

International Special Report

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Related Research

• Sovereign Review

- <u>Emerging Europe's Current Account</u> <u>Deficits: Mind the Gap!</u>
- EMU Convergence Report: 2007
- Bank Systemic Risk Report
- <u>Inflation and Emerging Market Sovereign</u> <u>Risk</u>

Emerging Europe Sovereign Review: 2008

Testing Times Ahead

- The economic and credit outlook for Emerging Europe (EE) is deteriorating as the combination of the euro area slowdown, maturing domestic booms and the commodity price shock presages a worse growth/inflation/current account (CA) trade-off across most of the region, while fragile financing conditions mean that macroeconomic adjustments may not necessarily be smooth.
- Fitch Ratings forecasts EE's GDP growth to fall from 6.9% in 2007 to 5.8% in 2008 (the lowest since 2002) and 5.2% in 2009, bolstered by growth in Russia (37% weight) of 7.5% this year and 6.5% next. But most countries within the region will grow much slower, and Estonia and Latvia are at risk of recession.
- The spike in commodity prices has unleashed a surge in inflation when many countries were starting to run up against capacity constraints and overheat after years of rapid monetary and GDP growth. Inflation has been highest in countries with fixed or managed exchange rates, including the Baltic states, Bulgaria, Kazakhstan Russia and Ukraine, and best contained in the inflation-targeting central European economies. High and volatile inflation increases the risk of exchange rate and banking crises, and reduces debt tolerance.
- Substantial current account deficits (CADs) are a concern across much of EE and one heightened by the credit crunch. This was the main reason Fitch revised the rating Outlooks to Negative from Stable on Bulgaria, Estonia, Latvia, Lithuania and Romania. Fitch has constructed an index of relative vulnerability to external financing pressures, based on CA balance plus FDI, external debt repayments due this year and net external debt stocks. Latvia, Croatia, Lithuania, Turkey, Estonia, Bulgaria and Romania come out as most vulnerable.
- EE sovereign external bond issuance at USD14.1bn year to date has already surpassed last year's total. But although private sector external bond issuance picked up in H108 on H207, it is still well below pre-credit crunch volumes. The rapid pace of bank credit growth is slowing, but remains elevated in parts of the CIS and Balkans. Foreign parent banks should continue to support access to funding and confidence in local banks, but there is a tail risk that a worsening in the credit crisis could trigger a fall in the availability of their financing to EE.
- Previous upward rating momentum has stalled: over the past 18 months there have only been three Foreign Currency upgrades: the Czech Republic, Slovakia and Armenia; and two downgrades: Latvia and Georgia. Moreover, the shift in the balance of Positive to Negative Outlooks from +5 in August 2007 to -5 in August 2008 highlights the downward pressure on ratings. Seven countries are now on Negative Outlooks the highest number Fitch has recorded. Although not Fitch's central scenario, the risk of a hard landing accompanied by an exchange rate crisis somewhere in the region is significant and rising.
- The conflict between Russia and Georgia has added another layer of risk to parts of the region at an inopportune time.
- Euro adoption is a material driver of sovereign rating actions in eastern Europe. However, the size of the inflationary shock highlights the challenges of meeting the Maastricht criteria, particularly for poorer countries and those with fixed exchange rates. After Slovakia in January, Fitch expects at least a three-year hiatus before the next country adopts the euro.

Sovereign Ratings

e e : e : e : g : :		
Country	FC IDR	LC IDR
Armenia	BB	BB
Azerbaijan	BB+	BB+
Bulgaria	BBB ^b	BBB+ ^b
Croatia	BBB-	BBB+
Czech Rep	A+	AA-
Estonia	A ^b	A+ ^b
Georgia	B+ ^b	B+ ^b
Hungary	BBB+	A-
Kazakhstan	BBB ^b	BBB+ ^b
Latvia	BBB+ ^b	A- ^b
Lithuania	A ^b	A+ ^b
Macedonia	BB+ ^a	BB+ ^a
Moldova	B- ^a	B ^a
Poland	A-	A
Romania	BBB ^b	BBB+ ^b
Russia	BBB+	BBB+
Serbia	BB-	BB-
Slovakia	A+	A+
Slovenia	AA	AA
Turkey	BB-	BB
Ukraine	BB-	BB-

Long-Term Foreign and Local Currency

Issuer Default Ratings

^a Positive Outlook

^b Negative Outlook; others Stable Source: Fitch



Introduction

This report reviews and flags up some of the main current economic and credit issues facing countries in EE. Of course, the 21 countries that Fitch rates in the region have different intrinsic characteristics and face different current economic, political and financial circumstances. The focus of the report is on broad topical themes rather than comprehensive country specific analysis - which readers can find in Fitch's sovereign credit analysis reports. With this in mind, the report covers the following main issues:

- Economic growth prospects;
- The impact from inflation;
- The risks from current account deficits and external financing pressures;
- Trends in credit growth and the role of banking sectors;
- Political and war risk following the conflict in Georgia;
- Sovereign credit rating trends;
- Sub-regional economic and credit trends;
- Annex: Prospects for Euro adoption.

Economic Outlook

One year on from the start of the credit crunch, backward looking data suggest that activity remains strong in EE, with the notable exception of the Baltic states. Fitch estimates real GDP growth in EE was a rapid 6.9% in 2007, albeit down slightly from 7.3% in 2006, with output growth robust in H207 and Q108. Indeed, the five largest economies in EE recorded remarkable year-on-year GDP growth numbers in Q108: Russia 8.5%, Turkey 6.6%, Poland 6.1%, the Czech Republic 5.1% (from 6.6% in Q407) and Romania 8.2% (and 8.9% in Q208). This underlined the strength of domestic demand and economic momentum going into 2008 (less so for Turkey).

GDP Growth Set to Slow

However, the darkening global economic and financial outlook means EE will not be immune from the global slowdown, and this is starting to be picked up by leading indicators and Q208 GDP data where available. Indeed, many countries in the region that have large CADs, high inflation and extended banking systems look relatively exposed to the impact of the credit crunch.

Main Projections (Annual averages) 2007 2008f 2009f Real GDP growth (%) Worlda 3.6 2.5 2.7 Euro area 1.9 1.7 2.6 Emerging Europe^b 6.9 5.8 5.2 o/w CE5 6.0 4.5 4.4 Baltic 3 8.9 2.2 2.4 CIS7 8.4 7.4 6.2 SEE5 6.1 6.2 49 Turkey 4.5 4 4.5 Interest rates (%) 5.05 2.30 2.44 US federal funds ECB refinancing 3.84 4.13 4.25 Oil (USD per barrel) 73 100 75 Brent ^a Weighted by 2005 GDP at market exchange rates ^b Weighted by 2007 GDP at market exchange rates CE5: Czech Republic, Hungary, Poland, Slovakia, Slovenia Baltic3: Estonia, Latvia, Lithuania CIS7: Armenia, Azerbaijan, Georgia, Kazakhstan, Moldova, Russia, Ukraine SEE5: Bulgaria, Croatia, Macedonia, Romania, Serbia

2010f

3.1

2.0

5.5

4.5

4.8

6.0

5.4

5.5

3.50

4.25

70

Fitch forecasts world GDP growth to fall to 2.5% in 2008 and 2.7% in 2009 from 3.6% in 2007¹. Fitch's house forecast for growth in the euro area, which is the main export market for EE as well as its main source of FDI and bank external borrowing, is 1.9% in 2008 and 2009. But the weak outturn for Q208 of a fall of 0.2% gog - thefirst contraction since the launch of the euro – points to downside risks.

For EE as a whole, Fitch forecasts GDP growth to decline to 5.8% in 2008 (the lowest since 2002), despite the boost from a better harvest than last year. 2009 is expected to be a more difficult year, with growth easing further to 5.2%, before firming slightly to 5.5% in 2010. Most countries within the region will grow significantly slower than that, as the aggregated number is boosted by Russia (37% weight), which Fitch expects to grow by 7.5% this year and 6.5% next.

Global cross-winds are generating increasingly divergent economic outlooks across EE. Countries that are commodity importers or that have sizeable exports to the EU, large external financing requirements, an extended financial sector or weak monetary and exchange rate policy frameworks look most exposed.

Trade Openness to Drag on Growth, Particularly for CE5

Many countries in EE are relatively open, making a "de-coupling" from the global downturn improbable. The "Central Europe 5" (CE5) of the Czech Republic, Hungary, Poland, Slovakia and Slovenia are particularly open economies (Poland less so) and closely integrated within the EU economy: exports of goods account for 79% of GDP in Slovakia, 70% in Czech and 68% in Hungary. The concentration of relatively cyclically sensitive industries such as cars and electronics could exacerbate the impact. In addition, strong wage growth and nominal exchange rate appreciation have pushed up relative unit labour costs, posing a risk to competitiveness, export performance and growth prospects. The chill from the euro zone is the main factor behind Fitch's forecast for GDP growth in the CE5 to fall to 4.5% in 2008 from 6% in 2007. Indeed, new orders and business and consumer confidence surveys in the euro area portend weaker demand in western Europe, with negative implications for the CE4 (CE5 excluding Slovenia; see charts below). GDP growth in the Czech Republic fell to 4.5% in Q208 yoy, from 5.1% in Q108, and in Slovakia to 7.6% from 8.7%.



