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Related Research

- *Global Economic Outlook (March 2009)*
- *Emerging Europe: Negative Outlook! (January 2009)*
- *Emerging Europe Rating Dynamics (November 2008)*
- *Emerging Europe Sovereign Review: 2008 (August 2008)*
- *Emerging Europe's Current Account Deficits: Mind the Gap! (January 2008)*
- *High-Grade Sovereigns and the Global Financial Crisis (March 2009)*

Table 1: Sovereign Ratings

Country	FC IDR	LC IDR
Armenia	BB	BB
Azerbaijan	BB+	BB+
Bulgaria	BBB-	BBB
Croatia	BBB-	BBB+
Czech Rep	A+	AA-
Estonia	A-/Neg	A/Neg
Georgia	B+/Neg	B+/Neg
Hungary	BBB/Neg	BBB+/Neg
Kazakhstan	BBB-/RWN	BBB/RWN
Latvia	BBB-/Neg	BBB/Neg
Lithuania	BBB+/Neg	A-/Neg
Macedonia	BB+	BB+
Moldova	B-	B
Poland	A-	A
Romania	BB+/Neg	BBB-/Neg
Russia	BBB/Neg	BBB/Neg
Serbia	BB-/Neg	BB-/Neg
Slovakia	A+	A+
Slovenia	AA	AA
Turkey	BB-	BB
Ukraine	B/Neg	B/Neg

Long-Term Foreign and Local Currency Issuer Default Ratings
Neg = Negative Outlook; RWN = Rating Watch Negative; all other Outlooks Stable
Source: Fitch

Worst Recession Since Early Transition

Fitch Ratings' new global forecasts were published yesterday in its Global Economic Outlook (GEO). This companion report provides Fitch's latest GDP forecasts for the countries in Emerging Europe (EE) and highlights some of the regional trends¹.

Overall, Fitch forecasts EE real GDP to contract by 3.1% in 2009, with only a modest recovery to +1.4% in 2010. This represents a severe recession following estimated GDP growth of 4.0% in 2008 and an average of 6.8% in the five years to 2007.

The slump in GDP this year will be the first since the Russian default crisis in 1998, when output fell 0.5%, led by the drop of 5.3% in Russia (the largest economy in the region). And it will be the steepest since the fall of 6% in 1994, when output was still falling in the Commonwealth of Independent States (CIS) after the collapse of the Communist economic system and when Turkey also had an economic crisis. Fitch forecasts GDP to contract in 19 of the 21 countries it covers in the region, be flat in one and grow in only one – a more widespread recession than in 1998/99 when half the countries continued to grow.

Growth in EE is expected to drop more than in other regions as the characteristics of many countries – such as trade openness, prior macroeconomic imbalances and commodity dependence – leaves them relatively exposed to the major shocks that have rocked the global economy: the sharpest and most synchronised recession in the world's "advanced" economies since World War II; a reversal of international capital and financial flows; and a dramatic decline in commodity prices.

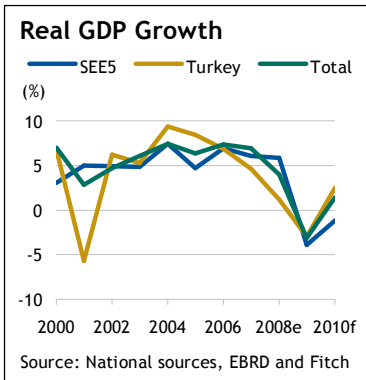
The central Europeans economies (less so Poland) will be badly affected through the trade channel as they are relatively open and their exports weighted towards cyclical industries such as cars. Commodity producers, mainly in the CIS, will see a sharp drop in income from the fall in their terms of trade. Some poorer countries in the CIS and Balkans are likely to see a drop in workers' remittances.

Most countries will be adversely affected by "deleveraging" and see a sharp slowdown or reversal of private capital inflows and credit growth. Those with large current account deficits (CADs), high bank loan/deposit ratios and/or dependence on foreign financing – particularly the Baltic and Balkan states, as well as Hungary, Kazakhstan and Ukraine – will suffer marked falls in domestic demand as they have to rapidly correct macroeconomic imbalances. In some countries, difficulties will be compounded by the presence of foreign-currency debt on balance sheets.

