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BRIC By Name, BRIC By Nature?

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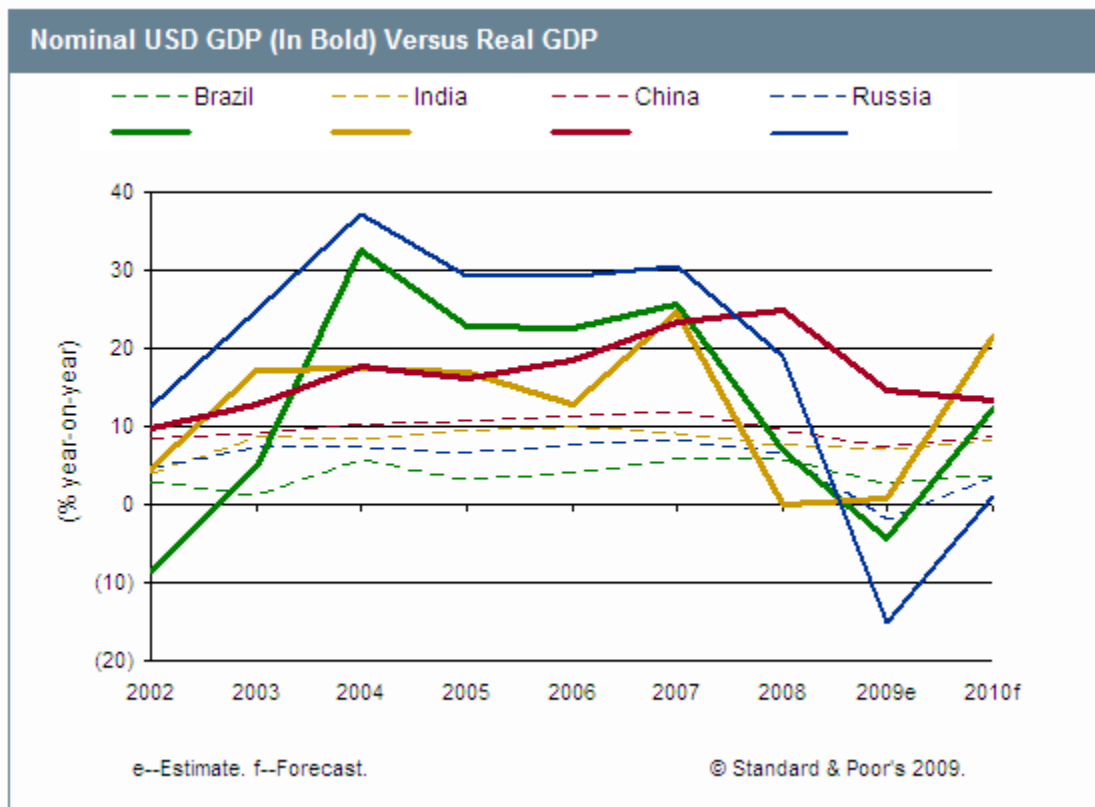
In 2001, Goldman Sachs bundled Brazil, Russia, India, and China together into an emerging market basket in deference to the four countries' size and economic potential. For most of the decade, despite significant differences in relative economic performance, the BRIC acronym has stuck. This is unsurprising in light of the benign global economic environment over the past six years, during which growth in the BRIC countries far exceeded historical averages and portfolio inflows into all four economies soared. Against the rapidly worsening global economic backdrop, however, it is worth asking whether the BRIC countries ever shared much in common, other than scale and high portfolio inflows. In the present environment, another inescapable question is which of the four BRICs are best positioned to weather the global financial crisis. Which will see greater instability of nominal U.S. dollar GDP? Which of the four economies are likely to benefit the most from large fiscal stimulus programs? And which are at greatest risk to diverge in general?

For various reasons--not least its strong public finances, relatively less exposed financial system, low levels of private sector leverage, and potential to raise consumption's share in GDP--Standard & Poor's Ratings Services are of the opinion that of all four BRICs, China is probably best positioned to find endogenous solutions--in particular fiscal stimulus--to withstand an externally driven crisis. Due to the collapse in its terms of trade, the falloff in financial account inflows, the distress in its banking system, and the absence of excess capacity on the supply side, Russia has access to fewer endogenous cures to the external gloom, although amid all the current difficulties, the Russian Federation can still boast some important ratings strengths, in particular relatively low levels of general government debt.

