Asia Economics Flash
February 23, 2012

Goldman Sachs Global Economics,
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# India Union Budget preview: Expect some fiscal consolidation

- The 2012 Union Budget will be presented on March 16 at a time when there has been a significant deterioration in the government's finances. We expect the central government's fiscal deficit to rise to 6% of GDP in FY12E from 4.7% in FY11.
- We estimate the general government deficit may rise to 9% of GDP in FY12E, largely due to a fall in tax revenues driven by the economic slowdown, and a big increase in fuel subsidies.
- Given the extent of the potential increase in the deficit, we expect the budget for FY13 to focus on fiscal consolidation. We think the central government may budget for the deficit to go down to 5.3% of GDP from an expected 6%.
- Our expectations are that the fiscal consolidation will be driven largely by revenues—we estimate an increase in excise and service taxes could reduce the deficit by 0.5 pp of GDP in FY13E.
- With a reduction in the above line fiscal deficit, we expect the net market borrowing requirement of the government to be similar to that in FY12, which we think is marginally positive for government bonds.
- Our fiscal impulse estimates suggest that adjusting for cyclical factors, the government will impart a negative impulse of 0.5 pp of GDP to domestic demand for FY13E.
- Our sector analysts expect the budget to be positive for infrastructure companies and power developers, and negative for autos, consumer goods, and oil marketing companies.

**India's 2012 Union Budget will be presented at a time when there has been a significant deterioration in the government's finances**. We did not believe that the budget presented in February 2011 would meet its targeted deficit of 4.6% of GDP (see *India Union Budget—a fiscal promise to keep and miles to go before it succeeds*, Asia Economics Flash, March 1, 2011) due to under-budgeting of subsidies and optimistic forecasts for revenue. As the economy slowed more than expected, we estimated the deficit at 5.8% of GDP, which was significantly above consensus (see *India: A worsening of the fiscal-monetary policy mix,* Asia Economics Analyst 11/18, October 20, 2011). Slowing growth, higher oil prices, and highly optimistic budgeting suggest to us that even our above consensus fiscal deficit targets may be exceeded.

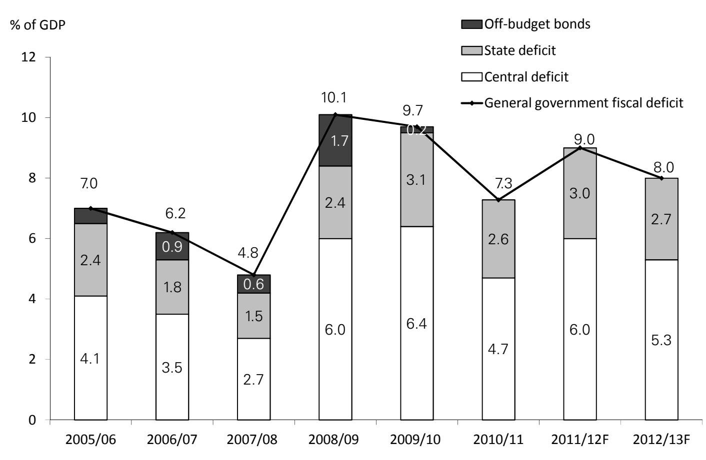
**The budget to be presented on March 16 represents an opportunity to break from the recent trajectory**. Budgets in India are perceived to be determined more by political economy considerations than purely economic ones. Therefore, the outcome of regional elections in India's largest state, Uttar Pradesh, and four other states may have a significant bearing on the budget (see *Takeaways from Delhi policy visit*, India Notes, February 3, 2012).

**A combination of a back-against-the-wall feeling, the need to arrest a sharp deterioration in public finances, and the best opportunity before the 2014 polls to focus on economic issues suggest a focus by the government on fiscal consolidation**. First, the economic slowdown (the government is now forecasting GDP growth of 6.9% in FY12 compared with its initial forecast of 8.75%) has heightened policy sensitivity and given rise to a "back against the wall" feeling among policy makers, which is generally when things get done on economic policy. Second, the sharp deterioration in the fiscal deficit and high borrowing requirements, which led to a sharp jump in bond yields in October-November, before the Reserve Bank of India (RBI) bailed the government out by buying its bonds, has demonstrated to the government that there is little option but to focus on consolidation. Third, the budget represents the best opportunity before general elections in 2014 to focus on economic issues, as there are very few elections in the rest of 2012. That said, the level of fiscal consolidation we envisage may at best be marginally positive for the markets. The risk to this view is a "business as usual" budget which aims to get the fiscal deficit down but with few tax increases or explicit expenditure cuts. This would support the market's scepticism and negative view about the ability to reduce the deficit, even if the intentions were there.