Usual cyclical forces – such as the fall in household income expectations and wealth, retrenchment in business investment, the inventory cycle and higher unemployment – will amplify the downturn. Most countries have limited capacity for counter-cyclical fiscal policy, but will benefit from lower global interest rates and fiscal expansion in the EU15. IMF and other international assistance will play a crucial role in providing financing and bolstering confidence in several countries.

Overall, Fitch's analysis identifies Hungary ('BBB' with a Negative Outlook) and Kazakhstan ('BBB-' on Rating Watch Negative) as the economies most exposed to the dramatic decline in global trade and financial flows and the deleveraging

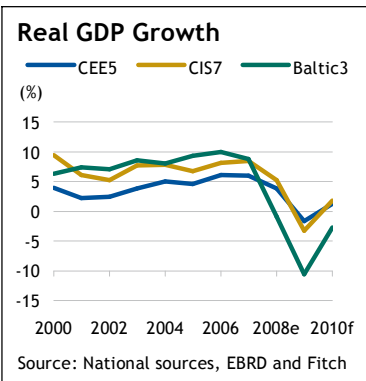
¹ Unless otherwise stated, Fitch defines EE as the 21 countries listed in Table 1, for which it has public sovereign ratings. EE GDP figures cited in this report are a weighted average, based on 2007 GDP weights



process, while Poland ('A' with a Stable Outlook) and Turkey ('BB-' with a Stable Outlook) are the least exposed to these shocks, albeit far from immune. Of the largest economies in the region, Fitch forecasts both Russia and Turkey to shrink by 3% and growth to be 0% in Poland.

Indeed, the aggregate figures conceal a wide range in growth prospects from +2.5% in Azerbaijan to -12% in Latvia. This underlines the need to differentiate between the countries rather than treat EE as a homogenous region, as reflected in sovereign rating levels and rating actions since the onset of the global financial crisis. Fitch has downgraded the sovereign ratings of 10 countries in EE, by a total of 14 notches, since August 2008. Ten countries are now on Negative Outlooks and none on Positive Outlooks.

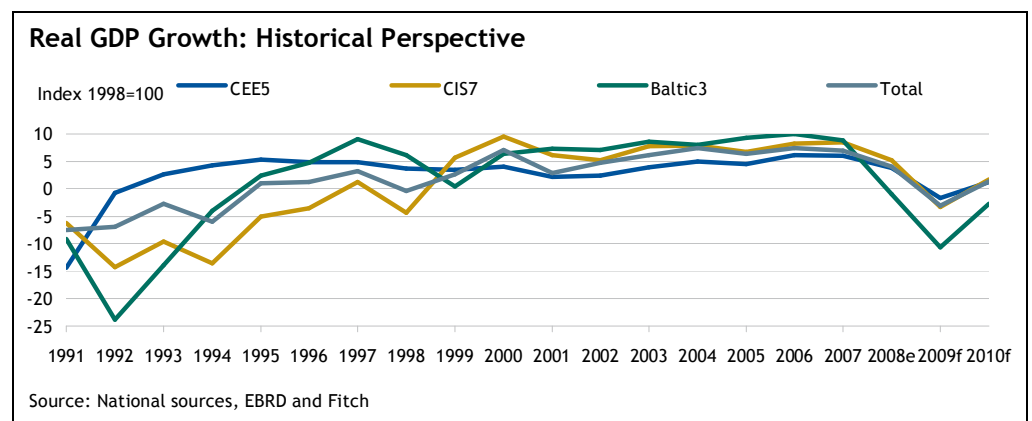
The severity of the reversal in growth prospects in EE and the weakness of the projected 'recovery' in 2010 will obviously have an adverse impact on unemployment, public finances and bank asset quality. These dynamics, in some cases augmented by budget austerity measures, increase the risk of political uncertainty - though political pressures vary significantly between countries. In general, Fitch believes the risks of serious political and social stability are moderated by EU membership. But political event risk is rising. A material increase in political and social instability, for example leading to violent unrest, a popular backlash against orthodox economic policies and the suspension of an IMF programme, would clearly have negative implications for a country's ratings.



