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Special Comment

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'Emerging' European Sovereigns: The Case for Risk Differentiation

Responding to Investors' Questions

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Summary

The ongoing global crisis has affected the economies of all European countries to varying degrees, with the result that the ratings of selected countries have come under scrutiny. This report focuses on "emerging" European countries – broadly speaking countries with bond ratings of A and below. (A companion report[1] presents our views on the risk of a break-up of the European Monetary Union – a risk we judge negligible at this stage – and on the support mechanisms that exist within the Union, which we believe are more important than generally thought.)

- There is no justification for treating all central and eastern European (CEE) governments as if their creditworthiness was uniform – differentiation is essential because not all countries are equally vulnerable. The most vulnerable are countries that engaged in an imprudent process of financial deepening, which we measure through our "Government Refinancing Risk Indicator".
- For the affected countries, a key question is whether international banks will absorb or amplify shocks. In our view, the risk of intra-EU financial retrenchment remains very limited – but a slowdown in credit allocation will aggravate the hard landing.
- A further question is whether the EU can help. There are various financial solidarity mechanisms, and it seems unlikely that troubled EU member states would be denied the helping hand that is being extended to European banks and corporates at national and regional level.

[1] Please refer to Moody's Special Comment entitled "EMU Steadfast Amid the Global Crisis: Risk of Eurozone Break-Up Negligible", March 2009.

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Turmoil Among 'Emerging' European Sovereigns: The Case for Risk Differentiation

- Overall, there are two types of rating pressure. First, some countries are experiencing a structural erosion of their economic strength – effectively a reversal of the convergence process. Second, concerns about refinancing risk have to be balanced with regional and international solidarity. This makes some ratings vulnerable to abrupt downward migration should our assumptions about EU solidarity prove to be unfounded.
- Taking account of the two key considerations of fundamental downward rating pressure and migration risk, we have grouped "emerging" European countries into four categories:
  - Countries whose rating is well anchored despite challenging conditions – e.g. the Czech Republic (A1), Slovakia (A1) and Poland (A2).
  - Countries whose relative credit fundamentals are resilient but potentially subject to some degree of rating volatility. For these countries (e.g. Romania, Bulgaria and Croatia, all of which are rated Baa3), event risk – either because of very tight financing conditions or exchange rate risk – makes our rating increasingly dependent on external support.
  - Countries whose relative credit fundamentals are eroded – as their convergence process is likely to be derailed for a prolonged time – but where material regional support will provide a rating floor, unless our support assumptions prove unfounded: the Baltic countries – Estonia (A1), Lithuania (A2), Latvia (Baa1) and Hungary (A3).
  - Countries whose relative credit fundamentals are eroded and where we perceive external support as being much less reliable – and this only applies to Ukraine (B1).

Countries mentioned in this report			
EU members			Outside EU
EMU		Non EMU	
Austria (Aaa)	Slovakia (A1)	Bulgaria (Baa3)	Croatia (Baa3)
Belgium (Aa1)	Spain (Aaa)	Czech Republic (A1)	Ukraine (B1)
Finland (Aaa)		Estonia (A1)	
France (Aaa)		Hungary (A3)	
Germany (Aaa)		Latvia (Baa1)	
Greece (A1)		Lithuania (A2)	
Ireland (Aaa)		Poland (A2)	
Italy (Aa2)		Romania (Baa3)	
Netherlands (Aaa)		Sweden (Aaa)	
Portugal (Aa2)		United Kingdom (Aaa)	

1. The Nature & Scale of Financial Risk Among "Emerging" European Sovereigns

Defining the Problem

Key Message:

Europe, and in particular Central and Eastern Europe, is not a homogeneous region. The scale of the challenges faced by all countries is currently limited, but liquidity risk could aggravate them.