For EE as a whole, the EU is by far the largest export market, as the destination for 73% of exports from the 10 EU member states and 43% for CIS countries. Exposure to the US is low at just 3.5% of exports. Booming demand in Russia (7% of exports), where imports of goods grew by 37% in USD in the year to Q108, could offer some respite. The chart below understates the trade exposure of countries such as Croatia and Turkey, which have sizeable tourism sectors.

• The CE5 are open economies, making "decoupling" from the global economy improbable

Export Exposures (% of total exports of goods, 2007)

	To EU	To US	To Russia				
EE Average	61	3.5	7				
o/w EU	73	2	6				
CIS	45	6	11				
Source: IMF and Fitch							

Euro area (RHS)

7

- 3

-5

¹ See "Sovereign Review" and "Global Economic Outlook", available on www.fitchresearch.com.



The downturn in export markets is a particular concern for the Baltic states, which are facing a sharp drop in domestic demand². In addition, statistics on the direction of trade highlight a risk of contagion between the three, in that the other Baltic states account for 29% of Latvia's exports, 19% of Lithuania's and 17% of Estonia's (a nominal value equivalent to 8%-9% of GDP in the case of all three countries, though less on a value added basis).

End of Credit Boom, already affecting Estonia, Latvia and Kazakhstan

Credit growth is now easing in most countries in the region (see *Banking Systems a Possible Weak Link* below), which should temper GDP growth over the next two years. A moderation in credit growth to a more sustainable pace would be welcome. However, "Goldilocks slowdowns" — neither too slow nor too fast — in credit and GDP growth are not assured. In Fitch's view, abrupt adjustments are a particularly risk in countries where credit growth has been rapid and CADs are substantial.

After years of break-neck GDP growth, credit booms and widening macroeconomic imbalances, domestic demand is contracting in Estonia and Latvia, which are now flirting with recession. The slowdown is, so far, less pronounced in Lithuania, as was the boom. But all three face a testing time over the next 12 months. Fitch expects average GDP growth in the Baltic states to fall to 2.2% this year and 2.4% in 2009, from 8.9% in 2007, with growth even softer in H208. A pronounced drop in credit growth is also contributing to a slowdown in Kazakhstan, where Fitch forecasts GDP growth of 5% this year and 3% next, after 8.5% in 2007 and 11.5% in 2006.



² See "Slowdown in the Baltic States: How will it End?", published on 22 August 2008 and available on www.fitchresearch.com.

 Intra-Baltic exports are equivalent to 8%-9% of GDP, highlighting potential contagion through the trade channel





Commodity Prices: Negative for Most of EE

The surge in commodity prices over the past 12 months represents a significant negative terms of trade shock for the vast majority of countries in EE that are commodity importers. It will lower real incomes, weigh down GDP growth and worsen CA balances, as well as raising inflation. In contrast, CIS energy producers – Azerbaijan, Russia and Kazakhstan – are seeing a massive boost to incomes, CA balances and fiscal revenues, though are also suffering from a serious inflationary shock (see later). Looser fiscal policy is also supporting growth in all three countries. Nonetheless, commodity price volatility and recent sharp price declines point to risks to the CIS in the event of further sharp reversals.



The chart above shows primary commodity exports and imports as a percent of GDP. For consistency, Fitch has used standardised UNCTAD data and definitions³, though these are from 2006, so understate the impact of commodities following the subsequent price rises in 2007 and 2008. One caveat is that focusing on primary commodities may be misleading, in that some countries export manufactured goods with high commodity content, eg iron and steel pipes in the case of Ukraine.

Inflation a Threat

The spike in energy and food prices has unleashed a sharp rise in inflation across EE, as in other emerging markets (EMs). Moderate income levels mean that food and energy have a greater weight in CPI baskets than in developed economies and the commodity price shocks have a larger impact on inflation rates. Moreover, a severe drought in parts of southern and central Europe last year and sharp increases in Russian gas prices exacerbated global commodity price trends. Other factors, such as the industrial structure, lower energy efficiency and EU-related excise tax or administered price increases, magnified the effect in many countries.



³ United Nations Conference on Trade and Development (UNCTAD) Standard International Trade Classification (SITC) categories 0+1+2+3+4+68+667+971.



• Inflation is highest in the CIS, where most economies are showing signs of overheating, and monetary policy is accommodative Furthermore, the commodity price shock struck EE at a time when many countries were starting to run up against capacity constraints and tight labour markets and were starting to overheat after years of rapid growth of bank credit, the money supply and GDP. This has been particularly the case in countries with fixed or managed exchange rate regimes, including the Baltic states, Bulgaria, Kazakhstan, Russia and Ukraine. The speed of monetary expansion has started to ease in the CIS (though remains elevated) and the Baltic states, but continues apace in the Balkans. Inflation has been best contained in the central European economies, which have robust monetary and exchange rate policy frameworks, including independent central banks, inflation targeting regimes and floating exchange rates, which have appreciated this year, dampening the effect of higher commodity prices.



Inflation Performance

				Policy	
Country	Latest	Target ^a	Gap	interest rate	Real rate
Inflation-targeting					
Czech Rep	6.9	3.0	3.9	3.5	-3.4
Hungary	6.7	3.0	3.7	8.5	1.8
Poland	4.8	2.5	2.3	6.0	1.2
Slovakia	4.9	2.0	2.9	4.25	-0.7
Romania	9.0	3.8	5.2	10.25	1.3
Serbia ^b	14.9	4.5	10.4	15.75	0.9
Turkey	12.1	4.0	8.1	16.75	4.7
Armenia	9.8	4.0	5.8	7.5	-2.3
Georgia	9.8	8.0	1.8	11.0	1.2
Moldova	15.6	10.0	5.6	18.5	2.9
Other					
Slovenia	6.9	n.a.	n.a.	4.25	-2.7
Estonia	11.1	n.a.	n.a.	5.25	-5.9
Latvia	16.7	n.a.	n.a.	6	-10.7
Lithuania	12.2	n.a.	n.a.	5.25	-7.0
Bulgaria	14.5	n.a.	n.a.	5.25 ^c	-9.3
Croatia	8.4	n.a.	n.a.	9.0	0.6
Macedonia	9.5	n.a.	n.a.	6.5	-3.0
Azerbaijan	24.6	n.a.	n.a.	13	-11.6
Kazakhstan	20.0	n.a.	n.a.	10.5	-9.5
Russia	14.7	n.a.	n.a.	7.0	-7.7
Ukraine	26.8	n.a.	n.a.	12	-14.8

^a Rolling or end-2008

^b Mid-point of target range; target is core inflation

^c Market rates. For some countries, market rates differ significantly from policy rates

Source: Datastream, IMF and Fitch

Fitch research in May highlighted the risk to EMs from high and volatile inflation, which is negative for EM sovereign creditworthiness as it increases the risk of macroeconomic volatility, which reduces sovereign debt tolerance and increases the risk of exchange rate and banking crises. Rising inflation can have political and social ramifications and government responses to these can weaken public finances,



• High and volatile inflation increases the risk of banking and exchange rate crises and reduces debt tolerance

 Inflation may be at or close to its peak, but it could prove persistent in countries where monetary policy is loose although budget energy subsidies are not prevalent in EE. For EU member states, the upsurge in inflation is leading to delays in euro adoption (see later). Furthermore, inflation can have adverse implications for the structure of public debt, could lead to an increase in foreign currency borrowing, shorter debt maturities and reduced investor willingness to take duration on local currency sovereign debt instruments. Fitch constructed an index of relative EM vulnerability to inflation shocks based on inflation dynamics, the degree of domestic overheating, monetary conditions and the importance of the local government debt market to the sovereign. Out of 73 Fitch-rated EMs, countries from EE filled five of the top seven places (Ukraine, Kazakhstan, Bulgaria, Latvia and Lithuania) and 15 of the top 30.

Inflation may be close to a peak in most countries in the region, as sharp food and energy price increases will soon start to drop out of the 12-month rate, commodity prices are off recent peaks, there are promising signs of a good harvest, and hikes in interest rates and an easing in the pace of monetary growth take their effects. However, high inflation could get locked into expectations and prove persistent, as capacity is tight in many countries, wages are increasing strongly and there is a risk that some central banks here been behind the curve in tightening monetary policy. In addition, some central banks appear to be placing more weight on providing liquidity to banking systems or holding down exchange rates than on fighting inflation; and real interest rates are markedly negative in many countries.

Impact on Domestic Debt Markets

In the relatively large domestic CE debt markets of Poland and Hungary, yields have increased alongside inflation and higher policy interest rates, but there has been little evidence of significant stress. Investor duration risk has held up well. As a share of total domestic debt, the share of short term debt (T-bills) has remained unchanged over the past year at 6% in Poland and has continued to fall in Hungary (19% in July 2008 compared with 22% in July 2007). Meanwhile, Hungary has increased the share of fixed rate issuance within its domestic debt market, to 72% in mid-2007 compared with 67% a year earlier. The issuance of floating rate bonds has risen only slightly in Poland and accounted for 24% of total domestic debt in May 2008 compared with 22% a year earlier. The rise largely reflects larger issuance of floating-rate bonds with a maturity of over five years, which may suggest some heightened investor uncertainty over the long-term inflation outlook.