## I. A large fiscal deterioration in FY12

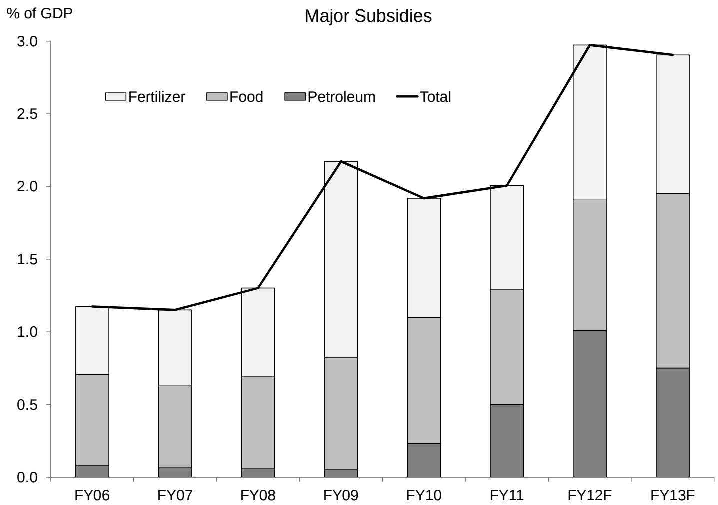
**We think the central fiscal deficit may rise to 6% of GDP in FY12E from 4.7% in FY11, and a budgeted deficit of 4.6%.** Of the deficit increase, we estimate that 45% can be explained by tax revenue shortfalls, and a further 22% by unbudgeted subsidy increases. On the expenditure side, there were significant overruns in subsidies—nearly twice of what was budgeted. Particularly in fuel, we expect the subsidy bill to be Rs900 bn (US$19 bn) a nearly four-fold increase over the budgeted Rs236 bn (US$5 bn). Other expenditures—both current and capital—have progressed largely as budgeted.

### Exhibit 1: We expect the general government fiscal deficit to come down in FY13



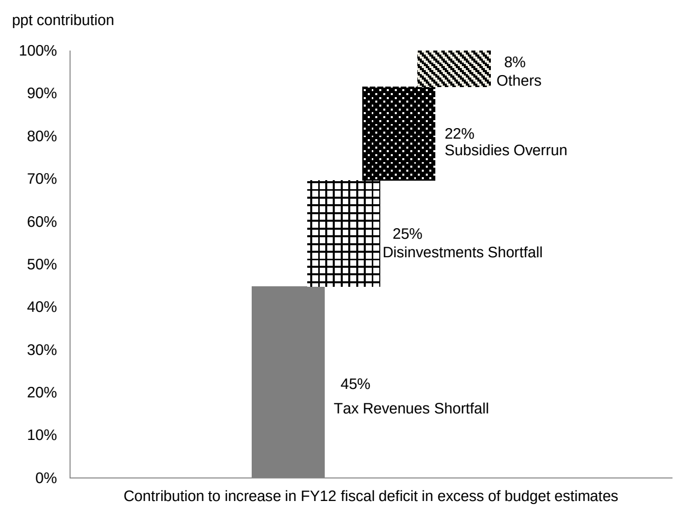

Source: CEIC, GS Global ECS Research estimates.

**Exhibit 2: Rising fertilizer and oil prices increased the subsidy bill in FY12, Food Security Bill likely to put pressure on subsidies in FY13**




Source: CEIC, GS Global ECS Research estimates.

**Exhibit 3: Tax revenue shortfalls and subsidy overruns were the major contributors to a much bigger-than-expected fiscal deficit**




Source: CEIC, GS Global ECS Research.

**On the revenue side, the shortfall is likely to be marked. Against a budgeted growth in revenues of 17.3%, we estimate the actual growth could be closer to 10%**. The big shortfalls are in corporate income tax and excise duties or production level taxes. These suggest that the shortfalls are mostly to do with the slowdown in economic activity.