Many analysts and journalists have written about "European" (writ large) sovereign risk, but many appear to have lost sight of the fact that the region is heterogeneous. We believe that we need to differentiate between at least three economic and institutional groupings: countries that are members of the European Monetary Union (EMU); EU members that are not part of EMU; and non-EU countries.

Moreover, regardless of the intensity of the crisis, the scale of the problem is limited – or more precisely, there is an inverted relationship between the scale of the problem and the intensity of liquidity risk.

Advanced economies (such as Ireland and the UK, followed by the other large EU countries) are facing a sharp macro-economic contraction and, in some cases, considerable public debt challenges as a result of the banking crises. However, despite the scale of the problem in many advanced economies, these countries have time on their side to address the problem. With the exception of Iceland, advanced EU economies do not face any tangible liquidity risk.

EU non-EMU emerging countries, on the other hand, have varying exposures to three major shocks: the contraction of their EU economic partners' economies and demand; credit attrition following years of credit over-extension; and the reduced – and in some cases shattered – prospects for continued economic convergence.

However, the scale of the problem is limited for the eurozone as a whole: for instance, the refinancing needs of the Latvian government are 0.4% of what the French government will borrow in 2009. Even when taking into account contingent liabilities, and assuming that the government will have to arrange further external financing if the situation continues, Latvia's total borrowings would still not exceed 3% of France's borrowing needs. By comparison, the financing needs of Poland – the largest country in the "emerging" part of Europe – amount to €61 billion, compared with €324 billion in the case of Germany.

The problem is that liquidity pressures are compounding the challenges for these countries, as shown by Moody's "Government Refinancing Risk Indicator", which is explained later on in this report.

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Remaining Gross Government Borrowing Requirements, 2009

Country	Bn Euros	% of GDP	% of Revenues	% of Germany's BR
Eurozone countries				
Austria (Aaa)	5.5	2.0	4.2	1.7
Belgium (Aa1)	38.2	11.0	23.4	11.8
Finland (Aaa)	12.9	6.8	13.5	4.0
France (Aaa)	293.7	15.0	30.3	90.8
Germany (Aaa)	323.6	13.1	30.7	100.0
Greece (A1)	32.0	12.7	32.0	9.9
Ireland (Aaa)	0.5	0.3	0.9	0.2
Italy (Aa2)	364.0	23.3	49.9	112.5
Netherlands (Aaa)	136.7	23.1	51.2	42.3
Portugal (Aa2)	23.2	13.6	32.6	7.2
Slovakia (A1)	0.8	0.9	2.9	0.2
Spain (Aaa)	151.0	13.6	37.0	46.7
EU non EMU countries				
Sweden (Aaa)	29.0	9.3	18.7	9.0
United Kingdom (Aaa)	207.1	12.8	32.8	64.0
Bulgaria (Baa3)	0	0	0	0
Czech Republic (A1)	5.8	3.2	7.8	1.8
Estonia (A1)	0	0	0	0
Hungary (A3)	15.3	14.2	31.7	4.7
Latvia (Baa1)	1.1	5.4	15.0	0.3
Lithuania (A2)	2.1	6.7	19.7	0.6
Poland (A2)	37.7	11.6	29.2	11.7
Romania (Baa3)	14.9	11.2	33.3	4.6
Non EU member countries				
Croatia (Baa3)	2.4	5.2	13.2	0.8
Ukraine (B1)	3.5	3.6	8.2	1.1

Adjusted External Financing Needs for 2009 [1]

Country	Bn Euros	% of GDP
Bulgaria (Baa3)	14.8	43.3
Czech Republic (A1)	12.1	6.6
Estonia (A1)	4.7	30.1
Hungary (A3)	11.3	10.5
Latvia (Baa1)	13.4	64.4
Lithuania (A2)	9.1	29.2
Poland (A2)	60.8	18.7
Romania (Baa3)	29.0	21.8
Croatia (Baa3)	8.2	17.3
Ukraine (B1)	10.5	10.6

[1] We assume countries use 60% of their foreign exchange reserves to cover external financing needs. External support of the EU/IMF is taken into account as well.

