

Criteria Report

Country Ceilings**Analysts**

David Riley
+44 20 7417 6338
david.riley@fitchratings.com

Paul Rawkins
+44 20 7417 4239
paul.rawkins@fitchratings.com

Richard Fox
+44 20 7417 4357
richard.fox@fitchratings.com

Purvi Hartalka
+44 20 7417 6318
purvi.halalka@fitchratings.com

James McCormack
+852 2263 9925
james.mccormack@fitchratings.com

Theresa Paiz-Friedel
+1 212 908 0534
theresa.paiz@fitchratings.com

Related Research

- [“Sovereign Rating Methodology”, 12 October 2007](#)
- [“Rating Above The Country Ceiling”, 8 August 2005](#)
- [“Distressed Debt Exchange Criteria”, 7 April 2006](#)
- [“Rating Banks Above The Local Currency Sovereign Rating”, 28 August 2007](#)

Summary

Country Ceilings capture the risk of exchange controls being imposed that would prevent or materially impede the private sector’s ability to convert local currency into foreign currency and transfer the proceeds to non-resident creditors – transfer and convertibility (T&C) risk. Country Ceilings are not ratings but rather a key analytical input and constraint on the Foreign Currency Ratings of entities and transactions originating in the sovereign’s jurisdiction.

Increased integration of national economies into global production, trade and financial networks has reduced T&C risk, as evidenced by the experience of sovereign crises over the last decade. However, T&C and country risk more generally remain strongly correlated with sovereign risk and hence Country Ceilings are “notched” from the Foreign Currency Issuer Default Rating (IDR) of the sovereign.

Country Ceilings above the sovereign Foreign Currency Rating are neither new nor recent, but only in June 2004 did Fitch Ratings publicly assign Country Ceilings to all the countries where it rates the sovereign. As part of its regular review of its criteria and methodologies, Fitch has concluded a review of its Country Ceiling criterion.

The review has not resulted in any change in the Country Ceiling methodology. Country Ceilings will continue to be notched from the Foreign Currency IDR of the sovereign (to a maximum of three notches) unless assigned on the basis of currency unions or supranational monetary arrangements. The key factors that Fitch believes influence the likelihood of a formal (or informal) moratorium on private-sector external debt are listed below:

- rule of law and governance;
- institutional constraints on restricting international trade and financial flows, such as membership of the WTO;
- degree of real economic integration in the global economy and hence the potential trade and investment losses that would arise from intervening in private-sector contracts;
- level of financial integration, including extent of restrictions and controls on capital flows in and out of the country;
- record of low and stable inflation, rendering macroeconomic stability less vulnerable to external shocks and consequently “unorthodox” policy responses such as exchange controls; and
- credibility and stability of the exchange rate regime and hence the incentives to impose controls on capital outflows.

A Country Ceiling above the sovereign rating does not imply that the private sector as a whole is a “better” credit than the government. Rather it reflects a judgement that some especially strong entities will be able to survive the shock of a sovereign debt crisis and service their foreign debt obligations and will not be prevented from doing so by the imposition of capital controls or a formal moratorium. The experience of recent sovereign crises has demonstrated that where governments do default, they often refrain from actively interfering with the private sector’s ability to service its own obligations, local and foreign.

Introduction

The methodology for assigning Country Ceilings was recently reviewed as part of Fitch's regular and on-going review of criteria and methodology¹. This Criteria Report replaces the previous report, "Country Ceilings", published on 17 August 2006. A full listing of Country Ceilings is maintained on FitchRatings.com and FitchResearch.com.

Sovereign, T&C and Country Risk

Although "sovereign risk" and "country risk" are often used interchangeably, they are not the same. The former is an assessment of the risk that the government of a sovereign nation will fail to honour its debt obligations. Country risk is a broader concept that relates to the risk to cross-border foreign-currency lending and investment arising from events in a particular country that are outside the control of the private sector. One such event is the imposition of exchange controls by the authorities that prohibit the transfer overseas of foreign currency to service foreign debt, referred to as "transfer risk". Another is "convertibility risk" – the risk that the FX market will close. Transfer and convertibility risk invariably go hand in hand.