Growth Forecasts

Fitch's latest GDP forecasts for each country and sub regions are shown in Table 2². The range of uncertainty around these forecasts is unusually wide at this juncture.

The final column in the table shows the subsidence in GDP growth prospects this year relative to 2008. Overall, Fitch forecasts the reversal in EE to be greater than in the advanced countries or largest emerging markets, reflecting its greater vulnerability to the shocks to the global economy and financial system. Within EE, Fitch expects the hit to GDP in central Europe and Turkey to be less (though still substantial) than in the CIS, Baltic states or south-eastern Europe. Growth in the four largest economies in the region: Russia, Turkey, Poland and the Czech Republic is forecasted to hold up better than the median for the region, thereby supporting aggregate or average GDP growth. An average GDP contraction of 3% this year implies GDP growth further below trend or potential growth than a comparable figure for the euro area.



² Sub-regional abbreviations used are: CEE5: Czech Republic, Hungary, Poland, Slovakia, Slovenia; CIS7: Armenia, Azerbaijan, Georgia, Kazakhstan, Moldova, Russia, Ukraine; Baltic3: Estonia, Latvia, Lithuania; and SEE5: Bulgaria, Croatia, Macedonia, Romania, and Serbia

Table 2: Main Projections

(Annual averages)	2007	2008e	2009f	2010f	Memo: change 2009 from 2008
Real GDP					
Euro area ^a	2.6	0.7	-3.4	0.4	-4.1
World ^a	3.5	1.7	-2.7	1.4	-4.4
BRICS ^b	9.7	7.4	3.2	5.9	-4.2
Emerging Europe^c	6.9	4.0	-3.1	1.4	-7.1
O/w Central Europe	6.0	3.8	-1.7	1.3	-5.6
Czech Republic	6.6	3.1	-2.5	1	-5.6
Hungary	1.1	0.6	-5	0.5	-5.6
Poland	6.6	4.8	0	1.5	-4.8
Slovakia	10.4	6.4	-2	2	-8.4
Slovenia	6.1	3.5	-4.3	0.8	-7.8
Baltics	8.9	-1.0	-10.6	-2.8	-9.7
Estonia	7.1	-3.6	-10	-2	-6.4
Latvia	10.0	-4.6	-12	-3	-7.4
Lithuania	8.8	3.1	-10	-3.0	-13.1
CIS	8.4	5.2	-3.3	1.7	-8.5
Armenia	13.8	6.8	-1.5	2	-8.3
Azerbaijan	23.4	10.6	2.5	3.5	-8.1
Georgia	12.4	3.2	-2	0	-5.2
Kazakhstan	8.5	3	-3.5	1	-6.5
Moldova	3	7.2	-1.5	1.5	-8.7
Russia	8.1	5.6	-3	2	-8.6
Ukraine	7.7	2.1	-7	-1	-9.1
South-eastern Europe	6.1	5.9	-3.9	-1.2	-9.8
Bulgaria	6.2	6	-5.5	-2	-11.5
Croatia	5.6	2.1	-2.5	1	-4.6
Macedonia	5.9	4.6	-2	0	-6.6
Romania	6	7.1	-4.5	-2	-11.6
Serbia	7.1	5.6	-2	0	-7.6
Turkey	4.6	1.2	-3	2.5	-4.2
Interest rates					
US federal funds	5.05	2.08	0.25	0.25	
ECB refinancing	3.84	3.89	1.00	0.50	
Oil (Brent USDpb)	72.6	97	40	40	

^a Weighted by 2005 GDP at market exchange rates

^b Brazil, Russia, India and China

^c Weighted by 2007 GDP at market exchange rates

Source: Fitch

Table 3 indicates the relative exposure of a country's GDP growth to the major global shocks. Note that this refers just to GDP growth prospects, not to a country's overall vulnerability to the global financial crisis. The table is necessarily simplistic and based on somewhat arbitrary cut-off levels, but is offered as an illustration. Fitch's GDP forecasts (above) incorporate its best view of prospects, building in relevant country specific factors and judgments.