Why Are Some Countries More Affected Than Others?

Key Message:

A core group of CEE countries has followed a prudent approach in terms of financial integration and therefore displays greater resilience – and this is reflected in the respective countries' ratings.

A lack of differentiation between the health of the economies in CEE has led to widespread misconceptions about the scale of the problems in the region. This in turn has also generated misunderstandings about the implications of those problems for the Western European countries with whom they are closely integrated.

The countries in the region generally share similar economic characteristics, investors and trade partners – a consideration that has led some observers to erroneously assume too many similarities among their relative economic and institutional strengths and even debt affordability. It is partly for this reason that a degree of panic has engulfed the region, spreading concerns about a region-wide "meltdown" – with no differentiation between countries.

The intensification of the global crisis last September/October affected many of the emerging markets that had previously seemed resilient to and even decoupled from what was going on in advanced industrialized countries.

Very early on, it became clear which European emerging markets – either by virtue of their membership of the eurozone or their relative economic strengths – would be likely to escape the crisis with their economic models and sovereign ratings more or less intact.

This first tier of countries is a relatively short list, encompassing Poland, the Czech Republic, Slovakia and Slovenia. However, these countries will still experience significant shocks to their growth rates because of their openness towards the rest of Europe and the world.

The fundamental difference between the most resilient countries and the others is that the former followed a much more restrained pace of financial integration, characterized by a slower speed of financial deepening (lower credit growth rate, higher reliance on deposit funding) and less reliance on (unhedged) foreign currency financing intermediated by banks.

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Countries	Speed of financial deepening: growth in % of domestic credit to GDP ratio 2000-07 period	Reliance on external funding: external debt growth in % 2000-07 period	Macroeconomic imbalances: Current account deficit + fiscal deficit or surplus (%of GDP)	
			FY2000	FY2007
Latvia (Baa1)	307.2	120.0	-7.4	-23.9
Lithuania (A2)	297.2	70.2	-9.1	-15.9
Bulgaria (Baa3)	232.3	12.4	-6.6	-18.0
Estonia (A1)	172.6	112.2	-5.6	-15.3
Romania (Baa3)	155.5	43.2	-7.6	-16.6
Croatia (Baa3)	75.5	35.1	-8.2	-10.3
Hungary (A3)	39.0	65.2	-11.4	-9.8
Poland (A2)	33.9	24.3	-9.0	-6.8
Czech Republic (A1)	6.9	11.7	-8.4	-3.6
Slovakia (A1)	-9.1	11.1	-15.7	-7.2

As a result, and as shown in the table above, the more resilient countries did not develop sizeable macroeconomic imbalances during the height of the credit boom. Consequently, they are less prone to experience the downturn in their property and financial sectors that the more vulnerable countries are experiencing.

Kristin Lindow, SVP-RCO Europe

2. Emerging Europe: Deconstructing Moody's Analytical Approach

Some countries have been hit harder than others, and we explained the reasons in the first section.

In light of the ongoing and prolonged "sudden stop"[2] in international funding that we are seeing, we believe that the ratings of some emerging European countries now depend increasingly on three factors:

- Is there a serious roll-over risk for the government?
- Are banks going to absorb or amplify shocks?
- Are there reasons to doubt that EU financial solidarity may be forthcoming?

How Does Moody's Measure Government Refinancing Risk?

Key Message:

Elevated refinancing risk induces an increase in the risk of rating migration. Hence, in terms of our sovereign bond rating methodology, Factor 4 ("susceptibility to event risk") is affected. The two forms of Government Refinancing Risk Indicator (GRRI and GRRI+) indicate that EMU countries do not exhibit significant refinancing risk. However, the picture is different for CEE countries as their GRRI/GRRI+ results suggest that the creditworthiness of Hungary, Estonia, Latvia, Lithuania, Bulgaria, Romania, Croatia and Ukraine is to some extent affected by heightened refinancing risk.