Country and sovereign risks are highly correlated, as the government is the key actor in both, but the risk of exchange controls primarily applies to the private sector. Other forms of country risk include sovereign intervention that materially impairs the creditworthiness of private-sector entities, such as changes in regulated tariffs, deposit freezes, punitive taxation and expropriation. Moreover, country risk can also drive a systemic deterioration in creditworthiness across all agents in the domestic economy, as a result of a severe economic and financial crisis, often manifested in currency maxi-devaluations, such as occurred in the 1997-1998 Asian crisis. In such situations, widespread private-sector foreign debt default may occur even though the government has not imposed formal exchange controls and has not itself defaulted.

The Old "Sovereign Ceilings"

Prior to June 2004, in most instances Fitch operated a simple "sovereign ceiling" approach, whereby the Long-Term Foreign Currency (LTFC) IDR of the sovereign was automatically regarded as the ceiling on the ratings of all transactions and issuers domiciled in that country. The assumption, based on experience of sovereign debt crises in the 1970s and 1980s, was that governments facing default may impose exchange controls and other restrictive measures that impede access to and the transfer of foreign currency by private-sector issuers to their foreign creditors. The rationale for this approach was that governments would impose a moratorium or exchange controls on private-sector external debt as a means of appropriating and monopolising the foreign-currency resources of the country in order to meet their own foreign debt obligations or for "national security" reasons (eg financing essential imports). Consequently, the sovereign Foreign Currency IDR was also the "sovereign ceiling" for all other ratings.

The most notable exceptions to the previous "sovereign ceiling" approach were members of currency unions or supranational currency arrangements – such as the euro area – and members of the European Union (EU). Critically, the free movement of capital embodied in EU and national law as well as institutional and political constraints materially reduce (though do not wholly eliminate) the risk of exchange controls being imposed by a member of the EU. Moreover, the difficulty of imposing capital and exchange controls in a common currency area implies that T&C risk within the euro area is negligible (underpinned by the euro area's strong external balance sheet and credit fundamentals). As a result, entity and transaction

¹ Fitch is committed to undertaking "regular" reviews and updates of its criteria and methodology; *Code of Conduct*, April 2005

Foreign Currency IDRs within the euro area are subject to a euro area ceiling (currently judged to be 'AAA') and are not constrained by the rating of the sovereign in which the entity resides.

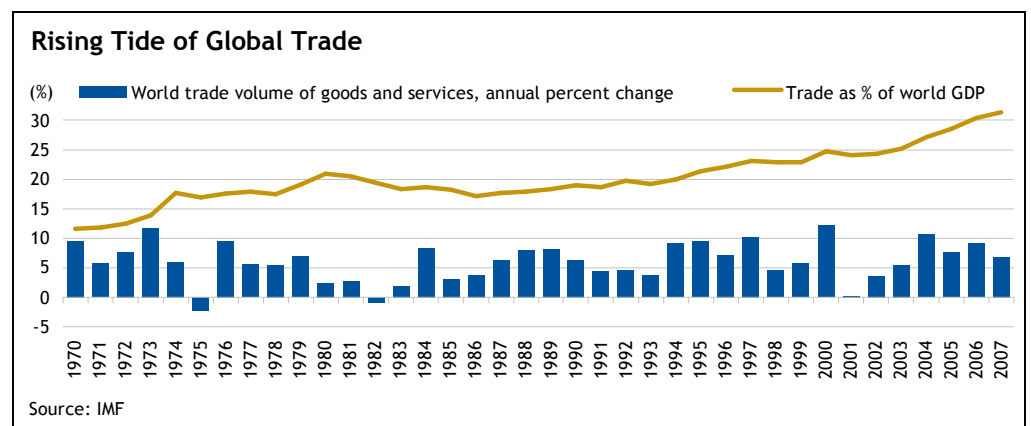
Fitch also maintains Country Ceilings based on common monetary and exchange rate arrangements for the Central African Economic and Monetary Community (CEMAC), West African Economic and Monetary Union (WEMU) and the Common Monetary Area (CMA) in Southern Africa.

