MOODY'S INVESTORS SERVICE

OUTLOOK

Central & Eastern European 2013 Sovereign Outlook: Subdued Macro Picture Tempers Credit Strengths

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Summary

We believe that the Baa3 average sovereign creditworthiness among countries in Central and Eastern Europe (CEE)[1] will be maintained during 2013. This assessment balances a number of strengths and challenges, such as (1) improved but subdued growth prospects for the region in the context of an unsettled global environment, (2) further although more moderate rises in public sector debt, (3) steadier commodity prices, which will support stable current accounts, and (4) some increases in foreign direct investment (FDI) flows to the region.

» **Growth outlook**: Despite growth is set to pick up in nine of the 15 countries, economic activity will remain subdued for the region as a whole, particularly when compared to the 5.6% average for the 2004-08 period. We expect that output for the CEE region to expand by 1.9% in 2013, from 0.7% in 2012.

» **Inflation outlook**: With a few exceptions, we currently expect most CEE countries to experience a reduction in inflation in 2013, based on our view that energy prices will stabilise and that in some countries economic performance will be restrained.

» **Credit growth**: Domestic credit expanded at a robust pace in the years leading up to the 2008-09 global financial crisis. Managing the increasing financial penetration proved to be a complex task for policymakers, given that credit growth decelerated markedly once the financial impact of the crisis had distorted demand and supply dynamics. Deleveraging will remain a drag on credit supply and on economic growth over the medium term.

» **Vulnerabilities remain**: Overall, the region remains exposed to the ongoing euro area sovereign crisis and other external developments through the trade channel, which can pose some risk of contagion even for the economic performance of countries whose demand is mainly domestically driven. If acute, these adverse developments could add significant pressure on the balance sheet of national governments in the region.

» **Creditworthiness will remain steady**: Despite a significant deterioration in creditworthiness immediately following the 2008-09 crisis, the region's overall credit quality has remained within investment-grade territory, at the equivalent of a Baa3 rating, with 8 out of 15 CEE sovereign ratings carrying a stable outlook, 2 positive outlooks and just 5 with a negative outlook.

[1] In this report, the CEE region comprises 15 countries: Albania (B1 stable), Bosnia and Herzegovina (B3 stable), Bulgaria (Baa2 stable), Croatia (Baa3 negative), Czech Republic (A1 stable), Estonia (A1 stable), Hungary (Ba1 negative), Latvia (Baa3 positive), Lithuania (Baa1 stable), Montenegro (Ba3 stable), Poland (A2 stable), Romania (Baa3 negative), Slovakia (A2 negative), Slovenia (Baa2 negative) and Turkey (Ba1 positive).

Growth set to pick up in most CEE countries

Although present, tail risks associated with the euro area crisis would seems to have receded mildly in recent months. Should market conditions remain relatively stable across the euro area, the economic environment will, for the most part, improve throughout CEE. Growth is set to pick up in nine of the 15 countries in the region, supporting economic strength—a key factor in our assessment of sovereign creditworthiness. Nonetheless, economic activity will remain subdued for the region as a whole and we expect that output for the CEE region will expand by 1.9% in 2013, from 0.7% in 2012 (see Exhibit 1), contrasting with a 5.6% average growth rate in the 2004-08 pre-crisis period.

EXHIBIT 1

CEE Key Indicators (Regional Median)

	2009	2010	2011	2012E	2013F
Real GDP (% change)	-5.7	1.5	3.0	0.7	1.9
Inflation Rate (CPI, % change Dec/Dec)	1.5	3.1	3.2	3.2	2.6
Gen. Gov. Financial Balance/GDP	-5.9	-4.9	-3.5	-3.0	-2.7
Gen. Gov. Debt/GDP	35.8	41.0	42.2	45.1	46.9
Current Account Balance/GDP	-2.6	-3.7	-1.4	-2.9	-2.9
Net Foreign Direct Investment/GDP	1.4	1.8	2.3	1.7	2.2

Source: Eurostat, National Statistics Agencies and Moody's

The more favourable economic growth outlook for the region will be supportive of fiscal consolidation programmes, which are set to slow after substantial progress in 2010-12. The general government deficit for CEE will narrow further in 2013 and fall below 3% of GDP for the first time since 2007. However, the region's debt-to-GDP ratio will continue to deteriorate, to 47% from an estimated 45% in 2012. We believe that the region's negative debt dynamics will persist beyond 2013 and that its debt levels will stabilise in 2014-15.