China and India remain poor countries

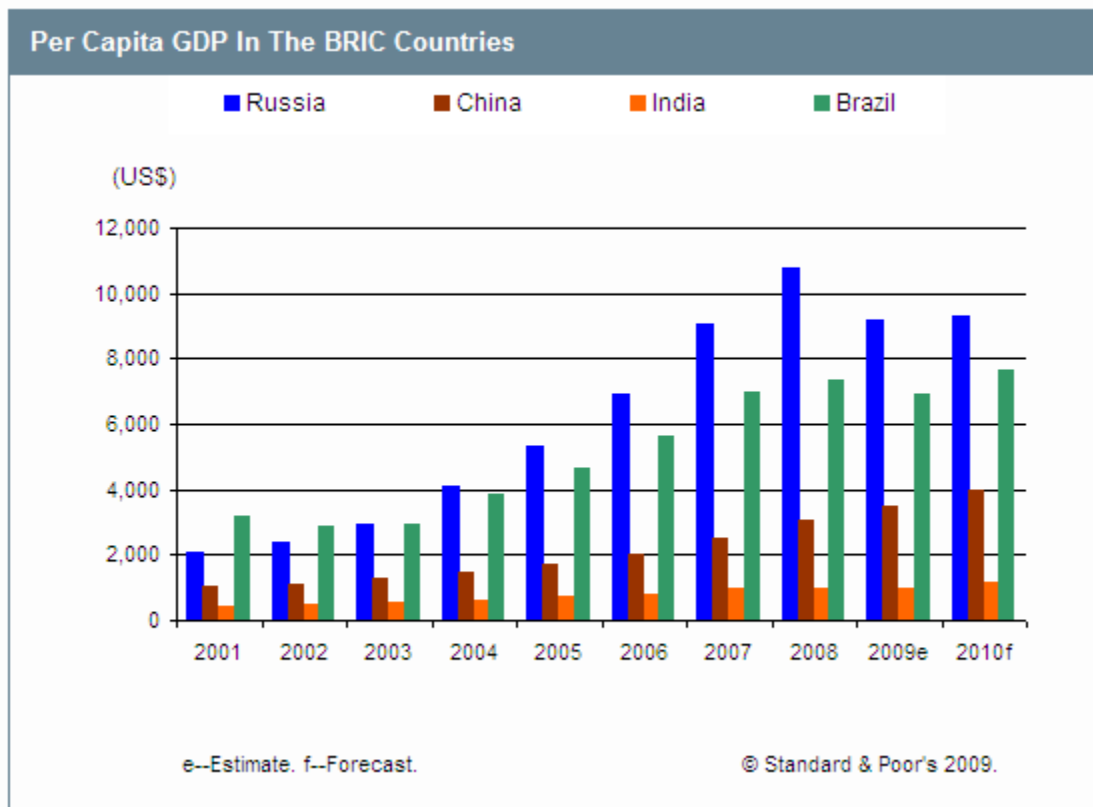
Although since 2001 the growth trend in all four BRICs was more or less the same (up), the pace of growth differed markedly. In Brazil, despite positive demographics, GDP growth peaked at a relatively modest 6% (1) last year versus 1% in 2001 (a year in which growth was, admittedly, depressed due to a severe localized energy crisis). In Russia's case, the peak was 8.1% in 2007 versus 5% six years ago. Over the same period, China's growth was both higher and more sustained--averaging just under 10% (see chart 1). The volatility of nominal, as opposed to real, GDP growth is far higher for all the BRICs, with the important exception of China, where exchange rate movements have been less abrupt and commodity dependency is non-existent. Indeed, of all four economies, we believe that only China's will increase in size in U.S. dollar terms during 2009. Nominal dollar-denominated GDP is an important factor when assessing capacity to service foreign currency debt; it is no small concern, for example, that Russian dollar GDP is likely to decline some 20% this year.

Chart 1



Of course, different growth trajectories partly reflect different starting points. Chinese per capita GDP has tripled since 2001 (at just over \$3,500 it is still one-half the level in Brazil) and just over one-third of the level in Russia (see chart 2). China and India remain poor countries, with vast pools of low-cost labor. As their exchange rates appreciate in line with expected relative productivity gains, however, we believe the income differential between China/India and Brazil/Russia will narrow, particularly as both China and India's terms of trade benefit from falling commodity prices.