**The general government deficit may rise to 9% of GDP in FY12 from 7.3% in FY11**. The states' deficit which tends to move in line with the central deficit, and driven by economic activity, we expect to widen to 3% of GDP in FY12 from 2.6% of GDP in FY11. Part of the increase in the general government's deficit was expected by the market given that the 3G auction receipts, which contributed 1.3% of GDP in FY11 is no longer there. In addition, against the planned privatization receipts of Rs400 bn (US$8 bn), we think the government will likely achieve only Rs100 bn (US$2 bn). The very large fiscal deficit and low privatization has increased the government's market borrowing by 26%. Thus, the government has already borrowed Rs4.6 tn (US$96 bn) from the market, which is well above the Rs4.2 tn (US$87 bn) that it had budgeted for. This has put a lot of strain on bond yields (see *India: A worsening of the fiscal-monetary policy mix,* Asia Economics Analyst 11/18, October 20, 2011), and had to be compensated by the RBI coming in to do open market operations (OMOs).

## II. Some fiscal consolidation in the FY13 budget

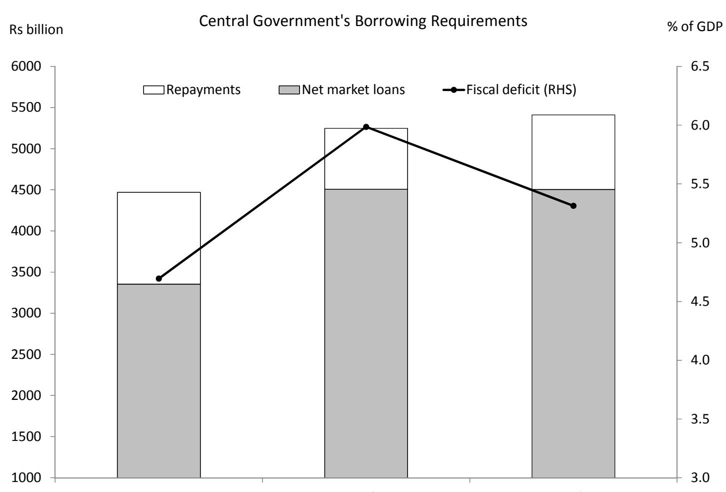
**We expect a focus on fiscal consolidation in the upcoming budget with tax measures dominating**. We expect the budget to contain tax measures amounting to 0.5 percentage point (pp) of GDP. These are: 1) an increase in excise duties from 10% to 12%; 2) an increase in the service tax from 10% to 12%; and 3) moving from a positive list in service tax to a negative list.

We estimate that a 2 pp increase in excise duties could give 0.3 pp increase in tax revenues, while the increase in service taxes and increasing its base can provide another 0.2 ppt increase in revenues. Therefore, we expect the revenue side to drive the fiscal consolidation.

On the expenditure front, while we expect increases in food subsidies due to the implementation of the Food Security Bill, we expect the budget to have growth in total expenditure lower than in FY12. We think this will likely come from slower growth in non-subsidy current spending.

**The government's borrowing requirements will largely be similar to FY12**. While we think the fiscal deficit above the line may be similar to FY12, on a gross basis, due to larger repayments than in FY13, the market borrowing may be a tad higher at Rs5.4 tn (US$114 bn). However, the general government market borrowing may remain very similar to that in FY12, due to an expected reduction in the above-the-line fiscal deficits of the states.

**Exhibit 4: The level of market borrowings may remain very similar to that in FY12**




Source: CEIC, GS Global ECS Research estimates.

## III. Impact of the budget on bond yields

**We think the budget will likely be marginally positive for bond yields**. Our calculations show that the general government borrowing requirement in FY13 can be financed through growth in bank deposits, insurance, mutual, and pension funds. We assume that the government may allow a further US$5 bn of investment by foreign investors in government securities. We also assume that the RBI may do OMOs of the order of Rs300 bn (US$6.3 bn), less than a third of the OMOs in FY12. That said, current long-end bond yields are being artificially depressed due to the large OMOs at the long-end that the RBI has conducted, and would have been higher otherwise. Therefore, we think some fiscal consolidation, and monetary easing at the short end should lead to a steepening of the yield curve. We forecast 10-year bond yields to be in the 7.75%-8.00% range for FY13.