Despite CEE's apparent reprieve from the euro area crisis, the external environment remains unsettled. The region's major trading partners in the euro area are likely to see muted growth in 2013, and in some cases we expect output to stagnate. We expect Germany (Aaa negative) to grow at 0.8%, Austria's (Aaa negative) economy will expand by 1%, and the UK (Aaa negative) to advance by 1.4%, while France's (Aa1 negative) economy will see no change in real terms from 2012 output levels. Nevertheless, we also expect steadier commodity prices, which will curb the energy and food import bill for CEE and support a stable current account deficit of just under 3% of GDP. FDI flows should recover in 2013 if global sentiment continues to improve. This dynamic should support healthier external finances, curbing external debt accumulation.

We expect a notable deceleration of economic activity in only two countries in the region, Latvia and Slovakia, while the majority will see either some acceleration in output growth or experience a similar performance to 2012 (see Exhibit 2, below). A number of these nations are set to come out of recession, including Bosnia, Croatia, the Czech Republic, and Hungary. We expect that Slovenia will be the only country to contract in 2013, due to the effects of a domestic banking crisis.

EXHIBIT 2

CEE Growth Outlook to Improve in 2013

Real GDP (% change)		Rating	2012E	2013F*
Outperformers	Turkey	Ba1	3.0	3.8
	Estonia	A1	3.0	3.5
	Latvia	Baa3	4.5	3.4
	Lithuania	Baa1	2.7	3.0
Average	Montenegro	Ba3	0.3	2.0
	Romania	Baa3	0.8	2.0
	Bulgaria	Baa2	0.5	1.9
	Slovakia	A2	2.5	1.9
	Poland	A2	2.2	1.8
	Albania	B1	0.7	1.3
Underperformers	Bosnia and Herzegovina	B3	-0.5	1.0
	Czech Republic	A1	-1.3	0.4
	Hungary	Ba1	-1.4	0.3
	Croatia	Baa3	-1.9	0.0
	Slovenia	Baa2	-2.3	-1.6
	CEE Average		0.9	1.6

* Positive growth rates that forecast an acceleration of more than 0.5 percentage points are highlighted in green, while a growth deceleration of over 0.5 percentage points is highlighted in red.

Source: Moody's

We forecast that even though growth throughout the region will accelerate, it will remain below potential and below trend, yet there will be some degree of dispersion. Three distinct groups can be identified based on forecast economic performance:

» Turkey is set to expand at the fastest rate within the region, and along with the Baltic nations forms the group of **outperforming economies**, which will grow at rates of above 3%, above our average forecast for CEE.

» Montenegro, Romania, Bulgaria, Slovakia, Poland and Albania will see fairly restrained growth rates that we expect will be close to the regional average, between 1% and 3%. These countries form the group of **average performers**.

» We expect weak recoveries for the countries coming out of recession. Bosnia, the Czech Republic and Hungary will grow at rates below 1%. Croatia's output will remain flat, and Slovenia will continue to contract. These countries form the group of **underperforming economies**.

Inflation risks contained for 2013

We currently expect most countries within CEE to experience disinflation in 2013 (see Exhibit 3, below), with a few exceptions. This expectation is mainly based on our belief that energy prices will stabilise this year and that the economic performance of some of these nations will be restrained. Turkey and Hungary will see inflation decelerate in 2013, although this will remain significantly above the regional average.