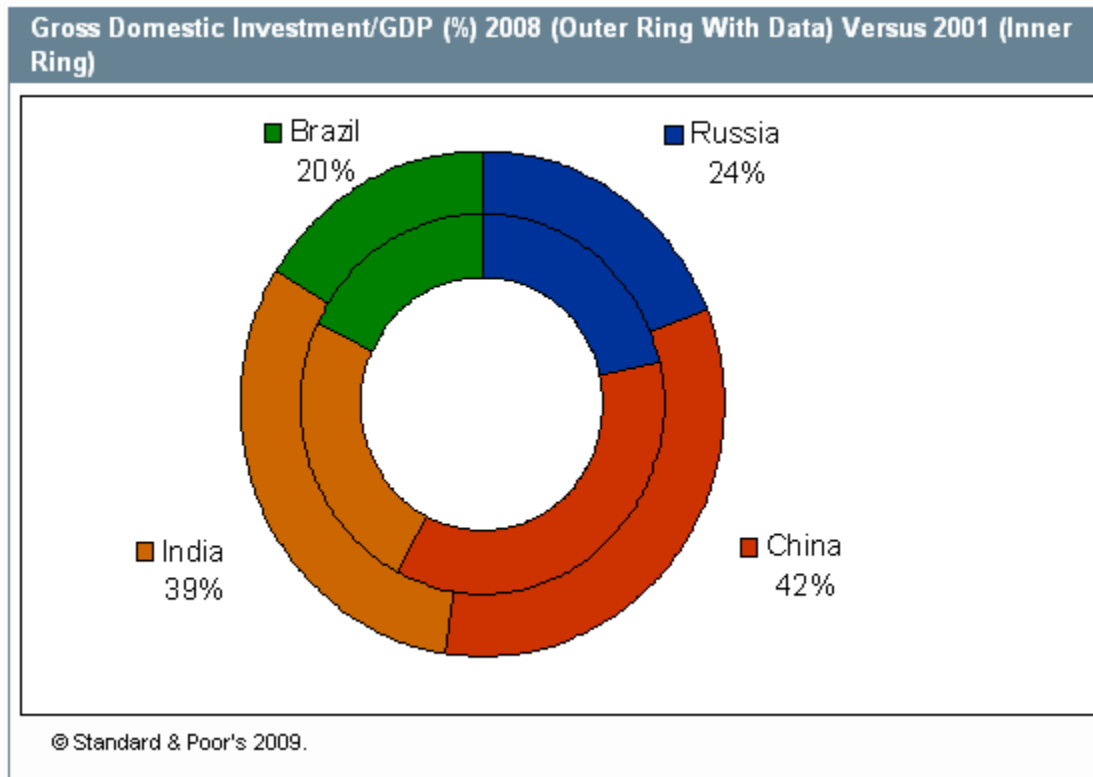
Chart 2



Temporary or permanent?

The trajectory and momentum of Chinese and Indian growth since early in the decade in our view manifests most of the characteristics of a structural--i.e., a permanent--break with the past. Evidence of this includes the unusually and consistently high levels of gross domestic investment and its increasing role in the economy (in China's case, investment has topped 40% of GDP consistently since 2003; see chart 3), as well as the tripling of average annual real export growth after 2001 for both India and China (a performance metric that neither Russia nor Brazil has approached).

Chart 3



A difficult environment for commodity economies

While China and India stand to gain from falling input prices, which should help to protect margins in key export sectors, Russia and Brazil are in our view net losers from lower energy, metals, and agro prices. Since the beginning of the decade, we see the investment boom in these two middle-income countries as closely correlated with commodity price developments, and hence has been interrupted by recent commodity price declines. We believe that second round effects of declining terms of trade on growth and public finances in Russia and Brazil will be similarly adverse, particularly for the less diversified Russian economy, where the gap between exports and imports in volume terms has widened from a large positive differential as recently as 2006 to negative 16% of GDP last year, versus close to zero for the more balanced Brazilian economy (see chart 4). The issue here should not be overstated. A real adjustment of Russia's exchange rate could, in principal, engender a rapid reversal of net exports back into positive territory. Encouragingly, we believe there are few indications so far of significant pass-through of exchange rate depreciation into inflation (partly due to the impact on CPI of declining energy costs). In light of the external environment, the onus of Russia's rebalancing during 2009-2010 will likely be on a decline in imports rather than any increase in real export levels.

Brazilian balance sheets in good health....

While in our view the near-term outlook for growth in Brazil has soured, what is comforting is that both Brazil's public and private sectors are entering the current crisis with stronger balance sheets than in the past. For Russia's

general government (although not for Russia's heavily leveraged corporate and financial borrowers), this is even more strikingly the case.

Whereas Brazil's net general government debt has only declined by 3% of GDP since 2001 versus the remarkable 52% of GDP drop for Russia, this apparent stability of general government debt levels in Brazil's case masks, in our opinion, a shift away from external and towards local currency funding at increasingly longer-dated maturities. From 2001 to 2008, foreign currency debt's share in Brazilian general government liabilities fell from one-third to one-eighth of the stock (2). Over the same period, the average maturity of Brazil's increasingly private sector-dominated gross external debt stock improved from 4.5 years to over 8 years. In our opinion, such positive developments in Brazil's government and private sector repayment schedule owe a lot to the increasing faith of international investors in the country's policy-making and other institutions, including those charged with the enforcement of contracts and property rights. On the contrary, the data on average maturity of Russia's stock of gross external debt shows no meaningful lengthening in the rollover period (indeed there has been a slight decline to just over four years) (3). While this is partly due to the large decline in the general government's share in gross external debt, we believe it also reflects the loss of investor trust in Russian institutions dating back to the appropriation of Yukos assets in 2003-2004. As a consequence of the global financial crisis, we observe that international investors have recently cut back their duration exposure to Russian corporates even more sharply, suggesting the average maturity of the nongeneral government debt stock has fallen off further.

Monetary regimes matter...