Table 3: Growth Exposure Matrix

Deleveraging and rebalancing ^b	Trade channel exposure ^a		
	Low	Medium	High
Low	Poland Turkey		Czech Republic Slovakia
Medium	Croatia	Armenia Macedonia	Azerbaijan Moldova Russia Slovenia
High	Georgia Romania	Bulgaria Estonia Latvia Lithuania Serbia Ukraine	Hungary Kazakhstan

^a See Table 5: trade openness, commodity dependence and remittances

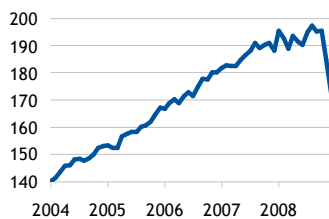
^b See Table 7: current account deficits, banking system leverage and credit contraction

Source: Fitch

World Trade Falls Off Cliff

Volumes, seasonally adjusted

(Index 1998=100)



Source: CPB Netherlands

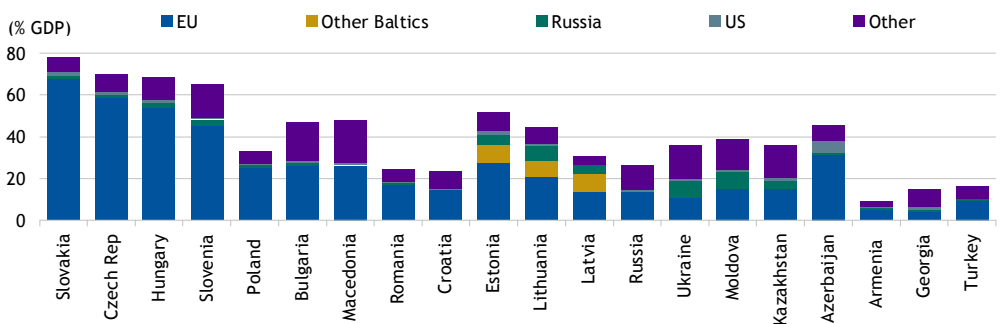
Global Recession Delivers Shock to Trade

The sudden, severe and synchronised recession in the world’s leading advanced economies – and in particular the abrupt fall in global trade and manufacturing output – has imparted a serious negative shock to activity in EE. The volume of world trade plummeted by 11.9% in Q408, while the volume of imports by the EU15 fell by 9.3%³. Moreover, this is making it harder for countries to correct macroeconomic imbalances through shifting resources to the export sector rather than shrinking domestic demand and is dampening the benefits on competitiveness from currency depreciations. Competitiveness effects may come through more strongly in the second half of the year, but countries with currency pegs will find it more difficult to rebalance their economies following depreciations by other countries in the region.

Many countries in EE are relatively open, so the global recession has been rapidly transmitted to exports. The Czech Republic, Hungary, Slovakia and Slovenia are particularly open economies and closely integrated within the EU economy (particularly Germany): exports of goods are equivalent to 79% of GDP in Slovakia, 70% in the Czech Republic and 68% in Hungary (2007 data). That said, exports typically have a high import content, so the effect on value-added is much lower.

Exposure to Global Recession: Trade Openness

Merchandise exports as % of GDP, 2007



Source: IMF Direction of Trade Statistics and Fitch

³ Figures seasonally adjusted, December 2008 on September 2008. Source: CPB Netherlands Bureau for Economic Policy Analysis