The Model:

In order to assess the refinancing risks that European sovereigns face in the current environment, Moody's has constructed the Government Refinancing Risk Indicator. The indicator reflects both the ability of sovereigns to access the market and their need to do so. The idea is simple: only countries that have considerable financing needs and are at the same time constrained in their ability to tap the market exhibit refinancing risk. A government can face a momentary buyers' strike, but if it has no need to tap the market for nine months or so, the situation would not be desperate. The volumes of the financing needs for 2009 (relative to GDP) are thus corrected for successful issuances in the year to date. Moreover, cash balances, liquid assets in funds as well as available external support (EU/IMF, for instance) are considered. The evaluation of market access is based on the level of CDS spreads.

GRRI/GRRI+:

We stipulate two types of Government Refinancing Risk Indicator, each of which differs in scope: whereas the simple GRRI measures the refinancing risk of the government, the scope of the GRRI+ is broader and additionally includes contingent liabilities that may arise in a "balance sheet substitution scenario". What we mean here is a situation where, in addition to its expected borrowing needs, the government needs to borrow more because its banking system is in troubles[3] and/or intervene to bail out private sector agents in the event that external financing dries up entirely – we capture here all banks and corporations' external funding needs.

[2] Please refer to Moody's Special Comment entitled "Rating Sovereigns During a Global 'Sudden Stop' in International Funding", published in November 2008.

[3] In addition to government funding requirements, we assume that they have to raise funds for an amount consistent with our stress-scenario of banking losses – we do not include all banks own funding requirements. Stressed losses for banking systems are calculated by looking at a worst case scenario which goes significantly beyond historical loss experiences and current mark-to-market valuations. These stressed loss assumptions are applied to both loans and structured securities. In terms of loans, we generally used a multiple of the loss rates experienced during recent periods of substantial economic slowdown. That multiple varied by asset class, and from country to country, but was generally 1.5 times to 3 times peak loss rates. For loan classes that are often the object of securitization, we also used stressed loan losses rates calculated in conjunction with our structured finance group. For structured securities, we assumed that they would not be held to maturity. Therefore, we applied mark-to-market loss rates, stressed to a 95% confidence level. It is important to note that these loss rates are significantly higher than our expected loss rates, even under a stressed scenario.