Another Brazilian strength is its strong track record of monetary management. We believe that during the past period of high commodity prices, Brazil's flexible exchange rate regime acted as a partial break on the cyclicity of money growth, inflation, and portfolio inflows--monetary side effects that come with the territory for nearly all commodity exporters. In contrast, Russia's more closely managed exchange rate policy, partly due to its greater predictability, tended to encourage locals to over-borrow in foreign currencies, while also inviting "hot money" inflows, which picked up markedly after the liberalization of the capital account in July 2006. As risk appetite deteriorated in the late autumn of 2008, we observe that nonresident capital flows into Russia reversed sharply alongside domestically driven capital flight, contributing to the \$155 billion (10% of GDP) fall of the Central Bank of Russia's stock of foreign exchange reserves during the five months ending January 2009. More recently, Russia has signaled a gradual shift toward a somewhat more flexible exchange rate regime. The adjustment could, we believe, ultimately create conditions for a rebalancing of Russian growth commencing as soon as 2011 or 2012. However, we believe that there will first be a weakening of the balance sheets of Russia's overextended banking and corporate sectors as the currency mismatch and the weakening economy cause asset quality to deteriorate. This process is likely in our view to push up the cost to the government of recapitalizing the financial system and ultimately weigh on the sovereign balance sheet.

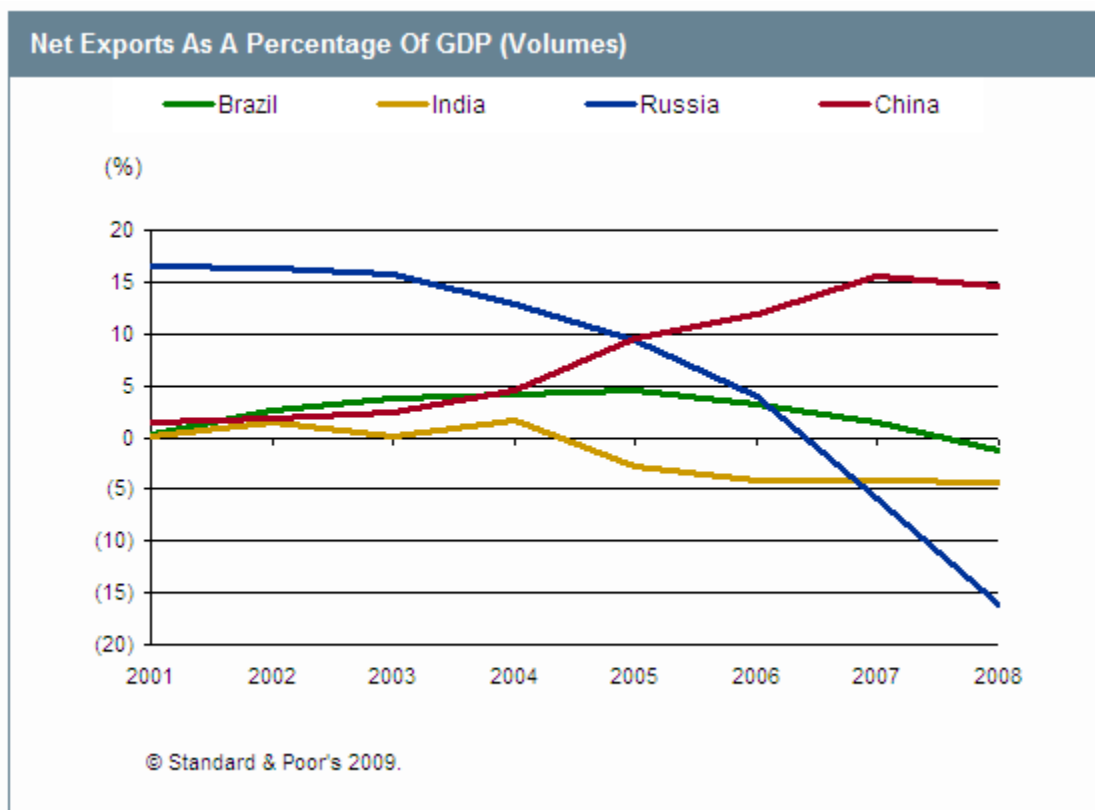
How large is China's export sector?

Despite being the largest of the four BRICs, China's economy is the most open, with exports equivalent to 43% of GDP, or more than three times the figure for Brazil. We believe that there are significant issues surrounding national accounts data, however, which suggest that China's reliance on the export sector is exaggerated. For starters, we see a large negative gap between domestic value added in exports and the gross export number. More than half of

Chinese exports fall under the category of "processed" trade, meaning that inputs are imported and processed before being exported. Complicating matters, we feel there are serious data issues surrounding the proportions of various components of GDP in China's national accounts data, which has been subject to frequent backwards revisions.

Nevertheless, we feel there is little question that China will suffer significantly from the fall-off in global demand. From 2001 until 2008 net exports increased their share in overall GDP by over 14 percentage points of GDP (although this data probably overstates net export levels significantly due, in our view, to misreporting of portfolio inflows and issues related to VAT payments). That increase was mirrored in a similarly spectacular decline of net exports in Russia (4) where the real appreciation of the exchange rate sucked in imports, commencing in 2005, while the partial nationalization of the oil sector in 2003 contributed to stagnation of petroleum production and hence nearly flat growth in volume energy exports.