**Exhibit 5: Demand for government securities large enough to absorb supplies in FY13**

| Center + State NET issuances | FY12 | FY13 |
|---|---|---|
| | GS est | GS est |
| *Rs. bn* | | |
| **Supply of net gov securities: center + state** | 6325 | 6337 |
| **Demand for government securities*** | | |
| SLR funds[1] | 2811 | 3316 |
| Insurance funds [2] | 1815 | 2178 |
| Open Market Operations | 1090 | 315 |
| Mutual funds[3] | 56 | 67 |
| FIIs[4] | 110 | 143 |
| Others[5] | 443 | 317 |
| ***as a % of net borrowing*** | | |
| SLR funds | 44 | 52 |
| Insurance funds | 29 | 34 |
| Open market operations | 17 | 5 |
| Mutual funds | 1 | 1 |
| FIIs | 2 | 2 |
| Others | 7 | 5 |

*Assumptions:*
*1) Deposit growth of Scheduled Commercial Banks at 18% yoy*
*2) Assumes assets of insurance sector will grow at 20% yoy*
*3) Based on difference in outstanding amount of government securities in debt mutual funds*
*4) Assumes $5 billion additional allocation in FY13, over and above present limit of $15 billion*
*5) Include Pension Funds, Primary Dealers etc*

Source: CEIC, GS Global ECS Research estimates.

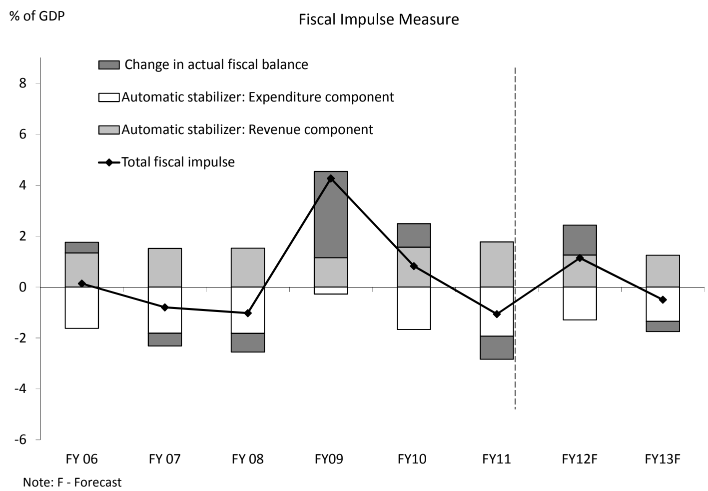
## IV. We think the government may impart a negative fiscal impulse in FY13

**Our fiscal impulse indicator[1] suggests that the government may impart a positive impulse of about 1.1 pp of GDP to aggregate demand in FY12 compared to the previous year**. To put this in perspective, this impulse is second only to that during the global financial crisis (GFC) in FY09 over the past decade. The fiscal impulse indicator allows us to estimate the contribution to demand from the fiscal side by stripping out the impact due to cyclical factors. Starting from the change in the fiscal deficit, we make two adjustments—first, if revenues increase proportionately with increases in nominal GDP then they are cyclically neutral (revenue stabilizer). Second, if expenditures rise in proportion to increases in nominal *potential* GDP, then they are cyclically neutral (expenditure stabilizer). These automatic stabilizers and their contributions to the change in fiscal deficit are shown in Exhibit 6.

**Our budget expectations suggest that the government may impart a negative impulse of 0.5 pp of GDP to aggregate demand in FY13**. This is primarily due to the forecast reduction in the budget deficit. In FY12, we estimate that the budget deficit component of fiscal impulse rose sharply, while the revenue component of the automatic stabilizer fell due to the slower growth of GDP. The expenditure component of the automatic stabilizer also fell in FY12 due to the reduction in India's potential GDP (see *India's growth potential—lower but still tiger-like*, Asia Economics Flash, September 14, 2011). In FY13, with our forecast of actual GDP and potential very similar to those in FY12, we do not expect a sharp change in either of the automatic stabilizers.

[1] Fiscal Impulse = $(\Delta Gt - g0\ \Delta Yt^*) - (\Delta Rt - r0\ \Delta Yt)$
$= -\Delta FBt - g0\ \Delta Yt^* + r0\ \Delta Yt$
where $\Delta$ represents change in period t relative to past year; r0 = base-year receipts-to-nominal GDP ratio; g0= base-year expenditure-to-nominal GDP ratio; Yt*: potential GDP; Yt: actual GDP; Rt= primary nominal receipts; G0: primary nominal expenditure and FB: primary fiscal balance. The measure makes an adjustment for cyclical changes in the fiscal policy as potential GDP/actual GDP changes relative to past year by the use of automatic stabilizer terms ($g0\ \Delta Yt^*$ and $r0\ \Delta Yt$). A positive value for FI indicates fiscal policy has been more expansionary compared to past year, and vice versa.