Fitch has always recognised that exceptional banks and corporates can be rated above the sovereign ceiling if their "stand-alone" credit fundamentals imply that they can absorb a sovereign debt default and if they are shielded from the risk of exchange controls by substantial FX revenues, off-shore assets or more highly rated foreign partners/parents willing to provide financial support. The methodology for rating companies through the Country Ceiling is detailed in the Criteria Report, "Rating Above the Country Ceiling", 8 August 2005.

Reduced T&C Risks

As international trade, investment and commerce have become much more important, the cost benefit calculus faced by policymakers has shifted against the imposition of exchange controls that impede the servicing of private-sector foreign obligations, rendering invalid the "sovereign ceiling" assumption that all governments in all instances of financial distress will impose a formal or informal moratorium on private-sector external debt service. Global private-sector capital flows as well as trade have increased dramatically over the last decade and private-sector capital flows have replaced official flows as the primary source of international capital for developing and emerging economies. Moreover, over recent years, policy authorities in emerging markets have implemented measures to deepen local capital markets, including easing access for non-resident investors.

Local financial systems are increasingly integrated into global networks as international banks consolidate and expand their presence. More and more financial institutions and companies from emerging markets are accessing international capital markets to invest abroad as well as at "home". And progressively more countries are removing restrictions on capital flows. The tide of "globalisation" is not uniform and some governments have imposed greater political and domestic control over "strategic" industries, such as energy and commodity sectors, highlighting the significant "country risks" faced by international investors in many jurisdictions.



Nonetheless, as economies have become more open to trade and integrated into global production and financial networks, the cost of imposing wide-ranging exchange controls has become greater in terms of reputation, trade losses, commercial and legal sanctions, lack of international credit and lower foreign and domestic investment, and hence weaker long-run growth prospects. Even if the

authorities do impose capital controls, the likelihood that these measures will be selective and short-lived has increased.

Restrictions on capital flows in advanced industrialised economies have been virtually eliminated and, indeed, the capacity of authorities in countries with complex free markets and open economies to impose capital controls has decreased greatly since the 1970s and 1980s.

The experience of sovereign crises (sovereign default and near-default events) since the mid-1990s provides support for the view that governments are less likely than in the past to impose FX controls and private-sector moratoria in order to prevent a sovereign default. Of the 13 emerging-market sovereign crises reviewed over the last decade or so (starting with Mexico in 1994-1995 and briefly summarised in Appendix A), 10 resulted in a default on some class of sovereign debt, but only Russia imposed a formal 90-day moratorium on repayments on private-sector external debt (though several Russian companies and banks circumvented the moratorium and made payments to foreign creditors).

In the case of the Argentina crisis in 2000-2001, the authorities did impose exchange controls that hindered but did not prevent private-sector borrowers making payments to foreign creditors. Payments of principal and interest by Argentine entities to foreign creditors were permitted under the exchange controls imposed, albeit subject to central bank approval, which at the height of the crisis was difficult to obtain. However, it was the severity of the economic and financial crisis – including the collapse of the exchange rate, deposit freeze, forced “pesoification”, sovereign intervention in price setting, and repudiation of contracts – that precipitated private-sector default rather than exchange controls. In fact, several Argentine banks and corporates remained current on their foreign debt obligations through the crisis. The experience of Argentina does underscore, however, that a sovereign debt crisis is often associated with severe financial and economic dislocation, which can result in “systemic” private-sector default even in the absence of a formal moratorium on private-sector external debt service.