Chart 4

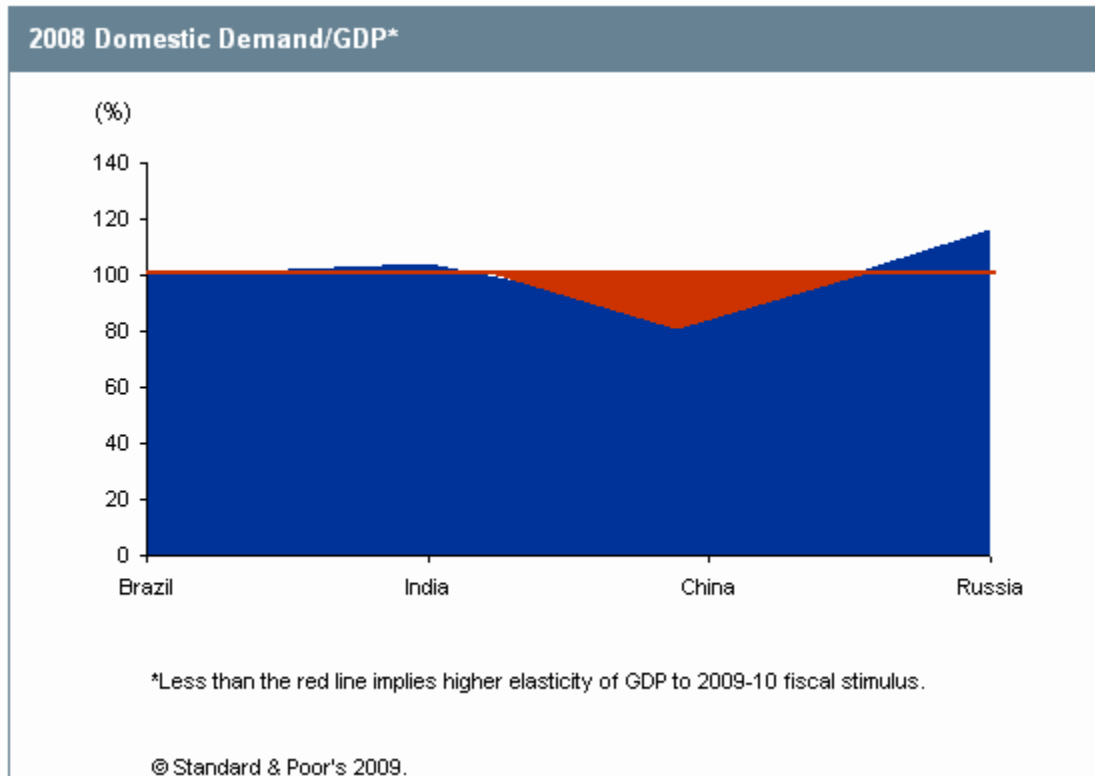


China's underconsumers...

The implication of China's high level of net exports and investment is that consumption in particular is disproportionately small as a percentage of GDP. The larger point is that aggregate supply is far greater than aggregate demand, and hence, in a world of declining external demand, the Chinese economy is clearly suffering from substantial excess capacity (see the red triangle in Chart 5). There is a highly positive upside to Chinese excess capacity, which is that the elasticity of growth to fiscal stimulus in China is, we believe, almost certain to be higher

than in Russia or India, where domestic demand's share of GDP in 2008 is far larger than total output. By stimulating consumption, we believe that China can steer its economy through the external crisis with greater confidence in growth prospects than its BRIC peers. On the contrary, unless it is limited to capital expenditure, we see fiscal stimulus in Russia and India as likely to create inflation as it is to create genuine growth.