The most significant change in CE domestic debt markets over the past year or so has been a fall in non-resident participation. This may reflect stresses at hedge funds that held large portfolios of CE debt and unloaded liquid CE debt securities to meet their liquidity needs, or normal portfolio decisions of foreign investors reflecting views on rates and currencies. Non-resident holdings of HUF-denominated debt grew steadily throughout 2007 and peaked at 33% of all HUF-denominated debt in January 2008, before declining to 29 % in June 2008. The fall has been of a

similar magnitude in Poland, where non-residents holdings stood at 17% of outstanding PLN-denominated debt in May 2008 from 22% a year earlier.

In Turkey – where the inflation shock has been larger, the inflation track worse and the monetary and exchange rate policy framework less well established – the average maturity of lira debt issued in the first half of the year increased to 27 months, down from 36 months in 2007.

External Finances Under Pressure

In 2007, five countries in EE (Latvia, Bulgaria, Georgia, Moldova and Estonia) had the largest CADs out of all 105 Fitch-rated sovereigns, with two more (Romania and Lithuania) amongst the top 10. CADs in these countries have risen to levels that look disconcertingly stretched by current global or historical standards. And Fitch believes the global credit crunch has elevated external financing risks⁴. Indeed, this was the main reason that Fitch revised the Outlooks to Negative from Stable on the ratings of Bulgaria, Estonia, Latvia and Romania in January, following Lithuania in December. The agency had already downgraded Latvia's ratings in August 2007, having put them on a Negative Outlook in April 2007.



It is rational for fast-growing transition countries with high investment rates to run CADs, and non-debt FDI and EU capital account funding are partly mitigating factors. However, the magnitude of CADs is unsustainable and raises several concerns. First, external borrowing to finance CADs is increasing external debt burdens in most of these countries. Second, CADs in combination with rapid bank credit growth, strong real estate activity, asset price booms and rising inflation raises point to economies overheating and the risk of a painful macroeconomic correction ahead. Third, tighter global liquidity, reduced global risk appetite and elevated risk premiums on countries



See "Emerging Europe's Current Account Deficits: Mind the Gap!", published 31 January 2008 and available on www.fitchresearch.com.

 In 2007, six countries in EE

 Latvia, Bulgaria,
 Georgia, Moldova, Estonia
 and Serbia – had the
 largest CADS of any Fitchrated sovereigns

• The credit crunch will make CADs more difficult to finance, heightening risks of painful macroeconomic adjustments and downward pressures on currencies FitchRat

with large CADs and declining growth prospects heighten the risk of finances drying up, which could lead to recession and/or downward pressure on exchange rates. Such a scenario poses additional risks for countries with currency board arrangements (CBAs; Bulgaria, Estonia and Lithuania) or currency pegs (Latvia).

Encouragingly, CADs are now narrowing in Estonia and Latvia, where domestic demand and import growth have slowed sharply. The trend is less clear in Lithuania, though the CAD in Q108 was less than in Q107. However, a clear adjustment of unsustainable macroeconomic imbalances has yet to take hold in Bulgaria and Romania. The slowdown in export markets will make it more difficult for them to reduce their CADs.

551	5			
(USDbn)	2006	2007	2008f	2009f
Current account balance	-1	-57	-68	-175
O/w CE5	-26	-33	-49	-57
Baltic 3	-10	-15	-17	-15
CIS7	93	71	107	15
SEE5	-25	-42	-61	-67
Turkey	-33	-38	-48	-50
MLT amortisation	197	216	249	263
Financing needs ^a	222	295	352	460
Reserves (%)	62	69	72	42
GDP (%)	12	13	12	9
Net equity FDI	62	86	74	70
Financing needs less FDI ^a	161	218	287	379
Short-term debt (t-1)	234	294	450	511
Financing needs + short-term debt ^a	435	575	783	971

Emerging Europe External Financing

NB Fitch has estimated private-sector amortisation where countries do not produce data

Adjusted to exclude countries with negative financing needs (CAD+MLT amortisation); NB Russia turns negative in 2009, thereby reducing ratios to reserves and GDP

Source: Fitch

Furthermore, EE's gross external financing requirements (GXFR) - CADs plus medium- and long-term amortisation - are by far the largest of any EM region in USD or relative to GDP or foreign exchange reserves (FXR). Moreover, Fitch estimates EE's GXFR could increase to around USD352bn in 2008 from USD295bn, though little changed in relation to FXR or GDP. The aggregate forecasts for 2009 depend heavily on Russia, where Fitch expects lower oil prices and booming imports to shrink the CA surplus, turning its financing needs positive and leading to a jump in the region's GXFR.

Fitch has constructed an index of relative EE vulnerability to gauge external financing pressures. It is based on equal weighting of three factors: the CA balance plus net equity FDI (as a percentage of GDP), short-term external debt on a residual maturity basis (as a percentage of FXR) and net external debt (as a percentage of current external receipts) for 2008. The countries are ranked across the three indicators and the sum of the ranks is translated to a rank of ranks⁵.

Not surprisingly, Latvia comes out as the most vulnerable country to external financing pressures, with the other Baltic states, Estonia and Lithuania, Bulgaria, Romania and Turkey filling five of the next six spots. It is somewhat surprising to see Croatia as high as second in this list, though relatively weak external finances have been the main factor constraining its rating at 'BBB-' for some time. Russia

• Fitch estimates EE's gross external financing requirement could rise to around USD354bn in 2008. from USD297bn in 2007, by far the largest of any EM region

 Latvia comes out top in Fitch's vulnerability index of exposure to external financing pressures and Russia least

⁵ The use of ranks and selection of specific indicators are somewhat arbitrary (though other indicators produce similar results). Ranks are based on Fitch forecasts for 2008 rather than actual data and do not reflect other credit factors. Fitch's sovereign credit ratings incorporate the agency's best assessment of all factors material to creditworthiness.

and Azerbaijan, whose CAs and external balance sheets are being bolstered by high energy prices, come out as least vulnerable.

Index of Vulnerability to External Financing Pressures							
	CAB + net		S-T external		Net external		
	equity FDI		debt⁵		debt		Overall
2008	(% GDP)	Rank ^a	(% FXR)	Rank ^a	(% CXR)	Rank ^a	rankª
Latvia	-17.4	1	344	1	105	1	1
Croatia	-8.2	5	166	3	86	3	2
Lithuania	-12.0	4	135	7	67	6	3
Turkey	-4.6	10	152	5	91	2	3
Estonia	-7.0	7	330	2	56	10	5
Romania	-13.3	3	100	12	78	4	5
Bulgaria	-13.4	2	101	11	56	9	7
Hungary	-3.2	13	158	4	64	7	8
Serbia	-7.4	6	28	19	73	5	9
Georgia	-4.9	9	103	10	55	11	9
Slovakia	-3.0	14	146	6	25	13	11
Ukraine	-2.6	16	112	9	59	8	11
Poland	-2.8	15	129	8	50	12	13
Armenia	-6.5	8	46	16	13	16	14
Moldova	-3.7	12	87	14	17	15	15
Kazakhstan	5.0	18	94	13	20	14	16
Czech Republic	-0.1	17	77	15	-8	17	17
Macedonia	-3.9	11	14	20	-15	19	18
Azerbaijan	17.8	20	33	18	-14	18	19
Russia	6.7	19	40	17	-51	20	19

^a 1= Most vulnerable

^b On residual maturity basis (ie end-2007 short-term debt plus 2008 amortisation on medium- and long-term debt) Source: Fitch

Divergent Exchange Rates Tell a Story

EE exchange rates have diverged markedly since the onset of the credit crisis, highlighting the different pressures countries are facing as well as contrasting monetary policy responses. Overall, CE4 exchange rates have strengthened substantially against the euro, despite retracing some ground since July, reflecting their relatively moderate CADs, lower inflation and more robust monetary policy framework. The role of the Czech crown as a carry trade funding currency in previously more risk loving times may have accentuated its subsequent appreciation. Initially, Hungary's twin deficits and weak growth outlook weighed on the forint, but it too has strengthened since March.





The relative weakness of the rouble, despite (until recently) buoyant commodity prices and Russia's massive CA surplus, partly reflects EUR/USD cross rates, but also underlines the country's relatively loose monetary stance and lower priority attached to fighting inflation than in the CE4. The fall in the lei in H207 partly

• Countries with large CADs or weak monetary policy frameworks have seen currencies sell off since the onset of the credit crunch, while CE4 exchange rates have appreciated reversed strong appreciation in H107, also reflected concerns over Romania's large CAD (and perhaps its role as a proxy trade for the Baltic states and Bulgaria, which have fixed exchange rates). Similar concerns about the CAD and inflation, as well as political risk, have weighed on the lira, though it has staged a strong recovery since July as political risk has eased and bolstered by the carry of high local interest rates. Interestingly, EE exchange rates have outperformed the currency of South Africa, which also faces a sizeable CAD and inflationary pressures.

Sovereign Issuance Up this Year...