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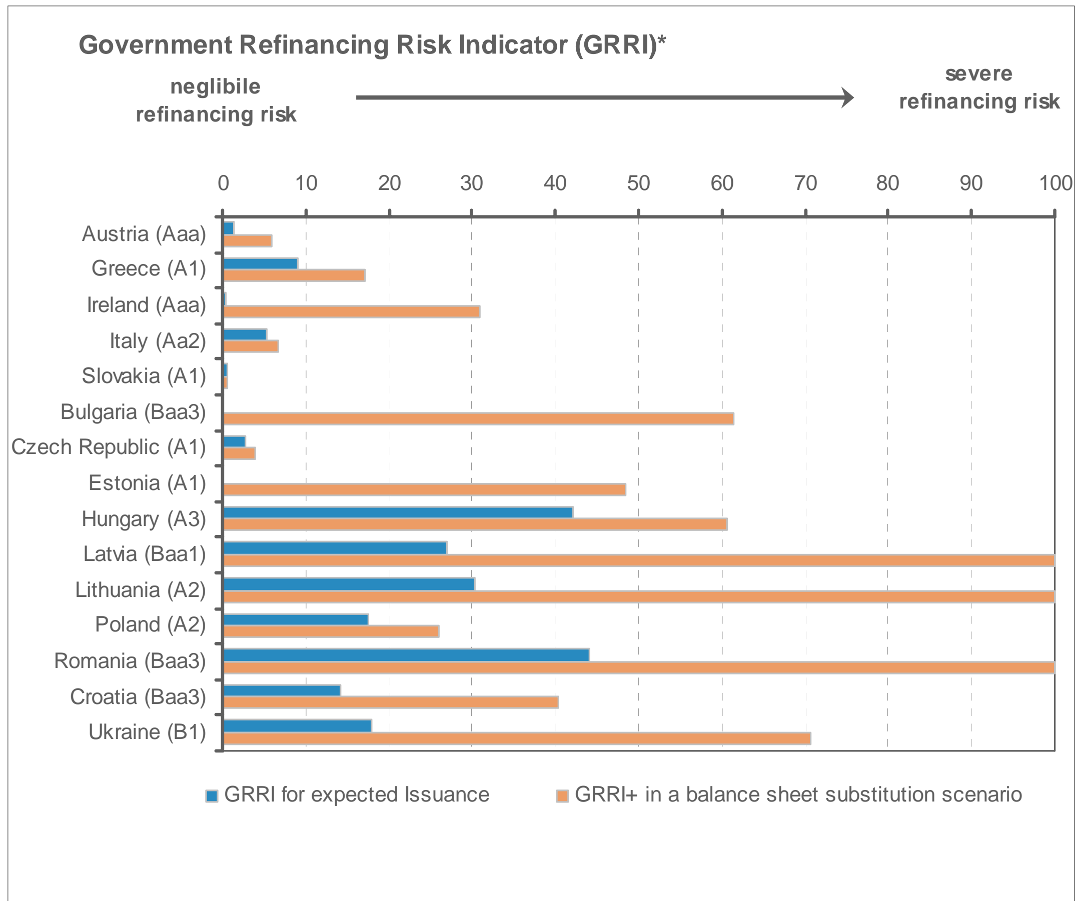

Interpretation:

GRRI/GRRI+ are easy to interpret. We classify risk levels below 20 as "very low", higher than 20 as "low", above 40 as "significant" and above 70 as "considerable". That being said, it is essential to acknowledge that – in comparison to the GRRI – the GRRI+ captures a more stressed scenario as it refers to an environment in which countries are forced to interpose their balance sheets in order to absorb banking system contingent liabilities and/or the external financing needs of the private sector.

EMU Results:

For EMU countries (as well as non-EMU Western European countries), the GRRI shows negligible refinancing risks. Only after imputing banking contingent liabilities does Ireland enter the range of "low" refinancing risk. We note that the refinancing risks of Slovakia, the most recent EMU entrant, are "very low", both in terms of the GRRI and the GRRI+.

CEE Results:

However, the results for non-EMU EU countries and countries in Central and Eastern Europe (CEE) that are aspiring to EU membership are less clear-cut. In terms of the GRRI, Latvia and Lithuania show "low" refinancing risk, whereas Hungary's and Romania's risks related to their respective borrowing requirements are "significant". The broader GRRI+ highlights the Balance of Payment risks that are present. In a balance sheet substitution scenario, only the Czech Republic and Slovakia retain their "very low" refinancing risk score. Latvia, Lithuania, Romania and Ukraine stand out as the most vulnerable countries, followed by Hungary, Estonia, Bulgaria and Croatia which exhibit "significant" refinancing risks.

Dietmar Hornung, VP-Senior Analyst
Kristina Kittelmann, Associate Analyst

The Role of International Banks: Shock Absorbers or Amplifiers?

Key Message:

In our opinion, the risk of a sudden and abrupt retrenchment of Western or Northern European banks from EU emerging countries is very low, but there is a material risk of a sustained slowdown in capital allocation to bank affiliates in emerging EU countries. The risk of a much less generous allocation of capital to subsidiaries outside the home country is relatively high.

Over the past decade, Europe has seen a rapid development in banking integration, with western European banks creating or acquiring banks in central, eastern and more recently southern Europe.