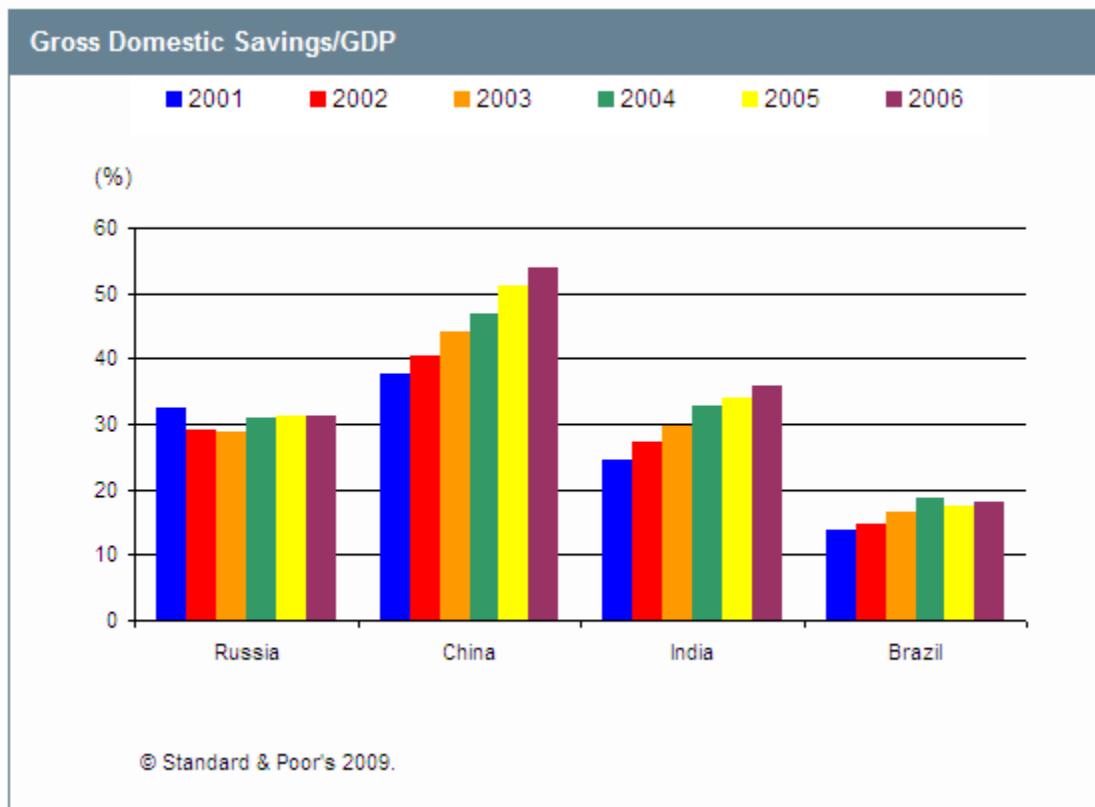
Chart 5



High stocks of public and private savings is a major ratings strength

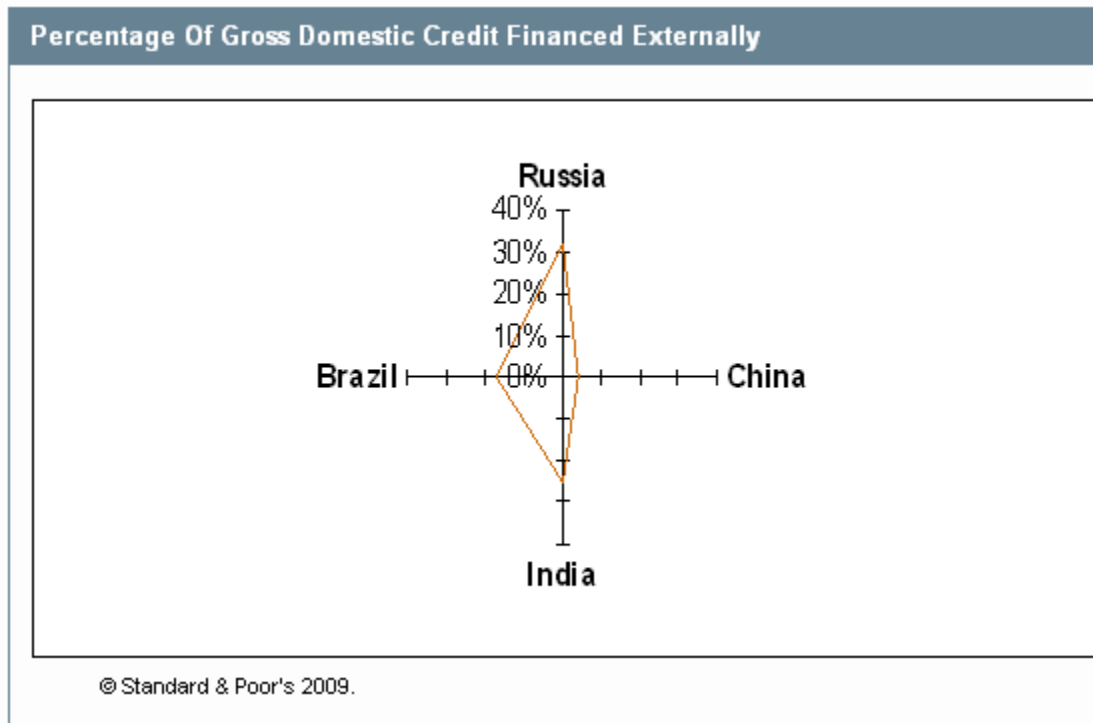
China also benefits from unusually high domestic savings rates (gross savings over GDP approaches 50% versus close to 20% for Russia and Brazil; 5), re-confirming the possibility of an increased role of consumption in the economy (see chart 6). Even so, not all data suggests that leverage is low, at least not in China's corporate sector. Of all the BRICs it is only China that posts domestic credit levels in excess of 100% of GDP. This is overwhelmingly corporate and not household debt, however.

Chart 6



Moreover, and critically in our view, in the current environment of global deleveraging, China's stock of domestic credit is domestically financed. Less than 5% of domestic credit is foreign financed versus over 30% for Russia, over 20% for India, and 13% for Brazil (see chart 7). In China's case, this would seem to delink prospects for domestic credit growth from the global banking crisis; indeed, in striking contrast to Russia and even Brazil, during the first month of 2009, we have observed no signs of a deceleration in domestic credit growth in China.