The imposition of a deposit freeze or other restrictions on the operation of banks is a common feature associated with sovereign debt crises, even where, as in the case of Korea (1998) and Mexico (1994-1995), a sovereign default was avoided. In contrast, the non-bank private sector in most instances was not prevented from servicing its foreign-currency obligations by exchange controls, moratoria or other direct sovereign intervention. However, the incidence of corporate default was much higher because of the associated economic crisis (the most notable examples being Indonesia and Argentina, where corporate balance sheets were hit by currency maxi-devaluations).

The most recent default of a sovereign rated by Fitch was by the Dominican Republic in May 2005 following what Fitch judged to be a “distressed debt exchange”². Yet despite deposit and capital flight and huge pressure on the peso precipitated by a banking crisis, the authorities did not impose capital and other controls preventing the private sector from servicing more than USD1bn of foreign debt.

The following broad conclusions can be drawn from sovereign crises since 1994-1995.

- A tightening of exchange and capital controls is often, but not always, part of the policy response to a sovereign crisis. However, T&C risk in terms of directly preventing the private sector from honouring its external debt obligations appears less pronounced than previously, especially for the non-bank private sector.

² “Fitch Downgrades Dominican Republic FC Rating to ‘DDD’ to ‘C’”, 5 May 2005

- In contrast with the traditional explanation that exchange controls are imposed so the sovereign can prioritise its access to scarce FX in an effort to meet its own obligations, the primary motivation for exchange controls has been to stabilise the exchange rate following the collapse of the previous currency regime, to avoid hyper-inflation and to prop up banking systems.
- The risk of direct sovereign intervention in the banking system remains high, reflecting the political importance of the sector (the depository of household savings and source of government funding), and its often primary role in transforming shocks into a wider country crisis through a deposit run, as well as its exposure to government debt.
- Sovereign crises are usually accompanied by economic crises that materially affect the ability of the private sector to service its external debt. In other words, the risk of a sovereign debt crisis (captured in the sovereign rating) remains highly correlated with broader “country risk”.

The experience of recent sovereign crises confirms that in a more “globalised” world, the simple “sovereign ceiling” approach is too blunt to capture accurately the T&C risk faced by private-sector borrowers and their foreign creditors.

The Country Ceiling Approach

The Country Ceiling approach reflects the impact of globalisation and the experience of recent sovereign crises. Because of the close correlation between “sovereign” and “country” risk a direct link between the Country Ceilings and the sovereign LTFC IDR is retained. Specifically, the Country Ceiling is notched from the LTFC IDR of the sovereign up to a maximum of three notches. The exception to this approach is where the Country Ceiling is determined by membership of a currency union, such as the euro area, or common monetary arrangements.

An Outlook is not formally assigned to a Country Ceiling since it is not a rating. Nonetheless, given the notching approach, it is likely that if the LTFC IDR was on Positive Outlook and was subsequently upgraded, the Country Ceiling would also be revised upwards; similarly for negative sovereign rating actions. Consequently, where the Country Ceiling is above the sovereign rating, those entities and transactions with ratings at the Country Ceiling may exhibit a greater degree of volatility than would normally be associated with ratings at that level³.

The Sovereign Rating Committee is responsible for assigning and maintaining Country Ceilings for all the countries with Fitch-rated sovereigns. The committee’s assessment is aided by a simple risk model that attempts to capture the costs and benefits and hence the incentives faced by the authorities in deciding whether to impose exchange and capital controls that could adversely affect the private sector’s ability to service its external debt. The more open the economy to international trade and capital, the greater the costs of exchange controls and private-sector debt default (see Appendix B). Consequently, the more open the economy, the less likely that, even in the event of a sovereign default, the authorities will impose a debt moratorium on the private sector (either formally or indirectly through severe exchange controls that do not distinguish between capital outflows and transfers that relate to contractual obligations with non-residents). Nonetheless, sovereign authorities would still impose a moratorium or FX controls if the perceived costs of not doing so are even greater. This is especially the case where the private sector is heavily exposed to currency risk and where the exchange rate is the key reference price for the economy, reflecting past episodes of chronic inflation and macroeconomic instability.