**Exhibit 6: Fiscal impulse could be negative in FY13 if budget deficit is reduced as envisaged**

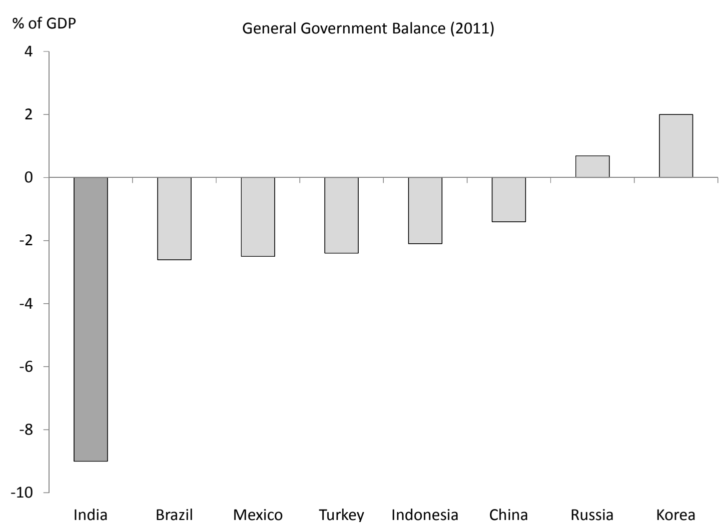



Source: CEIC, GS Global ECS Research estimates.

## V. Cross-country comparisons suggests that fiscal consolidation is an imperative

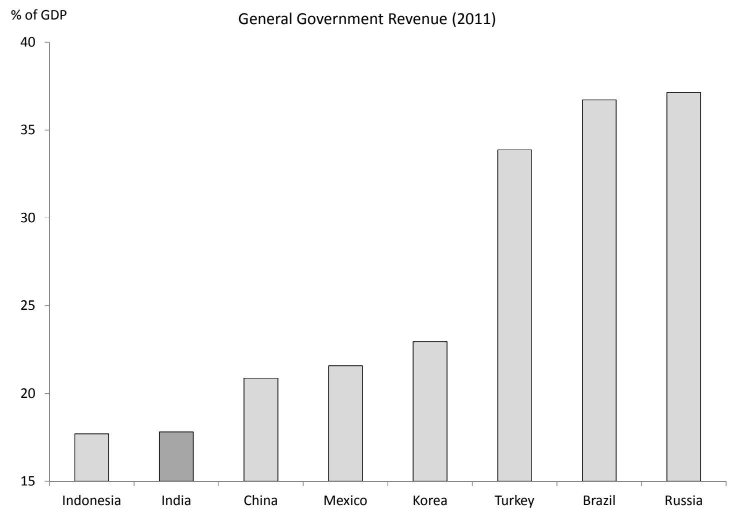
**India's general government fiscal deficit is one of the highest among growth markets** (see Exhibit 7). This is largely due to a low tax base, rather than too much spending. Hence, it is imperative that the government increase the tax-to-GDP ratio, and there are low-hanging fruits in increasing revenues. While we expect the FY13 budget to begin fiscal consolidation, we do not envisage the tough, structural reforms that are necessary to lead to a sustainable increase in the tax-to-GDP ratio. These would comprise broad-basing the tax regime, implementing the Goods and Services Tax, and improving tax administration to reduce the extent of the underground economy.

**Exhibit 7: India's general government fiscal deficit is one of the highest among growth markets…**



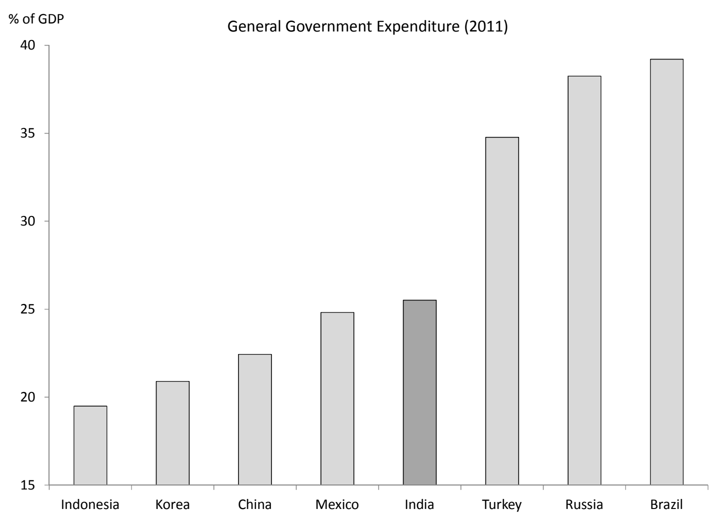

Source: CEIC, GS Global ECS Research estimates.