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EE sovereigns have stepped up issuance of external foreign currency bonds this year to a value of USD14.1bn year to date, already surpassing the USD13.2bn for 2007 as a whole. The numbers were boosted by a EUR2bn issue by the Czech Republic, as well as borrowings from regular large issuers Hungary, Poland and Turkey. Annual financing plans suggest sizeable further issuance in the pipeline for Ukraine, which decided against issuing a bond it was road-showing in June owing to adverse market conditions, Poland and Turkey. Interestingly, Latvia issued a 10-year EUR400m eurobond in February at a spread of only 120bp over mid-swaps, approximately 150bp below the 10-year credit default swaps levels at the time of pricing. The figures underscore the capacity of investment grade sovereigns or those with well established market names to continue to access international capital markets, even while many private sector entities have found that more difficult since last summer.

	2007	2008	2008	2008	2009
(USDbn)	2007	planned	year to date	maturing	maturing
Armenia	0	0	0	0	0
Azerbaijan	0	0	0	0	0
Bulgaria	0	0	0	C	0
Croatia	0	1.2	0	1.2	1.1
Czech Rep	0	1.4	3.1	C	0
Estonia	0	0	0	0	0
Georgia	0	0.5	0.5	C	0
Hungary	1.5	3.4	2.5	0	1.3
Kazakhstan	0	0	0	0	0
Latvia	0	0	0.6	0.3	0
Lithuania	0.9	0.6	0	0.3	0
Macedonia	0	0	0	0	0
Moldova	0	0	0	C	0
Poland	3.6	5.7	3.8	1.6	3.2
Romania	0	1.2	1.2	0.9	0
Russia	0	0	0	3.6	1.5
Serbia	0	0	0	C	0
Slovakia	1.4	1.5	0	0	0.7
Turkey	4.6	5.5	2.5	3.4	2.5
Ukraine	1.2	1.1	0	0	0.5
Total	13.2	22.1	14.1	11.3	10.8
Source: Dealogic and F	itch				

...But Private Sector Issuance Hit by the Credit Crunch

In contrast, private sector external bond issuance has been impaired by the credit crunch, with transactions in H207 falling to less than a third of the value seen in H107. There was some recovery in the first seven months of 2008, though the value of deals is still well below the pre-crisis peak. The global bond market has been an important source of private sector funding for Russian and Kazakh bank and corporate issuers, partly reflecting the relatively low foreign ownership of their banking system as well as the presence of some large commodity exporters.

Indeed, the abrupt loss of global capital market access for Kazak banks in summer 2007 was the trigger for a severe external financing squeeze and downward pressure on the currency, leading to a drop in central bank reserves in H207. High oil prices have helped to improve external finances this year, but a collapse in bank

• Year-to-date EE sovereign issuance at USD14.3bn has already surpassed last year's total, in contrast to the fall in private sector external bond issuance since the credit crunch

• Russian and Kazakh banks and companies are the most reliant on the international market, exposing them to financing risk, though they were able to increase issuance in H108 compared to H202 credit growth and the real estate sector has worsened the economic outlook and bank asset quality is deteriorating 6 .

Non-Sovereign External Bond Issuance

(USDbn)	H107	H207	Jan 08-Jul 08				
Total	42.3	13.1	28.6				
O/w Russia	25	9.1	19.8				
Kazakhstan	8.2	1.2	3.5				
Source: Dealogic							

Banking Systems a Possible Weak Link

Rampant bank credit growth has been a major driver of domestic demand, CADs and overheating in many countries in the region; and banks have been key channels for external financing either via foreign parent banks or direct market borrowing. Countries in EE saw some of the fastest rates of credit growth in the world during the last credit boom. In terms of bank credit growth to the private sector in real terms, averaged over 2006 and 2007, EE countries occupied the top five spots out of all Fitch-rated sovereigns: Azerbaijan (65%), Georgia (53%), Kazakhstan (53%), Armenia (50%) and Romania (50%). A further seven were in the top 16: Ukraine (45%), Latvia (35%), Lithuania (35%), Bulgaria (33%), Moldova (33%), Russia (31%) and Macedonia (30%). The CE4 stands out for having avoided the excess.

Rapid or above trend credit growth in conjunction with asset price booms and real exchange rate appreciation is used by Fitch in its Macro-Prudential Indicator (MPI) to highlight, in as objective a way as possible, the existence and severity of a set of macroeconomic circumstances that have been shown to anticipate most past episodes of banking system distress and, in some cases, full-blown crises⁷. Six countries in EE are in the MPI 3 "high" vulnerability category: Azerbaijan, Kazakhstan, Romania, Russia, Slovakia and Turkey (based on data up to end-2007).





Encouragingly, bank credit growth is now slowing in most countries, although it remains at an elevated level and the trend is not clearly established in some. In Estonia and Latvia, credit growth has been slowing steadily since the beginning of 2007, and in both countries growth was still in positive territory at 18% in June (on three-month-on-three-month annualised basis); and it has been easing in Lithuania since January. The nature of the slowdown partly reflects foreign banks' capacity and willingness to continue to supply credit, while tightening lending standards. In

 Rapid bank credit has been an essential element of the EE CAD and overheating story. Over 2006-2007, EE accounted for 12 out of the top 16 Fitch-rated countries with the fastest real credit growth

 Credit growth is now easing in most countries in the region, but there is a risk that the slowdown could be abrupt, heightening risks to growth and asset quality

• The importance of foreign banks in EE means the global credit crunch could trigger a marked fall in the supply of financing; and the opens up potential for contagion between eastern and western Europe

⁶ See "Kazakhstan: Reserves Rising Again, But Bank Asset Quality Suffering", published 17 July 2008 and available on www.fitchresearch.com.

⁷ See "Bank Systemic Risk Report" published 7 April 2008 and available on www.fitchresearch.com.



the Baltic states the credit slowdown appears to have been driven mainly from the demand side as the economy has slowed, housing affordability became stretched and then asset prices fell back. In Kazakhstan, however, where foreign bank ownership is much lower, the sudden stop to banks' access to external funding triggered a more precipitous drop in the supply of credit. The contrasting fortunes highlight the risk for countries further behind in the credit cycle that the adjustment phase may not necessarily be smooth. An abrupt decrease in the availability of credit would risk triggering sharp slowdowns in growth and falls in asset prices, all of which can feed back on themselves and lead to a deterioration in bank asset quality — as evident in Kazakhstan.

Overall, Fitch views the prevalence of foreign parent banks in much of the region as a positive feature that enhances their subsidiaries' access to financing and residents' confidence in local banks. Foreign parent banks should continue to derive benefits from their exposure to EE countries in the form of higher interest margins and market growth compared to operations in 'old' EU member states. However, there is a tail risk that, in the event that the credit crunch deepens or shocks emerge at key foreign parent banks, they could face heightened pressures on their own funding and capital, potentially leading them to cut the availability of external financing to the region. Furthermore, the strong links between developed-country parent banks and banking systems in countries in eastern Europe with large external financing requirements raise the spectre of potential contagion flowing in both directions. Nonetheless, this is only a potential risk - although banks' exposure to EE may have affected share prices, these links do not appear to have had a material impact on the supply of credit to the region, so far.



Bank Exposures to Emerging Europe End-2006 Global assets (%) Raiffeisen 43.0 Erste 33.6 KBC 15.1 Swedbank 13.5 UniCredit 11.0 SFB 6.5 Société Générale 4.7 Intesa Sannaolo 32 Commerzbank 2.2 ING 1.5 Citi 1.2 Source: Raiffeisen and Fitch

Ownership concentration does not seem excessive in terms of individual foreign banks' shares of the EE banking system (CE5, Baltics, Balkans plus Ukraine; end-2006 figures), with UniCredit leading the way with a market share of 11%, followed by Erste (8.5%). However, sub-region concentrations are higher: for example, Fitch estimates that between them Swedbank and SEB (both Swedish banks) own 56% of bank assets in the Baltic states. Conversely, the exposure of some western European banks to EE is material: Fitch estimates (end-2006 figures) that around 43% of Raiffeisen's global bank assets are in EE, 34% of Erste's, 15% of KBC's (mainly in the CE4), 13% of Swedbank's (mainly in the Baltics) and 11% of UniCredit's.

War and Political Risk

The conflict between Georgia and Russia, and Russia's bad relations with many of its neighbours, have heated up some long-standing concerns and imparted another negative shock to EE at an inopportune time.



Georgia

On 8 August, Fitch downgraded Georgia's Long-Term local currency (LC) and foreign currency (FC) Issuer Default ratings (IDRs) to 'B+' from 'BB-' and assigned Negative Outlooks to the ratings. Despite the ceasefire agreement, a lasting peace agreement and political stability is not guaranteed. There have been some encouraging signs of the economy's resilience and Fitch would expect support from international financial institutions. But the conflict has caused some decline in foreign reserves and an outflow of bank deposits, and it is likely to carry costs in terms of activity, the budget and private sector capital inflows. It remains too early to judge how severe the impact will be on the economy, but risks remain on the downside⁸.