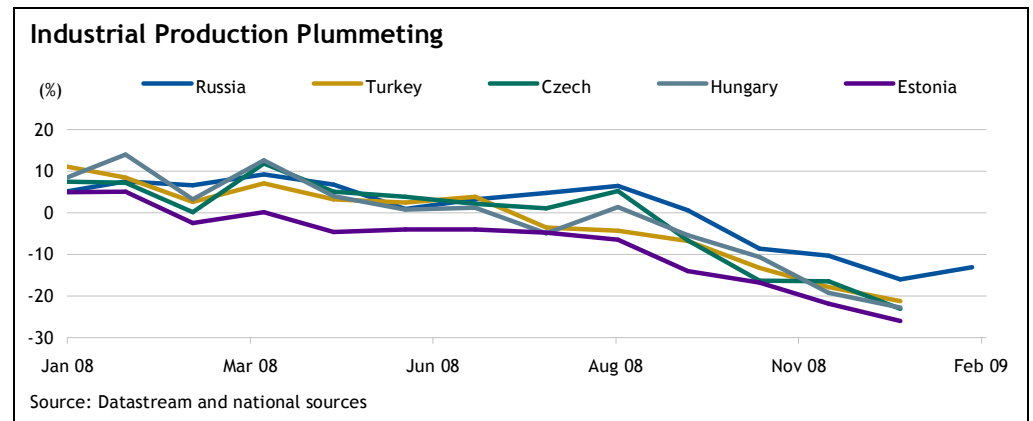
Table 4: Car Production

Per 1,000 of population, 2007

Slovakia	106
Slovenia	99
Czech Republic	92
Japan	91
South Korea	85
Belgium	79
Germany	75
Spain	65
France	49
Sweden	41
US	35
Hungary	29
Turkey	24
Italy	22
Poland	21
Brazil	16
Russia	12
Romania	11
South Africa	11
China	7

NB: Production in Slovakia increased to 180 per 1,000 persons in 2008, according to the Automotive Association of the Slovak Republic
Source: OICA and Fitch

The concentration of relatively cyclically sensitive industries such as cars and electronics is exacerbating the impact. Slovakia has the highest car production per capita in the world. This can be seen most clearly in industrial production (IOP) numbers. For example, in the 12 months to January IOP was down by 27% in Slovakia, 26% in Estonia, 23% in the Czech Republic and Hungary and 21% in Turkey. A glimmer of light is that in Poland and Russia IOP in the year to February was slightly better than in January (-14.3% from -15.3% for Poland, and -13% from -16% for Russia).



Fitch's projected drop in euro area GDP by 3.4% in 2009 (from +0.7% in 2008) and German GDP by 3.7% (from +1% in 2008) is bad news for EE. 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. The deterioration in prospects for Russia, a previous growth engine and destination for 7% of EE exports, is a further setback, particularly for the other CIS countries and the Baltic states. Table 5 understates the trade exposure of countries such as Croatia and Turkey, which have sizeable tourism sectors. In addition, 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 for all three countries).

Commodity and Remittances Incomes will also Decline

Despite being more closed economies, major oil commodity exporters such as Azerbaijan, Kazakhstan, Russia and Ukraine are being adversely affected by the collapse in oil, metals and other commodity prices. Although the drop in export prices does not directly affect output, it reduces real incomes, which support consumption, investment and government expenditure, as well as corporate profits and cash flow.

Another group of countries – including particularly Armenia, Georgia, Moldova, Macedonia and Serbia, which rely on substantial remittances from workers overseas or diasporas – could also see a drop-off in current external receipts and incomes. For CIS countries, the majority of remittances come from workers in Russia. Although remittances have proved relatively resilient in past downturns, some impact is likely. Indeed, the recent IMF press release on Armenia said: "Remittances and capital inflows, which sustained rapid economic growth in recent years, have decelerated markedly"⁴.

⁴ "IMF Approves USD540m Stand-By Arrangement for Armenia", IMF Press Release No. 09/68, 6 March 2009

Table 5: Exposure to Growth Through the Trade Channel

	Export openness ^a	Commodities ^b	Remittances ^c	Overall ^d
Armenia	9	-6.3	13.5	Medium
Azerbaijan	46	22.2	4.4	High
Bulgaria	47	6.2	5.7	Medium
Croatia	24	-5.8	2.9	Low
Czech Republic	70	-6.5	0.8	High
Estonia	52	-3.4	2.3	Medium
Georgia	15	-10.7	6.8	Low
Hungary	68	-3.2	0.3	High
Kazakhstan	36	35.5	0.2	High
Latvia	31	-4.5	2.1	Medium
Lithuania	45	-2.9	3.8	Medium
Macedonia	48	-10.4	14.3	Medium
Moldova	39	-15.3	38.3	High
Poland	33	-1.5	2.6	Low
Romania	24	-4.1	5.6	Low
Russian Federation	27	20.2	0.3	High
Serbia	22	-7.3	13.8	Medium
Slovakia	78	-8.1	2	High
Slovenia	65	-9.1	0.7	High
Turkey	16	-2.8	0.2	Low
Ukraine	36	-6.9	3.9	Medium

^a Merchandise exports as % GDP (2007)

^b Net exports of primary commodities as % GDP (2006)

^c Workers' remittances as % GDP (2007)

^d "High" triggered if export openness >65%, commodity surplus >20%, or remittances >15%.