This development – whereby host countries farmed out banking intermediation to reputable western banking groups, and where these reputable banking groups accompany their long-term clients outside their borders and find new sources of business growth – was widely seen as a "win-win" game. Host countries gained financial stability and banking expertise, while parent banks gained new sources of profit.

Over the past few weeks, the focus of investors' anxiety has alternated between the host countries (with concerns about whether they can really rely on parent banks to help shore up the banking system, if needed) to the western European countries (centered around concerns about the risk of western governments potentially being dragged down while trying to support their banking system because of their international exposure).[4]

Our view remains that international banking integration is likely to be more resilient in the EU than anywhere else in the world for the following reasons:

- The depth and importance of trade and economic flows within the single market to both core and peripheral EU countries, with banks "following" their corporate clients in neighbouring countries, and anticipating an eventual convergence in terms of credit intermediation towards the levels of advanced economies.
- EU-wide bank regulatory and supervisory rules make it extremely difficult to pull out of a member country abruptly.
- The complex nature of the nationality of a bank (as some of the Austrian banks that are heavily exposed to CEE countries are in fact themselves owned by Italian or German banks; therefore, the concept of Austrian banks retrenching is not clear-cut).

Therefore, economic, regulatory and ultimately also reputational reasons seriously discourage western EU banks from "pulling the plug" on a subsidiary or affiliate in the host country. The table below offers metrics to corroborate our views.

In this respect, the sovereign risk of countries, whose banking systems are significantly dominated by foreign banks, depend on three criteria:

- The level of diversification of the foreign banks (the more diversified the better).
- The robustness of the parent banks, as determined by a weighted average of the parent banks' Bank Financial Strength Rating.
- Lastly, the importance of the local banks for the parent, based on their contribution in terms of profits. This is clearly important for banks such as Raiffeisen, which derived about 80% of pre-tax profits in 2007 from its activity in the region. However, this would arguably be a backward-looking indicator. Therefore, we look at the headroom left in terms of intermediation capacity; in other words, when credit/GDP in the country remains well below the median level in the Eurozone.

[4] This was addressed in Moody's Special Comment entitled "West European ownership of east European banks during financial and macroeconomic stress", published in February 2009.

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Countries	% of banking system foreign owned	Diversification indicator [1]	Weighted BFSR of largest parent banks [2]	Attractiveness [3]
Estonia (A1/RUR-)	98%	0.84	C	Limited
Slovakia (A1/POS)	97%	0.27	D+	Very high
Czech Rep. (A1/STA)	90%	0.24	C	Very high
Lithuania (A2/RUR-)	85%	0.69	B/B-	High
Bulgaria (Baa3/STA)	80%	0.22	D+/D	High
Hungary (A3/NEG)	80%	0.20	D+	Material
Latvia (Baa1/NEG)	78%	0.65	B/B-	Limited
Poland (A2/STA)	75%	0.15	D+	Very high
Romania (Baa3/STA)	74%	0.17	D+	Very high

[1] Herfindahl-Hirschmann index using BIS data: EU12 + Switzerland consolidated foreign claims of reporting banks on individual East European countries In USD million, data as of March 2008. The closer to 1 the higher concentrated.

[2] Weighted BFSR as of March 2009 of 4 largest exposures to parent banks in Europe ranging from 68% to 92% of total Western European bank claims of BIS reporting banks in each country. Data as of March 2008. International banks' foreign claims consist of financial assets such as loans, debt securities, and equities, including equity participations in subsidiaries.

[3] Room for further financial deepening (as compared to median Eurozone credit/GDP level of 126% FY 07) Below 40% of GDP limited, between 40 and 55 material, between 55 and 70 high, and above 70 very high.

The table above suggests that, with the exception of the Baltics, the origin of the parent banks is diversified. For the Baltics, the risk is heightened by the fact that the room for further credit intensification is limited, as suggested by high credit/GDP levels. At the same time, this is compensated by the relative strength of the parent banks and the degree of economic integration within the Nordic region – not to mention the explicit commitment of home regulators.