Ukraine

The conflict and talk of a new cold war have raised the risk of contagion to other countries. Ukraine as a CIS country that has had a "colour revolution" and has NATO aspiration is the most obvious parallel. President Viktor Yushchenko's decree regarding restrictions on the movement of the Russian Black Sea fleet based in Crimea heightened tensions. And Russia could seek to use the ethnic Russian majority in Crimea to foment unrest — the mayor of Moscow, Yuri Luzhkov, has questioned the legal status of Crimea. Nevertheless, military conflict does not appear a significant risk — if it were to occur, it would be a major negative political, economic and credit event not only for Ukraine but also for Russia and other countries. The main risks for Ukraine appear to be that these tensions could increase domestic political infighting or complicate negotiation over Russian gas prices — but these were existing problems. A further risk is that it could reduce FDI if investors reappraise country risk; but the rationale from Ukraine's location, cheap labour costs and World Trade Organisation (WTO) accession remain.

Ukraine's credit default swap (CDS) spreads have spiked further since the Georgian conflict, but the exchange rate has been steady. Of course many factors are at work, but CDS tentatively suggest some relative impact on Latvia, Poland, Russia and Ukraine compared with Bulgaria, Hungary and Turkey.





Azerbaijan, Armenia and Moldova

Georgia is a key trade transit country for Azerbaijan and Armenia, and to a much lesser degree Kazakhstan. The conflict has caused some disruption to activity at the Georgian ports of Poti and Batumi, and to trade and some damage to rail infrastructure, but no damage has been reported to key oil and gas pipelines. Fitch understands that petrol and grain are currently in short supply in Armenia.

⁸ See "*Conflict Poses Risks to Georgian Economy*", published 19 August 2008 and available on www.fitchresearch.com.

Withdrawal of Russian troops should allow repairs to be carried out and trade to resume (the Georgian authorities estimate that the railway bridge in the Kaspi area could be repaired in around three weeks). In that case, the impact on Armenia and Azerbaijan should be short-lived and manageable.

Developments this year in Kosovo, South Ossetia and Abkhazia have brought the thorny problems of sovereignty, secession and international intervention back into the spotlight. Fitch does not expect military conflict to flare up in other post-Soviet frozen conflicts involving Moldova over Transdniestria or Armenia and Azerbaijan over Nagorno-Karabakh, though risks have increased at the margin.

Poland and the Baltic States

Russia's difficult relations with Poland and the Baltic states, which of course are all members of NATO and the EU, have long preceded events in Georgia. The agreement to site a US missile defence base on Polish territory has incited Russian anger and a threat to target Poland with nuclear weapons in the event of a nuclear war with the US (thankfully a risk off our chart). Poland is not very exposed to Russian trade (including energy imports) or investment, and Fitch does not see any material increase in risk to its credit outlook. The Baltic states have greater trade (including energy) exposure to Russia (see earlier) and feel more of a political threat. Latvia and Estonia have sizeable ethnic Russian minorities and all three countries have had various disputes with Russia in recent years. However, Fitch would not expect the Russian factor to affect FDI from key Nordic partners or other EU countries. The central rating consideration for the Baltic states is their sizeable CADs and uncertainties over the macroeconomic adjustments underway. Concerns about Russia could re-double efforts on the part of Poland and the three Baltic states to reach an agreement on building a new nuclear plant to replace Ignalina in Lithuania, which is due to close in 2009.

Russia

Fitch does not currently expect to take a negative rating action on Russia's sovereign rating owing to the conflict, as signalled by the Stable Outlook. The conflict is small in relation to Russia's military power and economy. Fitch does not expect trade or financial sanctions, though WTO accession is likely to be further delayed. Nevertheless, the Russian private sector's dependence on external borrowing means that it is not immune from international investor sentiment. Even before the war with Georgia, Fitch had expected private sector net capital inflows to fall to around USD40bn this year from a record USD81bn in 2007. The war, the dispute over control of the TNK-BP joint venture and pressure from the Kremlin on the steel producer Mechel, have brought political and corporate governance risks back to the fore and added to the country's risk premium and cost of capital. Substantial external borrowing by the Russian private sector has increased its external debt to USD413bn at end-2007, from just USD109bn at end-2004. More difficult capital market access could lead to some pressures on Russian banks' funding and reduce the pace at which they can expand credit, and on corporations that face substantial external amortisations as well as funding needs for investment projects. However, official FXR of USD580bn (including sovereign wealth funds) provide a massive liquidity cushion.

Credit Rating Trends

The strong upward rating momentum that characterised sovereigns in EE since 2003 has stalled. Since February 2007 there have only been three FC IDR upgrades in the region: the Czech Republic, Slovakia (due to euro adoption) and Armenia. Despite fears over macroeconomic imbalances in much of the region, so far there have only been two downgrades: Latvia and Georgia. However, the shift in the balance of Positive to Negative Outlooks or Watches from +5 in August 2007 to -5 in August 2008 highlights the downward pressure on ratings and credit quality. Seven countries in the region are now on Negative Outlooks, an unprecedented number

• The balance of Positive to Negative Outlooks has shifted from +5 in August 2007 to -5 in August 2008

since Fitch started sovereign ratings in the region in mid-1990s: Bulgaria, Estonia, Georgia, Kazakhstan, Latvia, Lithuania and Romania. Only two out of 20, Macedonia and Moldova, are on Positive Outlooks.



The increase in Negative Outlooks is consistent with the darkening economic and credit outlook: weakening growth, higher inflation and macroeconomic volatility, stretched external financing requirements, shifting bank credit trends following recent booms, and fragile global confidence and financing conditions. Although not Fitch's central scenario, the chances of a hard landing accompanied by exchange rate crisis somewhere in the region over the next 18 months are significant and rising. Hard landings matter for creditworthiness as they are likely to have an adverse impact on a country's bank asset quality and public finances. Devaluations of fixed exchange rates can have particular severe effects when foreign currency debt is prevalent on public and private sector balance sheets.

The weight of past upgrades has raised Fitch's average sovereign FC IDR in EE to between 'BBB-' and 'BBB', the highest of the broad EM regions. In fact, the change in average ratings understates the trend in creditworthiness, as new ratings tend to be added towards the lower end of the scale. Fitch's Sovereign Credit Index, which controls for new ratings coverage by chain linking, shows a steeper upward trend since 2003. However, that too has flattened off since early 2007 as the number of upgrades has diminished, while Latin America has taken over as the most upwardly mobile region.





• Average ratings in EE have flattened off, after strong upward momentum since 2003

Regional Round-Ups

Central Europe

Rating trends for sovereigns in Central Europe (Czech, Hungary, Poland, Slovakia and Slovenia) have been broadly positive over the past 12 months. The Outlook on Hungary's IDRs (FC 'BBB+') was revised to Stable from Negative in November 2007 as confidence increased that the authorities would succeed in meeting targets to reduce the government deficit in 2007 and 2008, helping to stabilise the government debt burden and contain the economy's external vulnerabilities. The budget deficit remains on track to slightly undershoot the government's deficit target of 4.3% in 2008. Negotiations over the 2009 budget, which comes ahead of elections that are due by April 2010, will be an important indicator of whether Hungary will be able to avoid a distinct election-related deterioration in public finances for the first time in its modern history. As such, the 2009 budget will be an important consideration in future credit trends.

The **Czech Republic**'s IDRs were upgraded by one notch (to FC IDR 'A+'/Stable and LC IDR 'AA-'/Stable) in May, driven by an improvement in the performance of public finances, the economy's relatively high income level and sound external position. Trends in **Slovakia**'s IDRs were driven by the country's progress with its ambition to adopt the euro in January 2009. Fitch placed the FC IDR on Positive Outlook in 2007 as judged that it was likely to meet the nominal Maastricht benchmarks, and then revised it to a Positive Rating Watch in May 2008 after positive reports by the European Commission and ECB. The FC IDR was subsequently upgraded to 'A+'/Stable in July on the day that formal approval of euro adoption was given by the Economic and Financial Affairs Council of the European Commission. **Poland** is the only sovereign of the CE4 not to have seen a rating or outlook changes over the past 12 months (following an upgrade of its LT and FC IDRs to 'A-'/Stable in January 2007). **Slovenia**'s ratings (FC and LC 'AA') have been unchanged since in July 2006, when the decision was taken to admit it to the euro area from January 2007.



All of the region's ratings are now on Stable Outlook, the first time since 2004 that the Outlook of at least one of them has not been Positive. While this is partly a reflection of actual rating upgrades over the past year or so, it also points to the less benign economic environment confronting the credits. International oil and food prices have contributed to a rise in the rate of inflation across the CEE over the past year (and halted a decline in the inflation rate in Hungary following the jump associated with higher administrative prices in 2007). In many cases, recent inflationary trends represent the most difficult test of monetary policy frameworks since EU accession in May 2004.

External demand is set to weaken this year as the economies of the region's main euro area trading partners slow, and export performance could be further undermined by the rapid appreciation of currencies that took place in the first half of 2008. Some easing in the pace of economic growth is welcome in the Czech



Republic and Poland, which were showing signs of capacity constraints. Aside from Hungary, Fitch's forecasts for GDP growth remain respectable and will continue to support income convergence with richer, western European countries. The largest influence on Slovakia's growth rate continues to be the expansion of industrial production from past inflows of FDI, most notably of cars. The external environment is particularly challenging for Hungary; while forecast real GDP growth of 2% in 2008 would represent an acceleration compared with last year, domestic demand has remained weak due to the government's fiscal retrenchment programme and tight monetary policy. But in contrast to other countries in the region, GDP growth increased slightly to 2.2% in Q208 from 1.7% in Q108.