³ The further down the scale a rating is, generally the greater the likelihood that the rating will transition to another rating level, higher or lower

The Country Ceiling model therefore scores more highly countries that are open in terms of international trade and capital, including the absence of restrictions on trade and capital flows, without a recent history of hyper or chronic inflation, with flexible exchange rate regimes and with a banking and corporate sector that is not heavily FX leveraged (and hence a source of further exchange rate weakness). Relatively closed, less developed economies with fixed or managed exchange rate regimes and a record of high inflation and capital controls correspondingly score poorly under the model. Governance and institutional factors are also included to capture the risk of arbitrary economic policy decisions. In addition, membership of international organisations and treaty commitments, such as the WTO, OECD and the EU, which discourage the imposition of controls on international trade and capital flows, also signal the authorities' commitment to liberal economic and financial relations with the rest of the world.

Country Ceilings are positively correlated with the sovereign rating (ie the higher the sovereign rating, the more likely and higher a Country Ceiling uplift).

Rating Above the Sovereign

Corporates, banks and structured transactions can only be rated above the sovereign LTFC IDR, up to the Country Ceiling, if their stand-alone credit quality is judged to be sufficiently strong to withstand a sovereign debt crisis. Sovereign credit analysts provide analytical support to help ensure that sovereign crisis scenarios are appropriately reflected in the rating assessment of financial institutions, corporates and structured transactions.

Most financial institutions are not rated above the Local Currency Rating of the sovereign, in view of the risk of sovereign intervention during a crisis and exposure to government debt. Exceptions are confined to those where there is judged to be strong support from a foreign parent or strategic partner and those that are sufficiently strong to absorb losses on holdings of government securities in the event of a sovereign crisis.

Rating Above the Country Ceiling

Exceptionally strong corporates or financial institutions that are shielded from transfer risk – either because of substantial export earnings, foreign assets, production overseas and/or foreign parents or because of strategic partners willing and able to provide financial support – may be rated above the Country Ceiling. Structured transactions that incorporate credit enhancements that militate against the risk of FX controls can also be rated above the Country Ceiling and the sovereign rating.

Sovereign Ratings Are Unaffected

The Foreign and Local Currency IDRs of the sovereign are not directly affected by the Country Ceiling. Fundamentally, this is because sovereign creditworthiness is not constrained by the risk of exchange controls (the private sector faces the risk of such intervention by the sovereign authorities, not the government itself), but rather by fiscal and external solvency and the risk that the FX market effectively closes (all of which are directly affected by government policies).

Government actions and policies directly affect the rest of the economy (unlike individual private-sector entities that have no influence over the performance of the economy as a whole), but government policy is in turn greatly influenced by broader economic developments. In other words, governments may pursue policies that are detrimental to their own creditworthiness, but which they believe are appropriate from a broader economic and political perspective (such as using scarce FX reserves to “defend” the exchange rate even if this puts at risk the government's ability to service its foreign debt). Governments may also in effect “nationalise” the foreign debt obligations of the banking sector or even key companies because of their importance to the continued functioning of the

economy, even if by doing so, the government's own creditworthiness is imperilled (as was the case in Korea in 1997-1998).

A Country Ceiling above the sovereign rating does not imply that the private sector as a whole is a "better" credit than the government. Rather it reflects a judgement that some especially strong entities will be able to survive the shock of a sovereign debt crisis and service their foreign debt obligations and will not be prevented from doing so by the imposition of capital controls or a formal moratorium.

As the experience of recent sovereign crises has demonstrated, governments have defaulted while allowing the private sector to service its own obligations, local and foreign. Fitch therefore will continue to assign ratings to the foreign- and local-currency debt obligations of sovereign governments independently of the Country Ceiling.