In conclusion, while we do not expect advanced European banks to pull out and create a "sudden stop" of financing, we are far less certain about host European countries outside the EU, and believe that external financing to these countries through the parent-subsidiary channel will be scaled down materially.

Pierre Cailleteau, MD
Aurélien Mali, Analyst

3. Rating Implications

If Funding Liquidity Risk is Exaggerated, Under What Circumstances Would Moody's Downgrade Some European Countries?

Key Message:

We believe there are two types of rating pressures: those stemming from transition risk because some ratings are increasingly based on multiple and hard-to-calibrate assumptions; and those driven by a sustained erosion in economic strength.

For most European countries, funding liquidity risk is exaggerated, as detailed in the previous section. Either there is no tangible funding problem as such – which is the case for eurozone countries in general – or there are clear roll-over risk pressures, but limited reasons to assume that the much-proclaimed (and actual) EU solidarity will not materialize.

The circumstances under which Moody's would consider downgrading the sovereign ratings of some European countries would be: (1) a structural erosion in the main rating factors and (2) an increased risk of rating migration.

Overall, our aim is to look through the crisis as much as possible (e.g. what shape will the country be in the day after the crisis abates?).

Our rating approach to the crisis so far has consistently been the following:

- The crisis is affecting most countries. Therefore, downgrading all countries "en masse" would be of limited value.
- Some countries are suffering more than others. In cases where we determine that a country is not experiencing a pause but rather a durable setback in its economic convergence process, we have implemented a downgrade. We will continue to do so on this basis.
- Some countries may additionally face some downward rating pressure when the risk that our central assumption of regional financial solidarity will not hold is perceived to be material enough to influence our overall credit assessment.

The main driver of rating downgrades is the structural weaknesses exposed by the crisis. As we said in a recent Special Comment,[5] the conditions for a downgrade are threefold: a material deterioration in credit metrics in absolute terms, in relative terms and the remoteness of a rapid recovery.

In the case of some countries, the underlying "economic model" – comprising the ingredients that made the country grow over the recent cycle – is perceived to be severely damaged. For instance, countries that relied on massive external financing based on an overstated expectation of rapid and linear convergence towards advanced EU living standards may well suffer a durable erosion of economic strength – in addition to the blow that their public finances will incur.

But, there is another consideration. Ratings in some cases may become more volatile.

Would we downgrade a country because it may need some external financial assistance to face a bout of extreme risk aversion? No. We do not downgrade countries when they require external multilateral or bilateral assistance in the midst of a systemic global crisis, just as we do not downgrade banks because they need some liquidity support from their central bank or even their home government.

Nevertheless, we acknowledge that downward rating pressure is typically associated with the activation of financial solidarity mechanisms.

[5] Please refer to Moody's Special Comment entitled "How far can Aaa governments stretch their balance sheets?", published in February 2009.

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In this respect, some of our sovereign bond ratings look increasingly like the ratings of banks when they need external financial support. In addition to fundamental credit parameters, we need to infer some degree of external financial assistance for certain countries. Not doing so would lead to significantly lower ratings – and a break-down of what we try to measure, namely expected loss. However, adding more parameters to our rating assessment increases migration risk, or the risk of multi-notch downgrades. If we over-estimate international support, the risk of an abrupt rating migration would be high.

Pierre Cailleteau, MD

4. Conclusion: The Case for Risk Differentiation

To summarise:

- Some countries were more vulnerable than others to the abrupt global economic and financial changes that took place in the aftermath of Lehman Brothers' demise.

  These are the countries that were either caught off-guard in the middle of their fiscal adjustment effort (Hungary, Croatia) or that had engaged in an aggressive strategy of financial deepening, thereby generating significant macro-economic imbalances (see Table 1 above). This description applies to a greater or lesser degree to the three Baltic nations, which are rated from A1/negative to Baa1/negative, as well as Baa3-rated Bulgaria, Romania and Croatia.