**Exhibit 8: ….mainly due to a low tax base…**




Source: IMFWEO, Haver, GS Global ECS Research.

**Exhibit 9: ….rather than too much spending**



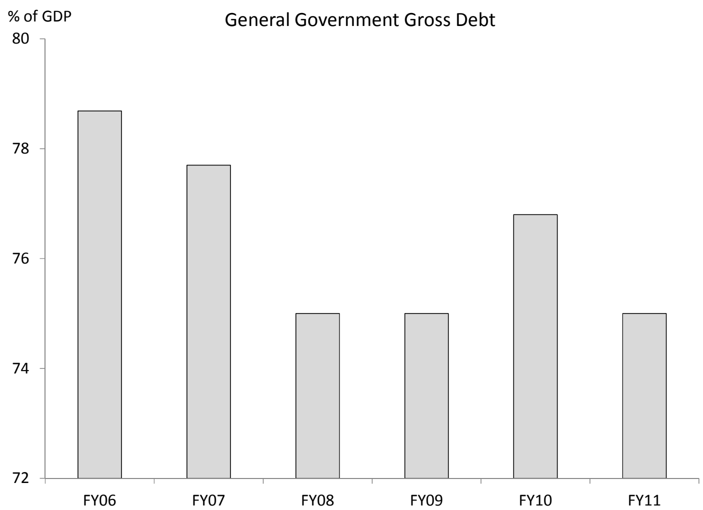

Source: IMFWEO, Haver, GS Global ECS Research.

**The high fiscal deficit raises several well-known macro concerns for India which are worth reiterating:**

- Keeps bond yields higher than otherwise, and crowds out the private sector.
- Keeps aggregate demand high and spills over into a current account deficit.
- Reduces "insurance cover" to deal with future shocks and enact counter-cyclical policies.
- Leads to an excessive reliance on monetary policy to fight against inflation.
- To the extent that the current fiscal deficit creates grounds for future deficits, such as the proliferation of entitlement programs, it raises structural concerns.

**While the large fiscal deficit is a key macro concern, we do not think it is an immediate vulnerability**. The deficit is financed almost entirely domestically, primarily by banks, pension, and insurance funds. Thus, there is a captive demand for government bonds, and little threat of large-scale selling by foreigners, in our view. Government debt is high, but has been stable in recent years, driven by high nominal GDP growth. High inflation over the past two years has had the effect of keeping the debt/GDP ratio stable.

**Exhibit 10: India's general government debt has been declining due to higher nominal GDP growth**




Source: IMF, GS Global ECS Research.

## VI. Risks to our expectations

The risks to our expectations of fiscal consolidation come from higher oil prices impacting fuel subsidies, higher phosphate and potash prices impacting fertilizer subsidies, and the economic slowdown persisting into the majority of FY13. Further, an early implementation of the Food Subsidy Bill could further expand the deficit.

The upside on fiscal consolidation comes from larger privatization receipts, including the re-auctioning of 2G licenses, greater buoyancy in tax revenues, and a quick pass-through to consumers of higher oil prices—particularly in diesel and LPG. We assess the risks to our fiscal deficit and market borrowing targets for FY13 to be balanced at this stage.