Appendix A

Overview of Sovereign Crises

Crisis country	Year	Sovereign debt default	Pre-crisis exchange rate regime	Exchange and capital controls imposed during crisis
Mexico	1994-95	No	Crawling peg	Additional exchange and capital controls were not imposed during the crisis, though there was a major banking crisis and bank failures.
Venezuela	1994-95	Domestic debt only	Managed	Extensive controls on current account as well as capital account transactions were imposed, including export surrender requirements and restrictions on the availability of FX for imports. Capital outflows were prohibited except for foreign debt repayments.
Romania	1996-97	No	Managed	Banks had their FX dealer licences revoked except for four state-owned banks. Limits were placed on bureaux de change. Consequently, the inter-bank FX market effectively closed and the private sector had difficulty obtaining FX.
Korea	1997-98	No	Managed	Additional exchange and capital controls were not imposed during the crisis. However, Korean banks' short-term foreign debt obligations were restructured into new obligations with a sovereign guarantee. Although the corporate sector was not prevented from meeting foreign debt obligations, there were several major corporate defaults.
Indonesia	1998	Bilateral external debt to official creditors was restructured. Single sovereign Yankee bond unaffected.	Managed	The Indonesian authorities did not impose additional exchange and capital controls during the crisis. Nonetheless, there were widespread bank and corporate defaults following the collapse of the rupiah. Bank Indonesia provided a US dollar guarantee in support of a swap of inter-bank debt owed to foreign banks for medium- and long-term obligations. The government also supported a voluntary restructuring of external obligations of the corporate sector, providing a FX guarantee.
Russia	1998-99	Rouble-denominated government securities; "Soviet-era" foreign-currency-denominated debt owed to official and private creditors. Remained current on Russian Federation eurobonds.	Crawling peg	Capital controls were tightened significantly, including enforcement of export surrender requirements. A 90-day moratorium on private-sector external obligations (including FX forward contracts) was announced by the authorities, suspending payments to non-residents of principal on loans with a maturity exceeding 180 days. According to the authorities, only USD400m payments of non-bank debt were due over this period compared to USD2.7bn of bank obligations. Moreover, many corporates and even some banks circumvented the moratorium to make payments to foreign creditors by using foreign assets or earnings or making deposits with the Russian branches of foreign creditor banks.
Ecuador	1999	Brady bonds, eurobonds and official bilateral debt were all rescheduled.	Fixed	Bank holiday was imposed, followed by deposit freeze. Capital controls were imposed, including export surrender requirements and advance deposits for import payments. However, the servicing of private-sector external debt was not prohibited.
Pakistan	1999	Official bilateral debt was rescheduled. Sovereign eurobond debt was also restructured, as was some domestic debt.	Fixed	Controls on capital account transactions were imposed, particularly with respect to capital outflows (such as on foreign investment abroad, loans to non-residents) as well as export surrender requirements and controls on import financing. US dollar bank deposits were frozen.
Ukraine	1998-00	Selective restructuring of domestic public debt followed by external debt restructuring	Fixed	Additional exchange controls were imposed, including export surrender requirements and controls on import financing. However, controls did not cover private external debt service and there were no indications that the private sector incurred arrears to foreign creditors due to capital controls.

Source: Fitch

Appendix A (cont.)

