. If such risks were to materialise and the long-term availability of external sources of liquidity support were to remain uncertain, the country's rating could transition to substantially lower rating levels.

RATIONALE FOR DOWNGRADE

The downgrade stems from three closely related drivers:

- 1) The fragile market sentiment that continues to surround euro area sovereigns with high levels of debt implies materially increased financing costs and funding risks for Italy. The country is a frequent issuer with refinancing needs of more than EUR200 billion in 2012. Although future policy actions within the euro area could reduce investors' concerns and stabilise funding markets, the opposite is also increasingly possible. Even if policy actions were to succeed in the short term in returning some degree of normality to euro area sovereign debt markets, the underlying fragility and loss of confidence is deep and likely to be sustained. As indicated by the A2 rating, the risk of default by Italy remains remote. Nonetheless, Moody's believes that the structural shift in sentiment in the euro area funding market implies increased vulnerability of this country to loss of market access at affordable rates that is incompatible with a 'Aa' rating. Moreover, the preponderance of downside risks and the potential for rapid rating transition which those risks imply are not compatible with a rating at the top end of the 'A' range. The repositioning of Italy's government bond rating to A2 reflects Moody's judgment of the balance of long-term risks facing the Italian sovereign. It is consistent with Moody's broader reassessment of sovereign risk in the euro area, focusing on member countries that are more susceptible to confidence-related shocks due to high public debt exposure and/or large fiscal imbalances.
- 2) The Italian economy continues to face significant challenges due to structural economic weaknesses. These problems -- mainly low productivity and important labour and product market rigidities -- have been an impediment to the achievement of higher potential growth rates over the past decade and continue to hinder the economy's recovery from the severe recession it experienced in 2009. These structural impediments to economic growth cannot be removed quickly. The government's reform plans have only just started to address some of these structural challenges, and they need to be implemented efficiently. Moreover, moderate medium-term growth prospects for the Italian economy have been further revised downwards due to potential adverse effects of a weakening European and global growth outlook. Economic growth will be a crucial factor determining the government's revenues, the achievement of fiscal consolidation targets and, ultimately, its debt trajectory.
- 3) Finally, there is increasing uncertainty for the government to achieve fiscal consolidation targets. Since more than half of the consolidation measures are based on government revenue growth, the plans are vulnerable to the high level of uncertainty around economic growth in Italy and elsewhere in the EU. Moreover, political consensus on additional expenditure cuts can be difficult to achieve. As a consequence, the government may find it challenging to generate the primary surpluses that are needed to place the public debt-to-GDP ratio and the interest burden on a solid downward trend. Moody's expects Italy's public debt-to-GDP ratio to reach 120% at the end of this year, up from 104% at the start of the global crisis. As well as posing a risk to Italy's financial strength, which is a key consideration under Moody's sovereign methodology, failure to achieve fiscal and debt targets could increase the country's susceptibility to financial market shocks.

PRINCIPAL METHODOLOGY

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

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