# Appendix

## Exhibit A1: Our sector analysts' expectations from the budget

| Sector *(Analyst name)* | Key expectations from budget | Probability/Impact |
|---|---|---|
| **Cement** *(Pritesh Vinay)* | Rationalization of excise duty from 10% to 6-8% (to bring cement industry at par with other infrastructure industries).<br>Review of import duty on coal, pet coke, gypsum and other fuels.<br>CENVAT credit may be allowed on Clean Energy Cess so as to mitigate impact on costs.<br>3% duty on imports under EPCG scheme may be abolished to promote exports/investments. | Low/Positive<br>High/Positive<br>High/Positive<br>Low/Positive |
| **Metals & Mining** *(Pritesh Vinay)* | Rise in import duty on Hot Rolled Coils (steel) from prevalent 5% to 10%.<br>Expect no change in export duty of iron ore (currently at 30% for fines and lumps). | Low/Positive for domestic steel producers<br>High/Neutral for ore exporters |
| **IT** *(Rishi Jhunjhunwala)* | Exemption of MAT (as high as 20%) on developers of SEZ and/or units operating under them.<br>Extension of the carry forward and set off of MAT credit entitlements (currently allowed for a period of 10 years).<br>Dual levy of VAT and Service tax on licensing of software . | High/Low<br>Low/Low<br>Low/Low |
| **Telcos** *(Sachin Salgaonkar)* | Based on the judgment of the Supreme Court on license cancellations, the government may look to auction c.480MHz of freed-up 2G spectrum and raise between Rs224bn (1/3rd of 3G winning prices) and Rs673bn (equal to 3G license winning prices). The TRAI is working on the pricing mechanism and expected to come out with recommendations in the next 6-12 weeks.<br>We expect the government to generate recurring revenues of Rs146bn in FY13. | Medium/Positive for incumbents<br>High/Neutral |
| **Consumer Goods** *(Puneet Jain)* | Mid double-digit increase in cigarette excise taxes. Companies will resort to price increases affecting volumes.<br>We could also see a 200bp increase in excise rates for consumer products, with a potential impact on volume growth. | High/Negative |
| **Real Estate** *(Puneet Jain)* | Incentives for affordable housing such as a) an increase in the limit for income tax deduction on interest on home loans, which is currently Rs150,000 and/or b) an increase in the limit for income tax deduction on interest on home loan principal payments, which is currently Rs100,000. | Medium/Positive |
| **Utilities** *(Durga Dath)* | Reduction of customs duty on imported coal which is currently stands at 5%.<br>Hike in customs duty on imported equipment.<br>Financial relief for SEBs in the form of new schemes in power distribution.<br>Continued Tax sops for setting up power projects based on renewable energy.<br>Assistance to raise low-cost and long-term resources to re-finance power projects. | High/Positive<br>Moderate<br>Moderate<br>Moderate<br>Moderate |
| **Fertilizers** *(Durga Dath)* | Inclusion of Urea in NBS Scheme, price decontrol. Increased subsidy budgets. | Moderate |
| **Automobiles** *(Sandeep Pandya)* | Potential increase in excise duties for the sector, particularly for diesel powered vehicles, which will be immediately passed on to consumers in our view.<br>We believe this could present challenges to demand growth and pricing power of companies going into FY2013E. | Negative |
| **Banks** *(Tabassum Inamdar)* | Increase in exemption limit for borrower on housing loans.<br>Withdrawal of tax benefit to housing companies.<br>Reduce tax arbitrage that exists between FMPs and deposits. | Positive for the CRE segment<br>Negative for HFCs<br>Positive for banks |
| **Capital Goods** *(Ishan Sethi)* | Levy of duty on imported power equipment - supporting domestic manufacturing. Likely to be a maximum of 19.5%<br>A potential increase in excise duty rate from current 10% | High/ Slightly positive<br>Moderate/Negative |
| **Infrastructure** *(Ishan Sethi)* | Incremental allocation to infrastructure sectors - roads, rail etc - especially focused on social spending through schemes such as Bharat Nirman, JNNURM, RGGVY.<br>Facility to streamline debt market for infrastructure - possibly through allowing higher investment in the Infrastructure tax saving bond. Current limite being Rs 20,000 - may be increased to Rs 50,000 or even higher.<br>A more streamlined definition for Infrastructure sector defining inclusions and exclusions from the definition<br>Possible announcement of an appropriate body to handle the infra sector holistically, new infra ministry etc. | High/Positive<br>High/ Very Positive<br>High/ Positive<br>Moderate/ Positive |
| **Logistics** *(Ishan Sethi)* | Clarity on the timeline and implementation of GST.<br>Concrete steps to expedite work on the Dedicated Freight corridors and Delhi Mumbai Industrial Corridor. | High/ Positive<br>Moderate/ Positive |
| **Media** *(Sachin Salgaonkar)* | As per the timeline for mandatory digitization of cable TV (Jul'2012 for metros and Mar'13 for Tier1 cities), the government may generate additional revenues of c. Rs800 mn as the under-declaration of cable TV revenues decrease and analog cable TV subscribers come under the addressable digital medium. | High/ Positive |
| **Oil & gas** *(Nilesh Banerjee)* | Re-introduction of excise duty on diesel with a concomitant increase in diesel price.<br>Extension of last date for eligibility for tax holiday for new refinery units constructed.<br>Govt. bears balance under-recoveries post the upstream discounts. | Moderate/Negative<br>Low/Positive<br>Moderate/Positive |

Source: GS Global Investment Research estimates.