Chart 7



For China, the crisis may be an opportunity

Thanks to its various advantages, we believe that present circumstances may offer China a natural opportunity to shift its economic model toward demand-led growth. Looser fiscal policy is one part of it. Steps to improve the social welfare net (education, pensions, health) might, in our view, also boost consumption as people would save less to meet those basic needs if the government paid for them. We note, in passing, that many of these steps are already being taken by the Chinese government.

India constrained by less fiscal space...

In our view, India faces the opposite challenge. The overhang of high government debt, large fiscal deficits, and comparatively less investment in physical infrastructure suggest that the aggregate supply curve has not moved outwards in recent decades as much as China's. We believe that both public and private consumption have contributed more to GDP growth in India over the years than they have in China. Domestic aggregate demand has not been a problem; on the contrary, as in Russia, it appears to have been the slow pace of expansion of domestic supply that has held back Indian GDP growth and contributed to a higher trend level of inflation compared with China. For this reason, India has, in our view, less room to use policies to stimulate domestic demand and might benefit from working on the supply side. That, however, takes time.

Russia: Banking crisis supersedes stimulus

A somewhat similar pattern is apparent in the Russian Federation, which, due to high commodity prices, appears to have amassed a fiscal buffer approximating 17% of GDP since 2000, and which regularly pays down general government debt. As a result, the Russian Federation continues to be a net creditor, although we believe this position is likely to shift to a slight net debtor position by end-2009 due to a likely recapitalization of the overextended domestic banking sector and financing of this year's expected general government deficit of 6% of GDP.

Where will Russia's economy be after this is over?

Ultimately, we see this financial crisis leaving an even larger share of Russia's economy in state hands. This is likely to drag on long-term productivity performance, lowering trend growth over the medium term, particularly compared to China. We observe that the cost of capital for Russian corporates has risen exponentially since the summer of 2008, far more than any other BRIC with five-year sovereign default spreads now trading over 300 basis points wide of several lower rated sovereigns. Corporate spreads appear to have widened out even further, and we believe this is dampening investment activity. As a consequence, past liabilities will likely drag on demand for some time. Moreover, as in India, we believe that Russia's commitment to productivity-enhancing structural reforms, including the liberalization of the market for goods and labor (as well as property) has been, at best, erratic, and may explain why at 13% during 2008, Russia's rate of inflation remains twice as high as average CPI for the other three BRICs.

Table 1

BRIC Countries Comparative Statistics										
GDP per capita (\$)	2001	2002	2003	2004	2005	2006	2007	2008	2009e	2010f
Russia (BBB/Negative/A-3)*	2,088	2,364	2,967	4,089	5,312	6,903	9,050	10,803	9,183	9,315
Brazil (BBB-/Stable/A-3)	3,170	2,859	2,954	3,860	4,674	5,650	6,994	7,365	6,938	7,673
India (BBB-/Stable/A-3)	454	467	538	622	716	794	975	959	953	1,140
China (A+/Stable/A-1+)	1,038	1,131	1,269	1,485	1,716	2,023	2,482	3,079	3,513	3,964
Real GDP (% change)										
Russia (BBB/Negative/A-3)	5.1	4.7	7.3	7.2	6.4	7.4	8.1	6.8	(2.0)	2.3
Brazil (BBB-/Stable/A-3)	1.3	2.7	1.1	5.7	3.2	3.8	5.7	5.6	2.5	3.2
India (BBB-/Stable/A-3)	5.2	3.8	8.4	8.3	9.2	9.7	9.0	7.5	6.8	8.0
China (A+/Stable/A-1+)	8.4	8.3	9.1	10.0	10.4	11.1	11.9	9.5	7.3	8.5
GDP (bil. \$)										
Russia (BBB/Negative/A-3)	307	345	432	592	765	989	1,290	1,535	1,301	1,316
Brazil (BBB-/Stable/A-3)	551	504	529	701	861	1,056	1,325	1,416	1,353	1,517
India (BBB-/Stable/A-3)	483	505	591	695	812	915	1,140	1,139	1,149	1,397
China (A+/Stable/A-1+)	1,324	1,453	1,640	1,931	2,244	2,659	3,279	4,091	4,693	5,325
CPI growth (%)										
Russia (BBB/Negative/A-3)	21.5	15.8	13.7	10.9	12.7	9.7	9.0	14.0	17.5	14.0
Brazil (BBB-/Stable/A-3)	6.9	8.5	14.0	8.2	6.7	4.1	3.7	5.8	4.8	4.6
India (BBB-/Stable/A-3)	3.6	3.4	5.5	6.4	4.5	5.4	4.8	7.4	5.2	6.0