Overview of Sovereign Crises

Crisis country	Year	Sovereign debt default	Pre-crisis exchange rate regime	Exchange and capital controls imposed during crisis
Argentina	2001	Fitch judged an exchange of domestic and external sovereign debt held by private creditors, concluded in December 2001, to be a distressed debt exchange and hence an event of default. Argentine authorities announced a moratorium in January 2002 on debt not previously exchanged.	Fixed	Restrictions on bank deposit withdrawals imposed in December 2001 – the “corralito”. All currency transfers abroad had to be approved by the central bank, including payments to foreign creditors. The central bank was selective in granting permission to the private sector to transfer FX abroad to foreign creditors, but this was relaxed within several weeks. Exchange control regulations were subject to a multitude of ad hoc changes in the months following the abandonment of “convertibility”, though generally exporters and those companies with offshore assets were not prevented from meeting their obligations. In January, dollar deposits were forcibly “pesoised” and the maturity of time deposits extended. Following the moratorium on sovereign external debt, surrender requirements on export proceeds were also imposed, along with strict limitations on inter-bank currency trading. There were widespread bank and corporate defaults due to direct sovereign intervention (deposit freeze/pesoification/tariffs) and the huge depreciation of the peso and contraction of the economy. Nonetheless, some Argentine corporates and banks did manage to remain current on their external obligations during this period.
Uruguay	2002	Yes	Crawling peg	One-week bank holiday imposed to stem deposit flight. Subsequently, USD-denominated time deposits of state banks were forcibly restructured. Access to deposits in foreign banks was unrestricted following the end of the bank holiday. Additional exchange and capital controls were not imposed. There was a severe banking crisis but corporate-sector debt payments were largely unaffected.
Moldova	2002	Yes	Managed	The authorities did not impose additional capital and exchange controls as a result of the restructuring of its sovereign eurobond and official bilateral debt. The sovereign bond restructuring, which was expected, had few macroeconomic ramifications.
Dominican Republic	2005	Yes	Managed	The banking crisis that began with the collapse of the second-largest commercial bank, BanInter, in the first half of 2003, eventually led to a restructuring of public external debt owed to official and private creditors (a distressed debt exchange of USD1.1bn in global bonds was completed on 5 May 2005). Yet despite deposit and capital flight and the associated pressure on the peso, which more than halved in value through 2003 and early 2004, the authorities did not impose additional capital and exchange controls that would have prevented the continued servicing of around USD1bn of external debt owed by the private sector.

Source: Fitch

Appendix B

Country Ceiling Model

Category	Measures	Comment
Rule of law and governance risks	World Bank indicators of political and governance risks.	Countries with weak civil institutions and rule of law are more likely to adopt measures, including capital controls that infringe on private property rights and in a crisis pursue economically “irrational” policies.
Institutional constraints	Membership of international institutions such as the OECD and EU as well as of common monetary and trade areas.	The potential benefits in a crisis situation of imposing severe exchange and capital controls are at least partially offset by the costs incurred in violating the letter or spirit of treaty commitments and membership of supranational institutions. Membership of such institutions also signals the authorities’ commitment to liberal economic and financial relations with the rest of the world.
International trade	International trade as a share of GDP; share of world trade; the extent of restrictions on current account transactions; membership of the WTO.	The more open to international trade and integrated into global production networks, the greater the damage to the economy of imposing indiscriminate exchange and capital controls that prevent the private sector honouring debt contracts.
International financial integration	Stock of foreign assets and liabilities as a share of GDP and extent of restrictions on capital account transactions.	As with openness to international trade, the greater the degree of financial integration and openness to international capital, the greater the costs of imposing exchange controls (as well as the greater difficulty in enforcing such controls).
Inflation risks	Inflation record over the last 10 years; number of years since an episode of chronic inflation; ratio of (local currency) broad money to GDP.	For countries that have a relatively poor record on inflation and where the exchange rate is a key reference price, the incentive to impose controls on capital flows during a sovereign crisis can be strong.
Exchange rate risks	Net external debt of the bank and non-bank private sectors; exchange rate regime.	The more heavily indebted the private sector, the greater the outflow of capital to service and repay external debt, especially during a crisis when international creditors are less willing to roll over maturing claims. Moreover, a heavily indebted private sector also implies a greater exposure to exchange rate risks. The combination of these factors greatly adds to the downward pressure on the exchange rate during a crisis. These pressures can be particularly acute and the incentive to impose capital controls strong when the authorities are seeking to defend a long-standing fixed or tightly managed exchange rate regime.

Source: Fitch

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