Baltic States

Fitch's concerns about the Baltic states' overstretched external finances in the context of fixed exchange rates or CBAs, coupled with persistent double-digit inflation, have led it to take a number of negative rating actions over the last 18 months. Fitch downgraded Latvia's FC and LC IDRs to 'BBB+' from 'A-' and 'A-' from 'A', respectively, in August 2007, having placed the ratings on Negative Outlooks in April 2007. The agency also revised the Outlooks to Negative from Stable on Lithuania ('A'/'A+') in December 2007, followed by Estonia ('A'/'A+') and Latvia ('BBB+'/'A-') in January 2008, reflecting the scale and persistence of their macroeconomic imbalances coupled with heightened financing risk from global credit conditions.

After years of strong growth fuelled by massive capital inflows and rapid credit growth, the Baltic economies overheated and macroeconomic imbalances widened. Tight labour markets, high and rising inflation rates, substantial CADs and the accumulation of large private-sector external debt burdens indicated that the pace of growth had become unsustainable and an adjustment of some sort became desirable and inevitable. All three Baltic countries had double-digit CADs in 2007: at 23% of GDP, Latvia's CAD was the largest of 105 Fitch-rated sovereigns while Estonia's and Lithuania's were 17.7% and 13.7% of GDP respectively. At 16.5% in the 12-months to July, Latvia had the highest inflation rate in the EU, while Lithuania's was the third highest at 12.4% and Estonia's the fourth highest at 11.2%.



However, all three Baltic economies are now experiencing, to varying degrees, clear signs of an economic slowdown. Driven by a fall in private consumption and investment, real seasonally adjusted quarter-on-quarter GDP in Latvia began to moderate in Q107 and growth was just 0.1% in Q108. The slowdown has been in even sharper in Estonia, where real seasonally adjusted quarter-on-quarter growth actually contracted by 0.5% in Q108. While Lithuania's economic boom was more modest and its external and internal imbalances less marked than those of Latvia and Estonia, it too is experiencing a decline in real GDP growth. However, the slowdown appears to have started later than in Estonia and Latvia. Real seasonally

adjusted quarter-on-quarter GDP growth began to slow in Q307 and was just 0.3% in Q108, although it picked up to 1.1% in Q208.

Nevertheless, the Baltic states face a challenging and uncertain 12 months as they undergo a rapid macroeconomic adjustment in a difficult global economic and financial environment. While GDP growth rates are declining, inflation remains high and external finances over-stretched. Fitch expects the Outlooks and ratings to be driven by the nature and cost of the adjustment of the Baltic economies. An orderly unwinding of macroeconomic imbalances would likely lead Fitch to revise the Outlooks back to Stable. A recession or protracted slowdown, particularly in conjunction with persistent high inflation, deteriorating competitiveness, and problems in the banking sectors, would likely lead to a downgrade. Devaluation of the Baltic currencies – which is not Fitch's central scenario – would also likely lead to a downgrade.

South Eastern Europe

Fitch assigned Negative Outlooks to the 'BBB' ratings of Bulgaria and Romania in January 2008, signalling the agency's concerns over growing external imbalances and signs of overheating: rising CADs (22% and 14% of GDP respectively in 2007), driven by strong capital inflows and credit-fuelled domestic demand growth, and accompanied by rising inflation. Bulgaria's stock of bank credit to GDP, which has risen steeply since 2006, is now approaching the sort of level at which a correction began in the Baltics. However, the stock of credit is lower in Romania (just 36.6% of GDP at end-2007), implying greater headroom for strong credit growth to continue. Ultimately, bank credit and domestic demand cannot grow faster than GDP indefinitely and an adjustment will eventually take place. Even if Bulgaria and Romania avoid sharp slowdowns, their deteriorating external balance sheets weigh on their ratings, justifying the Negative Outlooks. Both Bulgaria and Romania's ratings are supported by their low general government debt to GDP ratios of 18% and 19%, respectively, at end-2007; and in the case of Bulgaria the budget surpluses it has been running since 2004. Romania's floating exchange rate could help it to adjust to shocks.





The Outlook on **Croatia's** 'BBB-' rating is Stable. Its richer economy has not run up imbalances on the scale of Bulgaria or Romania. However, the CAD may rise above 10% of GDP in 2008 as high commodity prices boost the import bill and weaker euro area demand slows export growth. Croatia's ratings are constrained by the economy's high external debt levels and its weaker fiscal position relative to peers. Progress with EU-related reforms would help to strengthen the business environment, encourage FDI and improve the economy's capacity to generate export receipts. Fitch's central scenario is for EU accession to take place in 2012.

The credit dynamics for **Serbia** ('BB-'/Stable) have been dominated by political risk over the past 12 months, though Fitch has maintained a Stable Outlook throughout the ebb and flow of events. Kosovo's declaration of independence and its





recognition by the US and a majority of EU states was a set-back that precipitated early elections. But after a nail-biting contest, pro-EU parties won the most seats and have formed a coalition government with the Socialist Party. The capture of Radovan Karadzic was a major fillip to progress on the long road to EU accession. But Serbia's substantial CAD, which was 12.8% of GDP in 2007, is a significant rating weakness.

Macedonia ('BB+'/Positive) has also been buffeted by political shocks this year. The long-running dispute over its name caused Greece to block its NATO accession in April, which could also be a barrier to gaining a start date to EU accession negotiations. Violence and voting irregularities in ethnic Albanian areas in parliamentary elections in June was also a negative development. However, the economy is growing steadily and the CAD is moderate by regional standards.

Turkey ('BB-'/Stable) has been hit by several adverse developments this year, including a surge in inflation and weakening in its inflation target, an oil pricedriven widening in its CAD amid a more challenging financing environment, a relaxation of its fiscal framework and an increase in political tensions⁹. The constitutional court's narrow decision not to ban the governing AK party, which has its roots in political Islam, has avoided a debilitating political crisis, but tensions persist. On the positive side, the level of Turkish GDP was revised up by over 30% this year, taking GDP per capita to above the 'BBB' range median, underscoring its credit fundamentals and the tolerance of its rating at the 'BB-' level to withstand a reasonable magnitude of shocks.

Commonwealth of Independent States and Georgia

The upwards momentum of CIS sovereign ratings has largely stalled over the past year, owing to a combination of overheating domestic economies, uncertain policy responses and a deteriorating global credit environment. Of three Positive Outlooks in place last year, **Ukraine** ('BB-') was revised to Stable in May on growing concerns over inflation and the sustainability of the economy's performance, while the Outlook on **Kazakhstan**'s 'BBB' rating was revised in stages to Negative in H207 as a bank-led boom ended in a hard landing. A third Positive Outlook, on **Armenia** ('BB'/Stable), was resolved in an upgrade in July 2008 as the economy's strong performance under disciplined macroeconomic policies continued. Armenia's small, relatively closed economy is less at risk from global shocks. Election-related violence in March 2008 highlighted political risk, although tensions appear to have eased, and the new administration has announced a raft of reforms aimed at tackling the underlying causes of discontent.

Fitch affirmed the ratings of **Azerbaijan** ('BB+'/Stable) in February and **Russia** ('BBB+'/Stable) in July. Despite the correction over the past month, high commodity prices continue to drive improvements in these countries' public and external balance sheets. However, Fitch's concerns over high inflation, rapid bank credit growth and signs of overheating in both economies have grown, while progress in tackling structural and institutional weaknesses has been limited. The TNK-BP dispute and Mechel affair have underlined the risks from the poor business environment in Russia, while the war with Georgia has dented international sentiment towards the country. More difficult access to global capital markets could put pressure on some Russian banks' funding and on corporations that face substantial external amortisations.

Fitch revised down the Outlooks for Kazakhstan and Ukraine as both countries' more heavily externally indebted economies face external finance risks arising from tighter access to international capital markets and threats to macroeconomic stability from high inflation. **Kazakhstan** has been most severely affected so far, as a credit boom came to a crashing halt amid heightened global market volatility



⁹ See *"Turkey: Déjà vu"*, published 28 July 2008 and available on www.fitchresearch.com.



since July 2007. Kazakhstani banks' asset quality is deteriorating as the real economy slows, which could, if sustained, erode capitalisation and lead to a requirement for sovereign support, in turn adding to pressure for a downgrade. Inflation picked up to 20% by July 2008, adding to risks facing the economy. But Kazakhstan's official reserves grew again in H108 after falling 25% in H207, with the CA boosted by high oil prices, lessening the risk of a currency crisis.



The squeeze on the banks and resulting slowdown in **Ukraine** so far has been much more moderate, with annual GDP growth slowing to 5.4% by June 2008 from 7.7% in 2007. Inflation of 26.8% yoy in July was still very high, but down from 31.1% in May. Fitch expects Ukraine's CAD to swell to 6.5% in 2008 from 4.2% in 2007 as strong credit-fuelled domestic demand sucks in imports, while another steep hike in Ukraine's gas import price could take the deficit to double digits in 2009. Strong capital inflows helped buoy reserves to USD37.9bn by July 2008, up USD6.7bn on the year to date. But a failure of capital inflows to keep pace with the rising CAD could lead to downwards pressure on the currency and sharply elevated risks for Ukraine's heavily dollarised financial system and the broader economy.