Table 1

BRIC Countries Comparative Statistics (cont.)										
China (A+/Stable/A-1+)	0.7	(0.8)	1.2	3.9	1.8	1.5	4.8	6.5	3.5	2.0
Current account balance (% of GDP)										
Russia (BBB/Negative/A-3)	11.1	8.5	8.2	10.1	11.0	9.5	5.9	5.0	(5.1)	(3.2)
Brazil (BBB-/Stable/A-3)	(4.2)	(1.5)	0.8	1.7	1.7	1.3	0.1	(2.1)	(1.8)	(1.5)
India (BBB-/Stable/A-3)	0.3	1.4	1.5	0.1	(1.0)	(1.0)	(1.5)	(5.0)	(7.1)	(7.7)
China (A+/Stable/A-1+)	1.3	2.4	2.8	3.6	7.2	9.4	11.3	8.7	6.6	7.6
Net general government debt (% of GDP)										
Russia (BBB/Negative/A-3)	45.0	38.8	28.4	17.1	5.2	(5.6)	(11.3)	(7.1)	3.1	8.3
Brazil (BBB-/Stable/A-3)	51.7	63.0	55.8	48.7	44.0	44.2	46.2	48.3	46.5	44.9
India (BBB-/Stable/A-3)	74.3	80.1	81.0	77.0	77.2	75.3	70.0	67.7	66.1	63.6
China (A+/Stable/A-1+)	29.9	26.0	23.4	24.0	20.9	18.1	17.3	12.3	13.9	14.8
Domestic credit to private sector & NFPE growth (%. y/y)										
Russia (BBB/Negative/A-3)	48.4	31.1	43.0	46.6	34.5	48.3	50.3	22.0	(7.0)	4.0
Brazil (BBB-/Stable/A-3)	4.0	12.4	8.4	18.7	21.4	20.0	27.4	29.9	11.9	11.9
India (BBB-/Stable/A-3)	9.3	21.5	9.7	30.6	26.2	27.6	20.4	25.0	18.0	22.0
China (A+/Stable/A-1+)	9.5	17.2	20.8	11.2	9.1	14.3	19.3	14.5	11.0	12.3

*Foreign currency ratings as at Feb. 3, 2009. e--Estimate. f--Forecast.

China's banking system is a source of stability, but also a long-term drag on growth

To some extent, the current banking crisis in Russia is not unique to the BRICs. Brazil's banking sector experienced several shocks during the 1990s and its system is arguably more seasoned as a result. China's banking system, on the other hand, remains state dominated and continues in our view to be a long-term drag on the reform process. Nevertheless, its activities are tightly controlled by regulation which, in the current environment, is a source of stability. In the face of recent events, Chinese leaders remain supportive of financial sector reforms. There appears to be greater understanding within the government that the current means of maintaining financial stability--through strict controls on so many aspects of banks' behaviour--cannot persist as the economy matures. The banking system now appears to favor large and asset rich companies (i.e. state-owned enterprises) to the exclusion of other borrowers. Over the longer term, risk assessment capabilities could be improved, while regulatory changes could help non-SOEs increase their access to capital. Developing local capital markets in all the BRICs (although Brazil's are in advance of the other three) might, in our view, also help to reduce overall risk management, and reduce the probability of future banking crises.

To conclude

The original justifications for the BRIC acronym--that is, high growth potential and demographic mass, may still apply, but the possibility of a long-term interruption in rising incomes in the BRICs appears to be a serious possibility. Since the label was coined in 2001, strong external demand, high commodity prices, and cheap foreign funding have all, we note, contributed to the untested assumption that potential growth levels in all four countries were similarly high. This may still be the case, but we believe that policy adjustments may be required to confront

the challenges created by these economies' longstanding structural inadequacies and difficult external environment.

While imbalances in Brazil still may not be material, the country in our view nevertheless remains vulnerable to the volatility of the commodity and credit cycles. Due to its oil dependency and the legacy of its three-year domestic credit boom, we see Russian imbalances as far more glaring, although this susceptibility is, in our view, largely offset by Russia's superior public finances. Even these, however, may well suffer during 2009-2011 as a portion of the Russian Federation's sovereign contingent liabilities becomes explicit and as a contracting economy drives the general government budget into deficit for the first time in over a decade. We see the challenge for India as being to consolidate public finances in order to reduce its debt burden. We see China, on the other hand, as being able to boast of both a strong balance sheet and a diverse and competitive economy. With negative external financing needs, China is, in our view, less sensitive to generalized risk aversion than the other BRICs--including Russia, which for the first time since 1997 is set to run a current account deficit during 2009; China also, we believe, stands to gain the most from its fiscal stimulus program given the potential to raise domestic consumption's role in the economy. Nevertheless, without sufficient and protracted stimulus, we think China's economy could potentially suffer a severe shock, which could enflame social pressures with political repercussions. Recent announcements from Prime Minister Wen Jiabao suggest a strong understanding of these risks and a willingness to access China's considerable assortment of domestic tools to steer the economy through the external crisis.

Footnotes

- 1) All real and nominal GDP growth data is from the IMF's International Financial Statistics (IFS) database with the exception of Brazilian data, which is from the Instituto Brasileiro de Geografia e Estatística
- 2) Ministerio de Fazenda, Brazil
- 3) Data from the Central Bank of the Russian Federation, the Russian Ministry of Finance, Standard & Poor's
- 4) Federal State Statistics Service, Standard & Poor's
- 5) IFS

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