  For several years now, we had believed that these countries had exceeded their speed limits, but also thought that most of them were close to their sought-after destination – namely, the eurozone.

- Other countries are much less vulnerable: the Czech Republic (A1), Slovakia (A1), Poland (A2) comprise the group of countries whose current ratings (barring unforeseen developments) seem reasonably well anchored.

- The countries that are vulnerable to current adverse conditions are affected simultaneously by three shocks: (1) hostile financing conditions; (2) public debt metrics and affordability – while starting from solid levels – are affected by the crystallization of contingent liabilities; and (3) the resilience of the "economic model", where elevated external financing which validates income convergence aspirations is under strain.

  Each of these shocks affects our rating factors and is therefore a source of downward rating pressure. Indeed, even with regional or international assistance, only the first shock can be mitigated.

- In addition, a related source of risk magnifies the problem of these countries. Most of these countries face either a problem because their competitors have devalued their exchange rate, or because their own currency may devalue – thus triggering potentially dire consequences for unhedged borrowers. This is a risk we captured in our assessment of "susceptibility to event risk."

  The decision of whether or not to devalue is critical for these countries. In fact, the economic and financial pain associated with either solution is very high. The adherence to the exchange rate (as several EU countries did in 1992-95) is supported by the anticipation of a more rapid transition to the eurozone. But again, the economic and social cost of adhering to the exchange rate peg is high (and populations may not realize that the alternative is not more palatable).

- The sole outlier is Ukraine, where not only credit fundamentals are being eroded, but we are also much less sanguine about whether external support is a reliable source of comfort. Although assistance was requested and received in a timely fashion, the scale of the financing gap has grown to extremely large proportions in light of the steep depreciation of the exchange rate and the collapse of economic activity. Meanwhile, political infighting has delayed the prompt and necessary implementation of a credible reform program.

- In conclusion, bearing in mind the two key considerations of fundamental downward rating pressure and migration risk, we have grouped "emerging" European countries into four categories:

  - Countries whose rating is well anchored despite challenging conditions – e.g. the Czech Republic (A1), Slovakia (A1), Slovenia (Aa3), Poland (A2).

  - Countries whose relative credit fundamentals are resilient but potentially subject to some degree of rating volatility – e.g. Romania, Bulgaria and Croatia, all of which are rated Baa3. For these countries, event risk – either because of very tight financing conditions or exchange rate risk – makes our rating increasingly dependent on external support.

  - Countries whose relative credit fundamentals are eroded – as their convergence process is likely to be derailed for a prolonged time – but where material regional support will provide a rating floor –

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unless our support assumptions prove unfounded: the Baltic countries (Estonia at A1, Lithuania at A2, Latvia at Baa1) and Hungary at A3.

- Countries whose relative credit fundamentals are eroded and where we perceive external support as much less reliable – a category that is only occupied by Ukraine (B1).

This is illustrated in the table below. The vertical axis suggests possible downward pressures arising from a fundamental erosion in structural strength; the horizontal axis indicates the liquidity concerns, as captured by our Refinancing Risk Indicator. In most cases, but to a different degree, the risk is mitigated by regional or international support actions.

Possible rating pressure based on a structural erosion in creditworthiness	Liquidity concerns			
	Very Low	Low	Significant, but mitigated	Considerable, but mitigated
Not material at this stage	Slovakia (A1+) Czech Rep (A1)	Poland (A2)	Bulgaria (Baa3) Croatia (Baa3)	Romania (Baa3)
Material risk			Hungary (A3-)	Latvia (Baa1-)
Elevated risk			Estonia (A1 RUR-)	Lithuania (A2 RUR-) Ukraine (B1 RUR-)

RUR- = rating under review for possible downgrade.

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Turmoil Among 'Emerging' European Sovereigns: The Case for Risk Differentiation

Report Number: 115168

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