Fitch downgraded the rating of **Georgia** to 'B+' from 'BB-' and assigned a Negative Outlook to the 'B+' rating on 8 August as the conflict with South Ossetian separatists and then Russia escalated. The ensuing war with Russia has materially increased downside risks to Georgia's economic outlook and creditworthiness.

Moldova's rating of 'B-' has remained unchanged at over the past 12 months. The rating, which is the lowest in EE, is on a Positive Outlook as the economy is growing and moderate budget deficits are helping to reduce its public debt ratio. However, a rise in inflation, substantial CAD and possible further increase in Russian gas prices could see the Outlook revert to Stable.

• Euro adoption will continue to be a material driver of sovereign rating actions in eastern Europe over the medium term

Annex: EMU Convergence

European Economic and Monetary Union (EMU) is a material driver of sovereign rating actions in eastern Europe as Fitch believes that it renders the risk of balance of payment and currency crises negligible and can, therefore, lead to one- or two-notch upgrades of FC IDRs¹⁰. Indeed, Fitch upgraded Slovakia's FC IDR to 'A+' from 'A' in July, following the formal decision by European finance ministers that it will become the 16th member of the euro area on 1 January 2009¹¹. Elsewhere, however, there have been further setbacks to euro adoption timetables over the past 12 months, and Fitch expects at least a three-year hiatus before the next country adopts the euro.

Meeting the Maastricht Criteria

The table below gives the latest snapshot of how the new EU members measure up against the Maastricht criteria, which candidates must meet to qualify for EMU.

Maastricht Scorecard

	Inflation (%)ª	Fiscal balance (% GDP) [♭]	Govt debt (% GDP) ^c	Long-term interest rates (%) ^d	ERM II entry	Reference rates met
Reference value	3.7	-3	60	6.4	2 years	5
Bulgaria	11.5	3.4	18.2	4.9	No	3
Czech Republic	5.5	-1.6	28.7	4.6	No	3
Estonia	9.7	2.8	3.4	7.1	Jun 04	3
Hungary	7	-5.5	66	7.3	No	0
Latvia	14.5	0	9.7	5.4	Apr 05	4
Lithuania	9.3	-1.2	17.3	4.7	Jun 04	4
Poland	3.7	-2	45.2	5.9	No	4
Romania	7.1	-2.5	13.1	7.1	No	2
Slovakia	2.8	-2.2	29.4	4.6	Nov 05	5
No. of countries	2	8	8	6	4	n.a.

^a Average of 12-month inflation rate over the 12 months to June 2008, based on Harmonised Indices of Consumer Prices (HICP). EU member states with lowest HICP

inflation: Netherlands 1.7%, UK 2.4% and Denmark or Sweden 2.6%. Average 2.2% + 1.5% = 3.7% reference rate

^b 2007, net lending under the Excessive Deficit Procedure (EDP), excluding private pension funds from the general government sector, i.e. including pension reform costs ^c End-2007, general government gross debt ESA95 basis, excluding private pension funds from the government sector

^d Average of 10-year government bond rates in 12 months to June 2008.

Rates for EU member states used in inflation criterion: Netherlands 4.3%, UK 4.8% and Denmark 4.3%. Average 4.4% +2.0% = 6.4% reference rate.

Estonia has no long-term government bond, but the ECB has created a proxy based on bank lending rates

Sources: Eurostat, European Commission and Fitch

- Aside from Slovakia, Latvia, Lithuania and Poland meet the most criteria: four out of five, while Hungary meets the least: none.
- Compared with Fitch's 2007 "*EMU Convergence Report*", Poland meets one more criterion, while the Czech Republic and Estonia meet one fewer, and the other countries the same number.
- However, that underplays the setback to euro adoption prospects over the past 12 months, as the surge in inflation in EE has put the reference rate even further out of reach. Inflation is by far the hardest criterion to meet and is the binding constraint for most countries. It is currently met only by Poland (as well as Slovakia).

¹⁰ Since 2004, Fitch has produced an annual EMU Convergence Report, which has reviewed the timetables, risks and rating implications of each country's prospective convergence path towards the euro. This year, however, owing to further slippage in EMU timetable, Fitch is folding its assessment into the *Emerging Europe Sovereign Review*. See "*EMU Convergence Report: 2007*", published 28 September 2007 and available on www.fitchresearch.com, for discussion of Fitch's rating approach to euro adoption.

¹¹ See "Slovakia: In the Euro Waiting Room", published 8 May 2008 and "Credit Update on Slovakia", 9 July 2008.

- Slovakia's green light proved poorer countries can qualify and be accepted for EMU, despite ECB concerns over their capacity to sustain low inflation...
- ...But it will be harder for countries with fixed exchange rates. And Slovakia will remain a test case within the euro area

• Five of the countries have yet to join the Exchange Rate Mechanism (ERM II) and none have joined since Slovakia in 2005. The minimum two-year membership requirement and the assessment period (spring for euro adoption in the following January), means that countries would need to join the ERM II in spring 2009 to keep open the option of euro adoption in 2012.

The Slovak Test Case

Slovakia's green light to adopt the euro was a fillip to hopes across the region, as it had become a test case following the rejection of Lithuania in 2006 on the grounds of concerns about the "sustainability" of its inflation performance (as well as missing the inflation reference rate by less than 0.1pp). Slovakia's experience proved that (1) it is possible for a country to meet all the criteria simultaneously and (2) the EU authorities are prepared to allow a relatively poor and fast growing country to join the euro area in those circumstances, despite concerns about its capacity to sustain low inflation once locked within the common currency. Furthermore, Slovakia's admission to the EU's top table may spur the Czech Republic and Poland to soften their euro-scepticism, particularly if they were to lose out to Slovakia on major FDI projects due to its euro membership.

That said, a key reason for Slovakia being able to meet the inflation criterion was the revaluation of its exchange rate within the ERM II – the final conversion rate was 21.7% stronger than the original central parity set in November 2005 (albeit reflecting strong productivity growth as well as disinflation considerations). In the future, revaluation (though likely of lower magnitude) could also help the Czech Republic, Hungary and Poland to meet the inflation criterion, but the fixed exchange rate regimes of the Baltic states and Bulgaria would preclude that option. Moreover, if Slovakia experiences a surge in inflation and an excessive financial boom under the "one size fits all" interest rates set by the European Central Bank (ECB), then it could strengthen the case for other countries delaying euro adoption until they have attained greater real convergence¹².





¹² Even though it is substantially richer than other new member states, Slovenia has seen a rise in its 12-month HICP inflation rate to 6.8% in June 2008 from 2.0% (12-month moving average 2.3%) in March 2006, the data available when the ECB and EC were undertaking their assessments. The Baltic states and Bulgaria have also experienced financial booms, large CADs and high inflation, having fixed their currencies to the euro.

Fitch ERM II and Euro Adoption Forecasts

Country	ERM II	Euro
Bulgaria	2010	2015
Czech Rep	2011	2014
Estonia	Joined	2013
Hungary	2010	2014
Latvia	Joined	2014
Lithuania	Joined	2013
Poland	2009	2012
Romania	2012	2015
Slovakia	Joined	2009
Source: Fitch		

Official Targets and Fitch Forecast Dates

Only Romania still has an official ERM II and euro adoption target date, which is 2012 for ERM II entry and euro adoption in 2014, though in several countries key individual policy makers, governments or central banks have said they hope their country to join as soon as possible or by a certain date.



Fitch's latest forecasts dates for ERM II and euro adoption are shown in the table to the left and the chart above ¹³. Compared with its forecasts in the "*EMU Convergence Report: 2007*", Fitch has pushed out its euro adoption forecasts dates by one year for Bulgaria, the Czech Republic, Estonia and Latvia, while there is no change for, Hungary, Lithuania, Poland and Romania. For all these countries, the timeline to the euro is too far off to warrant any euro-related rating actions.

Baltic States

Fitch expects Estonia and Lithuania to adopt the euro in 2013 and Latvia in 2014. The recent upsurge in inflation (HICP in 12 months to June) to 17.5% in Latvia, 12.7% in Lithuania and 11.5% in Estonia underlines the challenge of meeting the inflation criterion. Recent unsustainable booms also cast doubt on the compatibility of their exchange rate regimes with delivering sustainable low inflation until they have achieved greater real convergence with the euro area. All three countries face a testing 12 months or so, as signalled by their Negative rating Outlooks, as macroeconomic imbalances unwind.

The sharp economic downturn underway in Estonia and Latvia, and more measured slowdown in Lithuania, where imbalances were less extended, should help to bring down inflation, but their adjustment paths are uncertain. Labour market flexibility and restrained price expectations will be key elements to a successful disinflation. Nevertheless, even in a benign scenario, lags in the feed-through of economic conditions to prices, the 12-month moving average inflation indicator and the assessment timetable mean Fitch thinks euro adoption is unlikely before 2013, while longer delays are possible. For Estonia, the speed of the economic adjustment underway, coupled with its relatively quick phasing in of excise tax and administered price increases, means 2012 is still just possible. But indirect taxes and administered price rises will take longer in Lithuania and the closure of the Ignalina nuclear plant in 2009 could add to energy price pressures.