**Exhibit A2: We expect some fiscal consolidation in FY13**

| Fiscal Table | FY12 BE | FY12 GS | FY13 GS |
|---|---|---|---|
| *Rs bn* | | | |
| **Revenue receipts** | **7899** | **7477** | **8864** |
| *% yoy* | *-1* | *-6* | *19* |
| Net tax revenue | 6645 | 6314 | 7664 |
| Non tax revenue | 1254 | 1163 | 1200 |
| **Capital receipts (including disinvestment)** | **550** | **282** | **400** |
| Disinvestments | 400 | 100 | 250 |
| **Gross tax revenue** | **9324** | **8783** | **10356** |
| *%yoy* | *17* | *10* | *17.9* |
| *Corporation tax* | *3600* | *3194* | *3583* |
| *Income tax* | *1720* | *1618* | *1755* |
| *Customs* | *1517* | *1568* | *1698* |
| *Union Excise duties* | *1641* | *1495* | *1917* |
| *Others* | *846* | *909* | *1404* |
| **Total expenditure** | **12577** | **13093** | **14568** |
| *%yoy* | *4.9* | *9.2* | *11.3* |
| Current expenditure | 10972 | 11637 | 12752 |
| *%yoy* | *6* | *12* | *10* |
| *Interest payments* | *2680* | *2944* | *3326* |
| *On budget subsidies* | *1342* | *2650* | *2900* |
| *Food* | *606* | *800* | *1200* |
| *Fertilizers* | *500* | *950* | *950* |
| *Petroleum* | *236* | *900* | *750* |
| *NREGA* | *400* | *400* | *400* |
| Capital expenditure | 1606 | 1456 | 1816 |
| *%yoy* | 1 | -9 | *25* |
| **Fiscal deficit (excl. disinvestment )** | **4528** | **5435** | **5555** |
| **Fiscal deficit (incl. disinvestment)** | **4128** | **5335** | **5305** |
| | | | |
| ***% of GDP*** | **FY12 (BE)** | **FY12 GS** | **FY13 GS** |
| | | | |
| **Revenue receipts** | **8.8** | **8.4** | **8.9** |
| Net tax revenue | 7.4 | 7.1 | 7.7 |
| Non tax revenue | 1.4 | 1.3 | 1.2 |
| | | | |
| **Capital receipts (includes disinvestment)** | **0.6** | **0.3** | **0.4** |
| *Disinvestment* | *0.4* | *0.1* | *0.3* |
| **Gross tax revenue** | 10.4 | 9.9 | 10.4 |
| *Corporation tax* | 4.0 | 3.6 | 3.6 |
| *Income tax* | 1.9 | 1.8 | 1.8 |
| *Customs* | 1.7 | 1.8 | 1.7 |
| *Union Excise duties* | 1.8 | 1.7 | 1.9 |
| *Others* | 0.9 | 1.0 | 1.4 |
| | | | |
| **Total expenditure** | **14.0** | **14.7** | **14.6** |
| Current expenditure | 12.7 | 13.1 | 12.8 |
| *Interest payments* | *3.0* | *3.3* | *3.3* |
| *On budget subsidies* | *1.5* | *3.0* | *2.9* |
| Capital expenditure | 1.8 | 1.6 | 1.8 |
| **Fiscal deficit (incl. disinvestment)** | **4.6** | **6.0** | **5.3** |
| | | | |
| **Net market loans** | 3430 | 4507 | 4505 |
| **Repayments** | 741 | 741 | 906 |
| | | | |
| **Gross market loans** | **4171** | **5248** | **5411** |

Source: CEIC, GS Global ECS Research estimates.

We, Tushar Poddar and Vishal Vaibhaw, hereby certify that all of the views expressed in this report accurately reflect personal views, which have not been influenced by considerations of the firm's business or client relationships.

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