Source: IMF DOTS, UNCTAD, World Bank and Fitch

Q408 Outturns and Base Effects

GDP outturns for Q408 show a steep decline in many countries for which data is available. The greatest declines so far are Latvia and in Estonia, where GDP fell by 10.3% and 9.4%, respectively, in the 12 months to Q408. More relevant for 2009 are the sequential quarter-on-quarter (qoq) GDP numbers. According to Eurostat data, GDP fell in Q408 from Q308 by 4.3% in Estonia, 3.9% in Latvia, 1.3% in Lithuania, 1.2% in Hungary and 0.9% in the Czech Republic (non-annualised, seasonally and working-day adjusted), indicating a marked deepening of the downturn. It remained positive in Slovakia at +2.1% and in Poland at +0.3%⁵. However, higher-frequency IOP numbers and surveys point to the recession gathering pace in Q109 in all countries.

The 2008 quarterly profile of Estonian and Latvian GDP reveals two phases of the recession. During Q1 to Q3, GDP was falling as they compressed CADs and made progress in unwinding imbalances after their excessive domestic booms. By Q3 there was some light at the end of the tunnel, with the pace of decline easing somewhat. However, in Q4 they were hit by the additional shock of the collapse in the global economy (and Sweden in particular) and the pace of contraction increased again.

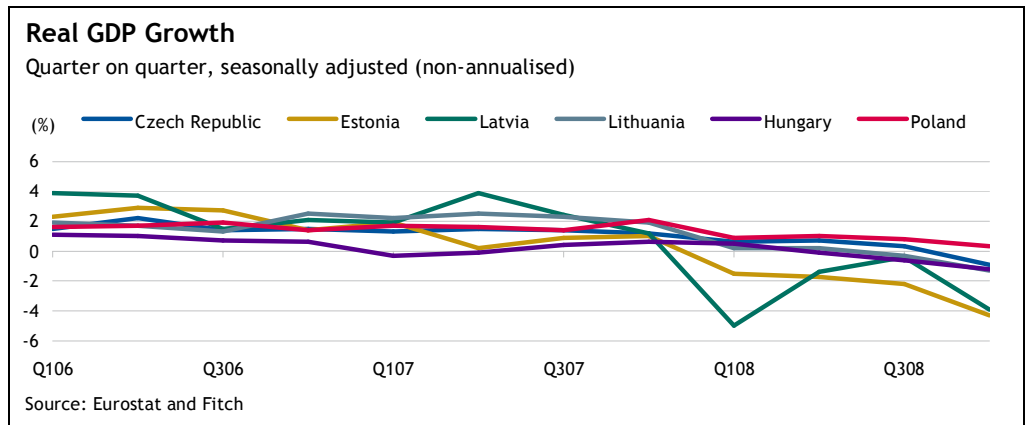
Moreover, the dynamics of growth in 2008 mean that the level of GDP in Q408 was below the 2008 average in the case of all three Baltic States, Hungary and the Czech Republic (see Table 6). This base effect means that it would take some positive qoq growth rates through this year to wipe out the arithmetic impact on the 2009 annual average growth rate.

⁵ Data only available for EU member states which joined in 2004.

Table 6: GDP Base Effect

GDP level in Q408 on 2008 average	
Czech Republic	-0.4
Estonia	-4.0
Latvia	-3.5
Lithuania	-1.1
Hungary	-1.2
Poland	0.9
Slovakia	3.0

Source: Eurostat and Fitch



Vulnerability to Capital Inflows and Credit Contraction

The forces of deleveraging and rebalancing are likely to be greater in EE countries where, prior to the outbreak of the global financial crisis, there were strong bank and asset price booms, massive CADs, high loan/deposit ratios and high dependence on external financing. The focus of this report is on GDP growth rather than banking or external financing risks per se. Even countries without large CADs or leveraged banking systems could face similar pressures if they face difficulties refinancing maturing external debt. Poland and Turkey, for example, may fall into this category.