EXHIBIT 3

CEE Inflation Outlook for 2013

Inflation Rate (CPI, % change Dec/Dec)		Rating	2012E	2013F*
Below Average	Czech Republic	A1	2.4	1.1
	Slovakia	A2	3.2	1.9
	Latvia	Baa3	2.1	2.0
	Slovenia	Baa2	2.8	2.2
	Lithuania	Baa1	2.9	2.4
	Montenegro	Ba3	3.5	2.5
	Bosnia and Herzegovina	B3	2.0	2.5
	Poland	A2	2.4	2.6
	Albania	B1	2.5	3.0
	Bulgaria	Baa2	3.2	3.1
Above Average	Croatia	Baa3	3.4	3.2
	Estonia	A1	5.0	3.2
	Romania	Baa3	3.8	3.2
	Hungary	Ba1	5.8	5.0
	Turkey	Ba1	8.0	7.8
	CEE Average		**3.5**	**3.0**

* Countries displaying disinflation in 2013 are highlighted in green, while those where inflation will accelerate are highlighted in red.

Source: Moody's

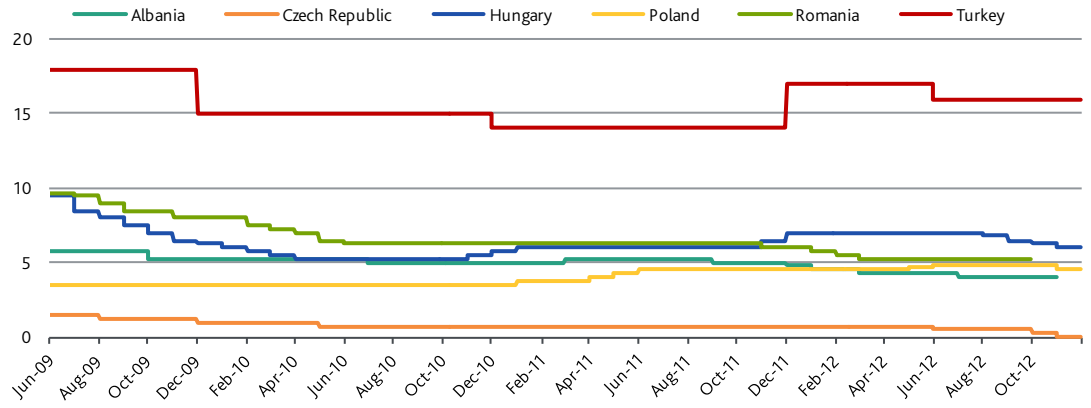
For the inflation-targeting countries in CEE,[2] these price dynamics show a mixed picture for the implementation of monetary policy to support the economy (see Exhibit 4, below). In the cases of Albania and Poland, we expect inflation to accelerate in 2013. There will be pressure to maintain or increase the policy rate in Albania. Poland's National Bank is likely to implement monetary stimulus through further cuts in its key policy rate despite a minor acceleration in consumer prices.

Hungary could loosen monetary policy further, continuing the process that started in mid-2012. Romania is likely to maintain or modestly cut interest rates if inflation decelerates. In the case of the Czech Republic, however, the monetary policy rate is at a historical low and close to the zero-bound. Therefore, despite our expectation that consumer price inflation is set to significantly slow down in the Czech Republic in 2013, there is little room for more cuts to the policy rate in the country. This limits the Czech National Bank's arsenal of tools to provide greater stimulus to the economy and increases the likelihood of it intervening in the foreign exchange market to weaken the koruna and provide a boost to the country's export sector.

[2] Albania (inflation target 3% ± 1%), Czech Republic (2% ± 1%), Hungary (3%), Poland (2.5% ± 1%), Romania (3% ± 1%), and Turkey (5.5%).

EXHIBIT 4

Monetary Policy Rates of CEE Inflation Targeters



Source: International Monetary Fund (IMF), Haver

Credit growth no longer supporting domestic demand

Domestic credit expanded at a hearty pace in the years leading up to the 2008-09 global financial crisis. Credit supply, especially consumer credit, catered to the strong demand for credit within CEE economies through 2008, helping to push real output growth rates above potential. Managing the increasing credit penetration proved a complex task for policy makers and financial regulators, and once the financial impact of the crisis distorted demand and supply dynamics, credit growth slowed markedly (see Exhibit 5).