Czech Republic and Poland

Meeting the inflation criterion will also be a challenge for the Czech Republic and Poland, but their trend nominal exchange rate appreciation and credible inflation targeting regimes leave them well placed relative to other member states, as does the Czech Republic's greater real convergence. Both countries have a relatively

• Fitch expects the upsurge in inflation in the Baltic states to push EMU out to 2013 to 2014

• Political will is the key constraint on the Czech Republic and Poland joining the euro

¹³ These are the dates that Fitch sees as the most likely. In general, they are not symmetrical in that there is a greater probability of delay than earlier entry.



short track record of fiscal discipline, with budget deficits only falling below 3% in 2006 in Czech and 2007 in Poland, helped by the economic cycle.

The fact that Poland meets all the criteria except for exchange rate stability, and so did the Czech Republic until the current spike in inflation, highlights that a lack of political will is the main barrier to them joining the euro. The Civic Platform-led government elected in Poland in October 2007 is keener to join than its predecessor and Finance Minister Jacek Rostowski has said publicly that ERM II entry is possible in 2009, which would be consistent with the euro in 2012. But this would be the earliest conceivable date and delays are quite possible. In the Czech Republic, the euro-scepticism of the Civic Democratic Party (ODS) government appears likely to prevent ERM II entry until after parliamentary elections scheduled for June 2010. Fitch is, therefore, forecasting ERM II entry in 2011 and euro adoption in 2014.



 Hungary does not meet any of the Maastricht criteria, but is it a tortoise amongst hares?

Bulgaria's macroeconomic imbalances underline the challenges it faces to attain sustained nominal convergence and appear to have led the ECB to discourage ERM II entry

Hungary

As well as reducing inflation, the government will need to stick to its ambitious fiscal retrenchment programme to qualify for euro adoption. It has made good progress to date in cutting the budget deficit from 9.3% of GDP in 2006 to 5.5% in 2007 and Fitch projects 4% this year. But although Fitch does not expect the sort of spectacular pre-election blow-out seen in the past ahead of spring 2010 elections, it thinks fiscal consolidation could stall in 2009-2010. If the current and subsequent government sticks to the fiscal hair-shirt, then euro adoption in 2013 is possible, but Fitch is retaining its long-standing forecast of 2014. The precedents of Cyprus and Malta suggest a government debt ratio of greater than 60% of GDP should not be a constraint, as long as it was falling. The agency is also retaining its ERM II entry forecast of 2010, as it is possible the government could follow the strategy of Slovakia in 2005 by joining as a confidence building signal before the elections as well as to keep open the possibility of EMU in 2013.

Bulgaria

Prior to EU accession in 2007, Bulgaria's policy had been to join the ERM II and adopt the euro as soon as possible, which would a logical "exit strategy" from its CBA. However, Fitch believes that the EU authorities have discouraged "premature" ERM II entry in view of Bulgaria's large CAD, which raises questions about the sustainability of its current macroeconomic settings and its equilibrium exchange rate. Fitch has similar concerns about macroeconomic imbalances, reflected in its Negative Outlook. 12-month HICP inflation increased to 14.7% in June. The experience of the Baltics, as well as Bulgaria's low income levels, suggest it will be difficult for it to meet the inflation criterion (including addressing concerns about a "sustainable" price performance, particularly with its CBA). There does not appear to a strong rationale for pinpointing any particular date for EMU (2012 is the earliest possible), but Fitch is forecasting 2015.



• Romania requires further time to attain real and nominal convergence, and Fitch does not expect it to adopt the euro until 2015

Romania

Romania is also showing signs of overheating and macroeconomic imbalances and was consequently placed on Negative Outlook by Fitch. Like Bulgaria, it is relatively poor, so the catch-up in incomes and price levels is likely to add to inflation over the foreseeable future. 12-month HICP inflation was a comparatively moderate 8.7% in June, but over a five-year track record inflation has been higher than in the other member states, which has contributed to long-term interest rates above the Maastricht reference rate as well as exchange rate volatility. In addition, the cyclically adjusted budget deficit was around 3% of GDP in 2006 and 2007, pointing to the need for some tightening in fiscal policy. The Romanian authorities recognise the need for the country to secure greater nominal and real convergence before entering the ERM II, which they plan for 2012. On that basis, Fitch is sticking to its forecast of euro adoption in January 2015, which in its view would be the earliest realistic date consistent with ERM II entry in 2012 owing to the lags in the assessment period.



Selected Indicators

Selected Indicators

				GDP per capita			
_	GD	P growth (%)	(USD)	Current account (% GDP)		
-	2007	2008f	2009f	2007	2007	2008f	2009f
Armenia	13.8	12.5	10.5	3,068	-6.2	-9.5	-10.0
Azerbaijan	23.4	18.6	15.6	3,521	30.7	38.6	37.2
Bulgaria	6.2	6	5	5,167	-21.7	-22.0	-19.5
Croatia	5.6	4.1	4.3	11,559	-8.6	-10.2	-9.6
Czech Republic	6.5	4.3	4.6	17,211	-2.6	-3.0	-2.7
Estonia	7.1	-0.5	1.5	16,238	-17.3	-10.3	-7.7
Georgia	12.4	5	5	2,334	-19.9	-17.5	-15.2
Hungary	1.3	2.2	2.8	13,738	-5.0	-4.5	-4.7
Kazakhstan	8.5	5	3	6,761	-6.9	4.0	-1.0
Latvia	10.3	1	1.5	11,927	-22.9	-19.4	-17.4
Lithuania	8.8	4.5	3.5	11,334	-13.2	-14.5	-11.7
Macedonia	5	4.5	5	3,651	-2.7	-6.7	-5.9
Moldova	5	7	8	1,324	-17.7	-17.1	-16.5
Poland	6.6	5	4.5	11,027	-3.8	-4.9	-5.5
Romania	6	7	5	7,710	-13.9	-17.0	-16.5
Russia	8.1	7.5	6.5	9,079	6.1	6.1	1.1
Serbia	7.5	6	5	5,513	-12.8	-12.0	-11.0
Slovakia	10.4	7	6.3	13,911	-5.3	-4.5	-4.2
Slovenia	6.1	4.2	3.9	22,942	-4.9	-4.9	-4.4
Turkey	4.5	4	4.5	8,775	-5.8	-6.4	-5.7
Ukraine	7.7	6	4	3,045	-4.2	-6.5	-10.5
Source: Fitch							

Selected Indicators

2007	Gross external debt (% GDP)	Net external debt (% CXR)	Liquidity ratio (2008)	FX reserves (months of CXP)	General govt debt (% GDP)	Bank credit to private sector (% GDP)
Armenia	32	6	228	4.8	15	14
Azerbaijan	20	-6	277	3.4	10	16
Bulgaria	100	39	124	5.7	18	67
Croatia	96	83	96	4.9	38	72
Czech Republic	43	-10	192	2.7	29	48
Estonia	110	51	83	1.8	3	94
Georgia	46	58	101	2.5	25	28
Hungary	103	72	81	2.3	66	61
Kazakhstan	88	37	152	6.3	5	62
Latvia	134	92	80	2.9	10	94
Lithuania	66	49	117	3.6	17	61
Macedonia	35	-19	705	4.5	25	39
Moldova	78	34	110	3.4	29	38
Poland	55	52	81	3.6	45	40
Romania	48	51	101	5.5	19	37
Russia	36	-43	259	15.3	8	38
Serbia	64	63	290	7.2	29	33
Slovakia	59	20	79	3.1	29	42
Slovenia	97	20	32	0.3	24	81
Turkey	43	81	92	4.9	39	30
Ukraine	61	65	97	5.1	10	59

CXR: current external receipts; CXP: current external payments. Source: Fitch

Long-Term Issuer Default Ratings at 25 August

	LTFC	FC outlook	LTLC	LC outlook	Country ceiling (FC)
Armenia	BB	Stable	BB	Stable	BB+
Azerbaijan	BB+	Stable	BB+	Stable	BB+
Bulgaria	BBB	Negative	BBB+	Negative	A-
Croatia	BBB-	Stable	BBB+	Stable	BBB+
Czech Republic	A+	Stable	AA-	Stable	AA+
Estonia	Α	Negative	A+	Negative	AA
Georgia	B+	Negative	B+	Negative	B+
Hungary	BBB+	Stable	A-	Stable	A+
Kazakhstan	BBB	Negative	BBB+	Negative	BBB+
Latvia	BBB+	Negative	A-	Negative	A+
Lithuania	А	Negative	A+	Negative	AA
Macedonia	BB+	Positive	BB+	Positive	BBB-
Moldova	B-	Positive	В	Positive	B-
Poland	A-	Stable	А	Stable	AA-
Romania	BBB	Negative	BBB+	Negative	A-
Russia	BBB+	Stable	BBB+	Stable	A-
Serbia	BB-	Stable	BB-	Stable	BB-
Slovakia	A+	Stable	A+	Stable	AAA
Slovenia	AA	Stable	AA	Stable	AAA
Turkey	BB-	Stable	BB	Stable	BB
Ukraine	BB-	Stable	BB-	Stable	BB-
Source: Fitch					

Long-Term Issuer Default Ratings at 26 August 2008

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