Several factors point to a significant reduction in private-sector capital inflows to emerging markets: the shrinking of international syndicated loan and eurobond markets; cutbacks in trade credit; capital and funding pressures at foreign parent banks; lower corporate investment and FDI plans; and heightened risk aversion. Such capital inflows and associated bank credit growth funded from foreign loans have been a key driver of rapid GDP growth and source of financing for CADs in recent years, but are now slowing sharply. Countries that relied heavily on these sources of finance will have no choice but to compress CADs and unwind macroeconomic imbalances, and are likely to suffer “hard landings”. EU member states should receive capital transfers of typically around 2% of GDP a year, as well as some positive net FDI (including from retained earnings), helping to finance some of their CADs.

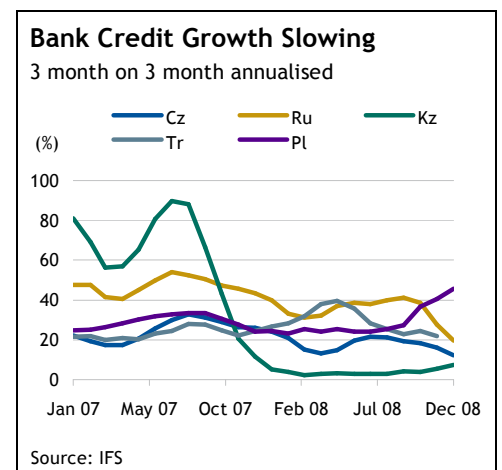
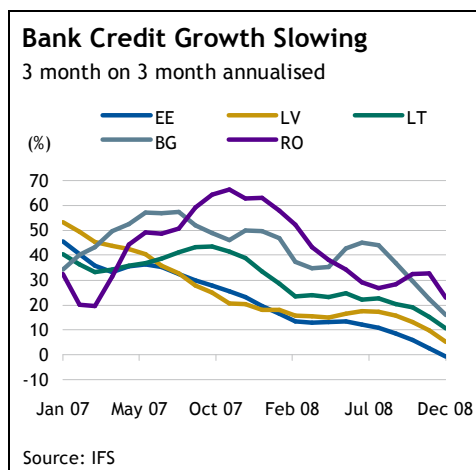


Table 7: Exposure to Rebalancing and Deleveraging

	CAB less FDI ^a	Loan/deposit ^b	Credit growth ^c	Overall ^d
Armenia	-2.2	162	1.1	Medium
Azerbaijan	8.4	147	1.3	Medium
Bulgaria	-14.9	129	-3.4	High
Croatia	-2.0	120	0	Medium
Czech Republic	0.8	80	2.5	Low
Estonia	-6.0	207	-3	High
Georgia	-13.3	204	-1	High
Hungary	-4.7	143	-1.9	High
Kazakhstan	10.1	174	-1.1	High
Latvia	-11.6	278	0.2	High
Lithuania	-10.6	197	0.6	High
Macedonia	-7.3	100	0.4	Medium
Moldova	-8.1	95	3.3	Medium
Poland	-3.8	110	1	Low
Romania	-9.0	131	-0.5	High
Russian Federation	6.6	135	0.5	Medium
Serbia	-12.6	120	0.4	High
Slovakia	-3.1	83	3.4	Low
Slovenia	-6.5	168	0.1	Medium
Turkey	-3.7	75	0.1	Low
Ukraine	-1.8	196	-12.0	High

^a Current account balance less net equity FDI (2008 estimates)

^b Bank loan/deposit ratios (latest)

^c Change in bank credit to private sector as % GDP (2009 forecast)

^d "High" if CAD less net equity FDI >10%, loan/deposit >170% or credit growth <0; "medium" if CAD less net equity FDI > 5%, loan/deposit >130%. Fitch has assigned "medium" rather than "low" to Croatia on a portfolio basis and as the 2008 CAD less FDI was boosted by MOL's purchase of INA. Others based just on these reference rates rather than factoring other judgments.