EXHIBIT 5

Credit Growth Has Slowed Markedly in CEE

	Credit Growth (Y/Y %)		
	2006-08 Ave.	2009-11 Ave.	2012 Q3
Albania	20.9	8.0	2.0
Bosnia and Herzegovina	24.7	0.5	6.9
Bulgaria	35.7	6.5	1.8
Croatia	16.1	3.9	1.7
Czech Republic	18.2	6.6	3.3
Estonia	27.9	-4.3	-0.5
Hungary	16.2	-0.2	-7.2
Latvia	31.8	-7.9	-5.9
Lithuania	32.5	-5.1	-4.9
Montenegro	114.5	-9.6	-3.8
Poland	29.7	11.5	3.7
Romania	51.9	10.3	7.9
Slovakia	15.1	9.9	3.2
Slovenia	20.1	1.3	5.0
Turkey*	16.7	20.8	11.7

* Turkey's high nominal GDP growth (13.6% average in 2006-08, and 11.2% in 2009-11) eases concerns about a credit boom

Source: IMF, Haver and Moody's

Beyond the slowing credit growth in CEE, we still find evidence of deleveraging through Q3 2012 in five countries within the region: Estonia, Hungary, Latvia, Lithuania and Montenegro. The only country in the region where the pace of lending growth continues at double-digit rates is Turkey, albeit in line with nominal GDP growth. Bosnia and Romania are the other two countries in CEE that have experienced credit expansion above 5% in the past year. Despite a more favourable economic outlook in 2013, we forecast that loan growth for most countries will be subdued and below the average historical capacity in the next 12 to 18 months.

These dynamics do little to support domestic demand growth in the region, and have contributed to an increase in non-performing loans. Although unlikely in the near future for most CEE counties, in the event of a sustained deterioration of banking system conditions leading to a banking crisis and the need for government support, sovereigns could experience an increase of contingent liabilities, damaging their creditworthiness. We maintain a negative outlook for the banking systems of all the countries in the region except Turkey, where the banking system outlook is stable (see Exhibit 6).[3] The negative outlook is based on our expectation that (1) CEE banking systems will face a difficult operating environment within the next 12 to 18 months due to subdued growth and retrenchment of parental support, and (2) profitability and asset quality in many of these systems will deteriorate.

EXHIBIT 6

CEE Banking System Outlooks

(As of 19 November, 2012)	Positive	Stable	Negative
Baltic Countries			Negative
Bulgaria			Negative
Czech Republic			Negative
Hungary			Negative
Poland			Negative
Slovakia			Negative
Slovenia			Negative
Turkey		Stable	

Source: Moody's

Several CEE countries have strengthened their financial regulatory and supervisory frameworks in response to the 2008-09 global financial crisis. Although the new regulations can constrain lending activities and credit growth, they are principally aimed at maintaining macroeconomic stability and curbing the risk of creating imbalances in the domestic economy.

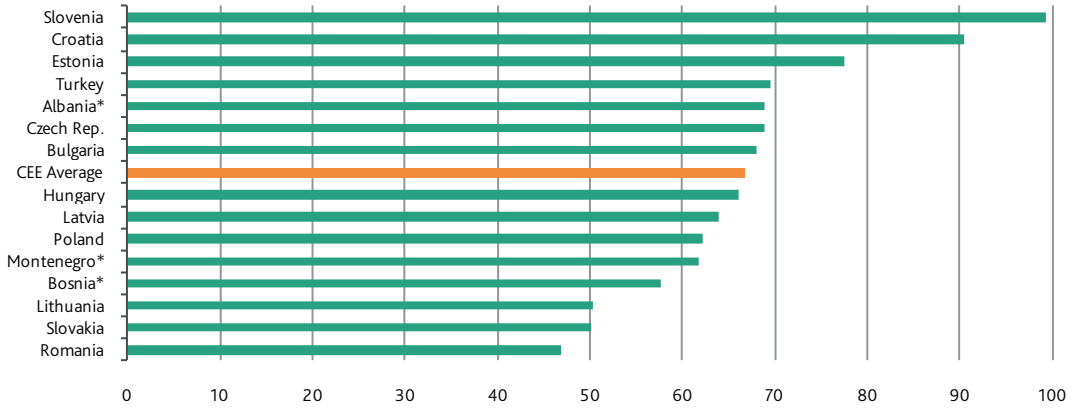
Post-crisis developments in the region's banking systems diverge considerably. The Baltic countries have been successful in recovering from the crisis and healing their respective banking systems, although there is still evidence of deleveraging, while issues associated with toxic real estate assets persist in the Slovenian financial system and their resolution will be a key theme for the sovereign in 2013. Deleveraging trends are also likely to persist in Hungary, while we expect slow credit growth in Croatia and Bulgaria.