Source: National sources, IMF and Fitch

In fact, credit growth has been slowing in many countries in the region for some time. In Estonia and Latvia, this trend started two years ago and has been relatively steady, though growth has now turned negative in Estonia. In contrast, Kazakhstan experienced a sudden stop in August 2007, highlighting the greater volatility and difficulty of attaining market financing relative to that from foreign parent banks. The charts also show that the credit boom in the Czech Republic, Poland and Turkey was milder than in the CIS, Baltics and south-eastern Europe, and consequentially deleveraging should be more moderate⁶.

Even if there were no limits on the supply of credit, the demand for credit is slowing or falling due to the fall in GDP and investment, reduced demand for mortgage transactions and lower value of mortgages owing to property price falls, precautionary savings, and the desire to reduce debt levels. On this basis, Fitch would expect negative credit growth in, for example, the Baltic states, even if foreign parent banks were content to add to exposures.

The negative impact on credit and GDP growth from financial deleveraging will be exacerbated by the usual cycle of falling asset prices and collateral values and rising non-performing loans. This will be compounded in some countries, such as Hungary, where currency depreciation is adding to debt burdens owing to the prevalence of foreign-currency debt on balance sheets.

Policy Options Limited

In general, countries in EE have less scope for counter-cyclical macroeconomic policy to dampen the recession than high-grade sovereigns, which have a high degree of fiscal financing and balance sheet flexibility, helped by the capacity to raise taxes on high-value-added and wealthy economies, proven debt tolerance,

⁶ The uptick in Polish credit growth in H208 reflects the effect of the depreciation of the zloty in raising the zloty value of foreign-currency loans. Similar effects are noticeable in Hungary and Ukraine

entrenched political and social stability, deep local capital markets and, in some cases, reserve currency and benchmark borrower status⁷.

A detailed look at fiscal and monetary policy and the impact of the recession on public finances is beyond the ambitions of this report. But here, it should just be noted that, to differing degrees, several countries in the region, including Estonia, Latvia, Lithuania, Hungary, Romania and Ukraine, are planning pro-cyclical fiscal tightening. This reflects a variety of factors, including the need to bolster international investor confidence, to reduce debt-financing volumes, to help macroeconomic rebalancing and to comply with IMF policy conditionality, as well as the desire to keep deficits below or close to the 3% Maastricht reference rate. Other things equal, this will take more demand out of the economy, accentuating the recession (though not necessarily relative to the counter-factual).

Notable exceptions are Kazakhstan and Russia, where governments are deploying fiscal sovereign wealth funds to increase government expenditure. The Czech Republic has also announced a CZK70bn (1.8% of GDP), of which CZK47bn is to be financed through Ministerial cash reserves (largely reflecting under-spending of planned EU co-financing from previous years), though the package may include some effect from the automatic stabilisers as well as new policy measures.

Nevertheless, most countries are receiving a boost from lower interest rates, which will alleviate debt service costs and boost disposable incomes. Central banks of some of the larger economies in the region, including the Czech Republic, Poland and Turkey, have made significant policy rate cuts since October. And most countries, including those with fixed exchange rates and where domestic lending rates are indexed to international market rates such as EURIBOR, are receiving a policy stimulus from cuts in US, Euro and Swiss rates. The euro area fiscal expansion should also have some effect in eastern Europe. Indeed, there is anecdotal evidence that the German fiscal incentive measure to trade in old cars for new ones has already rippled out east.

Finally, the IMF and other international assistance will play an important role in several countries - particularly some EU member states - in terms of providing financing, reducing currency pressures, bolstering confidence, supporting incomes and easing the pace of deleveraging and rebalancing. Armenia, Hungary, Latvia and Ukraine have already received large IMF-led rescue packages. Romania and Serbia have entered negotiations with the Fund and Fitch expects some others to follow. The EU has increased its headroom for providing Community financial assistance to member states outside of the euro area to EUR50bn, of which EUR6.5bn has been committed to Hungary and EUR3.1bn to Latvia. In addition, the World Bank, EBRD and EIB have announced a EUR24.5bn package to support banks and bank lending in the region. Hungary has received support from the European Central bank in form of a swap line, Poland from the ECB and Swiss National Bank, and Latvia from the Danish and Swedish central banks; while the Swedish Central bank has offered some support to the Central Bank in Estonia.

⁷ See "High Grade Sovereigns and the Global Financial Crisis," available at www.fitchratings.com

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