[3] Please see individual country Banking System Outlooks, available on www.moodys.com.

The CEE region presents a mixed picture in terms of overall financial penetration as measured relative to GDP. We estimate that, on average, the ratio of domestic credit-to-GDP for the region was 67% as of Q3 2012 (see Exhibit 7, below). Most countries exhibit credit penetration ratios near the CEE average, the lowest being those of Romania (47%), Slovakia (50%), and Lithuania (50%). Although household and overall private sector leverage remain at healthy levels for most countries in the region, high levels of penetration in Slovenia (99%) and Croatia (91%) warrant close monitoring given the inherent risks of rising unemployment rates in these countries.

EXHIBIT 7

Financial Penetration in CEE as Measured by Domestic Credit/GDP



* Data as of end-2011

Source: National Central Banks, Haver and Moody's

The region remains vulnerable…

Risks to our forecasts remain skewed toward the downside. The most prominent risk for the CEE region is an intensification of the euro area crisis. The impact of such a scenario could result in differing degrees of contagion for CEE sovereigns based on three potential channels of transmission: (1) the trade channel[4], which could hurt the real economy; (2) the government finance channel, which could alter funding conditions and bond yields; and (3) the financial channel, which could lead to changes in the operating environment for the banking system.

Based on the economic openness[5] of the countries in CEE, we classify the 15 economic growth models as either domestic-demand driven or external-demand driven (see Exhibit 8, below):

» Nine countries have an openness ratio above 100% and we consider these to be **external-demand driven**. They are for the most part small economies that have grown at relatively low rates over the past five years. Hungary, Estonia, Lithuania, Slovenia and Latvia have, on average, contracted over the past five years. The outlier of the group has been Slovakia as the strongest growth performer.

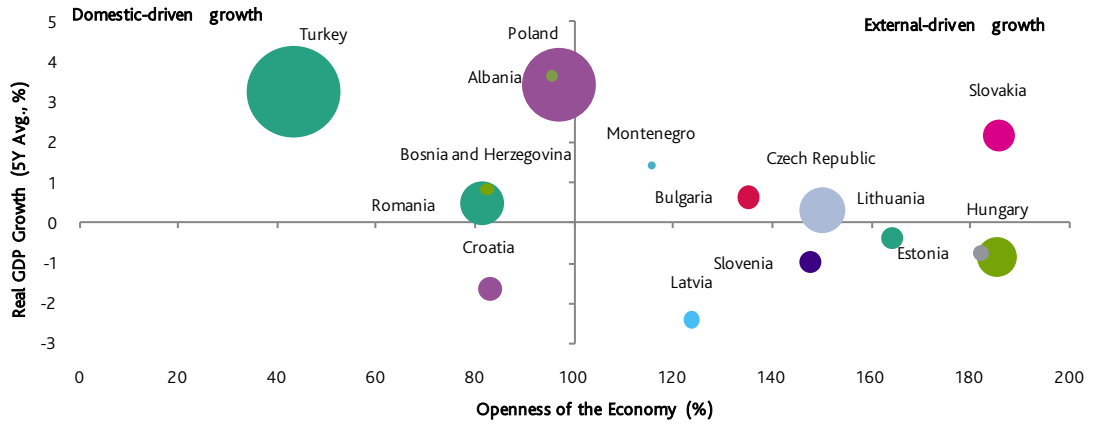
» The remaining six countries, which we consider to be **domestic-demand driven**, include three of the largest economies in the region: Turkey, Poland, and Romania. The five-year growth average has been more favourable for this group, save for Croatia, which has contracted by an average rate of 1.6%. As these economies depend on a more reliable consumption base, their performance has been more resilient, making them less vulnerable to swings in external demand.

[4] Please see CEE and CIS Countries Could be affected by Possible Euro Area Economic Shocks, Albeit to Varying Degrees, 29 August 2012

[5] Openness of the economy is defined as (exports of goods and services + imports of goods and services)/GDP.

EXHIBIT 8

External Demand Dependence and Growth in CEE*

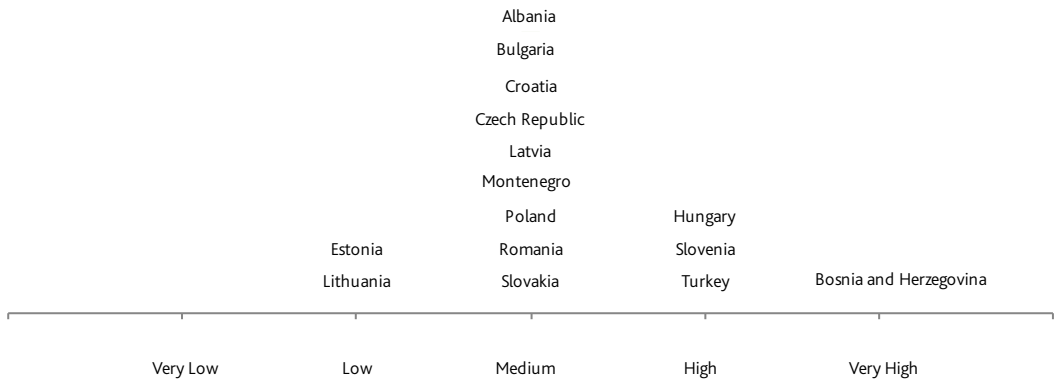


* Amplitude of the bubble represents size of nominal GDP
Source: Moody's

Overall, the region remains exposed to external developments through the trade channel, which can have a contagion effect even for the economic performance of the domestic-demand driven countries, and ultimately impair economic strength and creditworthiness. In addition to this exposure, the sovereigns themselves can be susceptible to shocks stemming from event risk. The fourth factor of our sovereign methodology tries to capture the susceptibility of sovereigns to event risk based on our view of political, economic and financial factors that may induce event risk, and the vulnerability of the government's balance sheet to sudden threats. In this regard, we consider most countries in the region to have medium susceptibility to event risk (see Exhibit 9).

EXHIBIT 9

Susceptibility to Event Risk for CEE Sovereigns



Source: Moody's

Combining the openness of the economy as a proxy for the countries' growth model with our assessment of susceptibility to event risk, we can see that the region remains vulnerable not only to external developments, but a combination of factors that can weigh on creditworthiness (see Exhibit 10, below).

EXHIBIT 10
A Heat Map for CEE

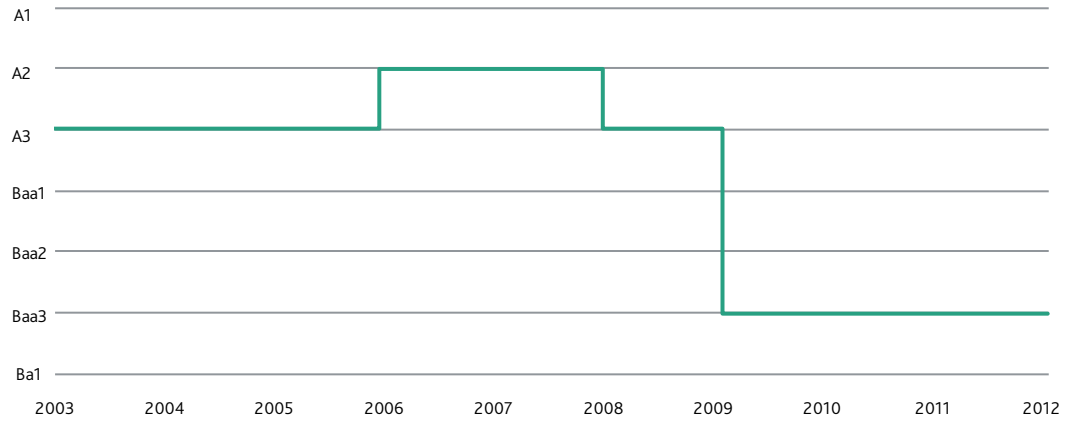
Openness of the Economy (%)	Factor 4 - Susceptibility to Event Risk				
	Very Low	Low	Medium	High	Very High
0-40					
40-80				Turkey	
80-120			Albania Croatia Montenegro Poland Romania		Bosnia and Herzegovina
120-160			Bulgaria Czech Republic Latvia	Slovenia	
160-200		Estonia Lithuania	Slovakia	Hungary	

Source: Moody's

...But creditworthiness is likely to be maintained

Despite the region's increased vulnerability, especially to euro area developments, the CEE region as a whole has maintained its creditworthiness since 2009 (see Exhibit 11). The region's overall credit quality has remained within investment-grade territory, at the equivalent of a Baa3 rating. This is despite a significant deterioration in creditworthiness immediately following the 2008-09 global financial crisis.

EXHIBIT 11
CEE Median Credit Quality*



* At year-end
Source: Moody's

Individually, the picture is more mixed for CEE sovereigns, as a number of them remain on negative outlook. However, despite a challenging environment, most have maintained stable outlooks (see Exhibit 12) and some are even seeing improvements in their credit profiles, which is illustrated by the positive outlooks on Latvia and Turkey. As growth recovers in 2013, the macroeconomic environment will be more supportive for the sovereigns' policy frameworks, against a backdrop of uncertainty surrounding global conditions.

EXHIBIT 12

CEE Ratings as of 1 January 2013

	Government Bond Ratings			Factor Scores				
Sovereign	FC	LC	Outlook	Economic Strength	Institutional Strength	Government Financial Strength	Susceptibility to Event Risk	Methodology Range
Czech Republic	A1	A1	Stable	High	High	High	Medium	A1-A3
Estonia	A1	A1	Stable	Medium	Very High	High	Low	Aa3-A2
Poland	A2	A2	Stable	High	High	Medium	Medium	A1-A3
Slovakia	A2	A2	Negative	High	High	High	Medium	A1-A3
Lithuania	Baa1	Baa1	Stable	Medium	High	Medium	Low	A3-Baa2
Bulgaria	Baa2	Baa2	Stable	Medium	Medium	High	Medium	Baa2-Ba1
Slovenia	Baa2	Baa2	Negative	Medium	High	High	High	Baa2-Ba1
Latvia	Baa3	Baa3	Positive	Medium	High	Medium	Medium	Baa2-Ba1
Croatia	Baa3	Baa3	Negative	Medium	Medium	Medium	Medium	Baa2-Ba1
Romania	Baa3	Baa3	Negative	Medium	Medium	Medium	Medium	Baa2-Ba1
Turkey	Ba1	Ba1	Positive	Medium	Medium	High	High	Baa2-Ba1
Hungary	Ba1	Ba1	Negative	Medium	Medium	Low	High	Ba1-Ba3
Montenegro	Ba3		Stable	Low	Low	Medium	Medium	Ba2-B1
Albania	B1	B1	Stable	Low	Low	Low	Medium	B1-B3
Bosnia and Herzegovina	B3	B3	Stable	Low	Low	Medium	Very High	B1-B3

Source: Moody's

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» Czech Republic, Government of, July 2012 (143753)

» Estonia, Government of, November 2012 (146917)

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» Sovereign Methodology Update - Narrowing the Gap - a Clarification of Moody's Approach to Local Vs. foreign Currency Government Bond Ratings, February 2010 (118820)

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