

China Economics Quarterly 中国经济研究季刊

3rd Quarter 2008



- Growth and inflation moderated further
- The government started to loosen policy
- Further slowdown and more policy easing are expected

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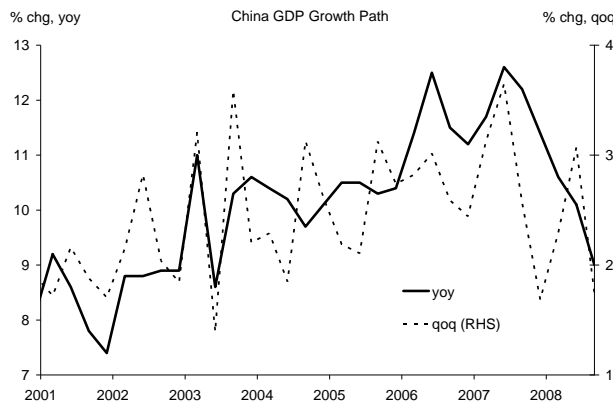
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China impression – 3Q2008:

- Real GDP growth and CPI inflation continued to soften in 3Q2008. (see *Real GDP growth came in at 9.0% for 3Q2008, CPI inflation moderated to 4.6% in September, October 20*).
- We believe the slowdown was partially induced by the Olympic/Paralympic-related restrictions on production, transportation and construction... (see *Olympic Games will likely lead to a slowdown in economic activity in the short term, August 8*).
- ...but more importantly, it reflected the impact from policy tightening since 2H2007 (see *Why China's inflation will soon head towards the 3%- 4% range, September 10*).
- The government announced various policy loosening measures in an attempt to minimize downside risks to growth.(see *The People's Bank of China cut benchmark interest rates and the reserve requirement ratio and China raised tax rebate rates for textiles/garment, July 31*).
- Nevertheless, we expect growth and inflation to moderate further, and more policy easing to come, especially in the next 6-9 months (see *Lower growth, lower inflation, and more active policy support—our forecasts changed for 2008-2009, September 26*).

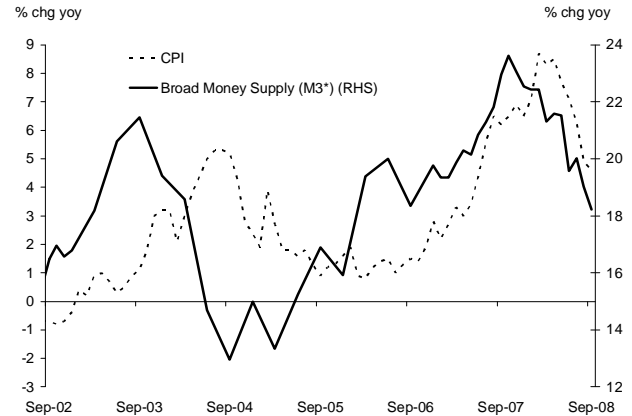
Key charts of the quarter:

Exhibit 1: Growth moderated further in 3Q2008...



Source: NBS, CEIC, Goldman Sachs Economics Research.

Exhibit 2: ...so did CPI inflation, driven by monetary tightening since 2H2007



Source: CEIC, Goldman Sachs Economics Research.

3Q2008 data summary:

% change, unless otherwise stated

	2008				2007			2006	
	3Q	2Q	1Q	4Q	3Q	2Q	1Q	4Q	3Q
GDP									
yoy	9.0	10.1	10.6	11.4	12.2	12.6	11.7	11.2	11.5
qoq (sa)	1.7	3.1	2.3	1.7	2.6	3.6	3.1	2.4	2.6
					2008				
	Sep	Aug	Jul	Jun	May	Apr	Mar	Feb	Jan
Industrial Production									
yoy	11.4	12.8	14.7	16.0	16.0	15.7	17.8	15.4	15.4
qoq (sa, ann)	3.7	9.0	14.5	16.4	21.7	20.7	20.3	14.5	13.4
mom (sa)	0.0	-0.4	-0.4	1.6	1.7	-0.4	3.3	1.2	1.8
Nominal Retail Sales									
yoy	23.2	23.2	23.3	23.0	21.6	22.0	21.5	19.1	21.2
qoq (sa, ann)	24.5	25.8	26.0	25.3	23.7	21.4	20.9	22.2	22.7
mom (sa)	1.5	1.6	1.9	2.3	1.6	1.8	2.5	1.1	1.2
Fixed Asset Investment									
yoy	29.0	28.1	29.3	29.5	25.4	25.3	27.2	24.3	24.3
qoq (sa, ann)	24.4	32.3	39.2	42.5	41.7	37.7	32.5	27.1	22.1
mom (sa)	0.9	1.3	1.8	2.4	3.0	3.2	3.1	2.7	2.4
Price Indicators									
Consumer Price Index									
yoy	4.6	4.9	6.3	7.1	7.7	8.5	8.3	8.7	7.1
qoq (sa, ann)	0.6	1.9	3.1	5.5	7.5	9.0	8.5	7.8	6.6
mom (sa)	-0.1	-0.1	0.1	0.2	0.1	0.5	0.5	1.1	0.5
Producer Price Index									
yoy	9.1	10.1	10.0	8.8	8.2	8.1	8.0	6.6	6.1
qoq (sa, ann)	9.4	10.0	9.8	9.4	10.6	10.7	11.5	11.3	11.0
mom (sa)	-0.2	0.3	1.4	0.8	0.5	0.6	1.3	0.6	0.9
Trade Indicators									
Exports									
yoy	21.5	21.1	26.9	17.6	28.1	21.8	30.6	6.5	26.6
qoq (sa, ann)	24.7	29.3	45.1	26.2	15.5	12.5	29.2	28.9	24.2
mom (sa)	1.4	-4.1	9.4	-4.8	6.6	8.0	-5.7	-1.7	10.2
Imports									
yoy	21.3	23.1	33.7	31.1	40.4	26.6	24.7	35.3	27.6
qoq (sa, ann)	3.4	19.0	49.1	38.4	28.4	22.2	33.9	40.4	37.1
mom (sa)	-0.6	-4.9	4.6	-4.5	9.3	5.6	-2.9	0.5	6.6
Trade Balance (USD bn)	29.3	28.7	25.3	21.4	19.9	16.5	13.3	8.4	19.4
% yoy	22.2	14.9	3.8	-20.7	-11.1	-1.4	97.6	-64.5	22.0
Financial Indicators									
M2									
yoy	15.3	16.0	16.4	17.4	18.1	16.9	16.3	17.5	18.9
qoq (sa, ann)	11.9	12.2	18.8	21.1	17.3	14.0	17.2	17.3	16.8
mom (sa)	0.8	0.7	1.4	0.8	2.1	1.9	0.0	1.4	2.6
Total Loans									
yoy	14.7	14.9	15.5	15.2	16.2	16.1	16.2	17.1	17.5
qoq (sa, ann)	15.7	13.1	14.4	13.3	11.3	13.5	19.0	19.9	15.4
mom (sa)	1.1	1.0	1.6	0.5	1.3	1.3	0.1	1.8	2.5
FX Reserves (USD bn)	1906	1884	1845	1809	1797	1757	1682	1647	1590
Proprietary Indicators									
GSCA	8.7	8.8	10.1	10.4	11.0	10.1	11.2	10.1	10.1
CEMAC-GS Coincident Indicator (Index)	101.80	102.52	102.93	103.58	103.45	103.34	102.50	102.62	102.61
CEMAC-GS Leading Indicator (Index)	99.74	100.44	100.96	101.68	102.15	102.50	102.80	102.54	101.92
GS China FCI (Index)	110.0	109.4	109.1	109.0	107.8	108.5	108.4	108.5	108.0
GSPCC (Index)	224.5	233.5	245.6	230.9	207.1	192.2	189.9	184.6	176.4
% yoy	44.5	55.5	68.2	58.6	40.6	32.1	30.7	26.4	21.5

Source: National Bureau of Statistics (NBS), CEMAC, PBOC, CEIC, Goldman Sachs Economics Research.

Lower growth, lower inflation, and more active policy support—our forecasts changed for 2008-2009

This article was first published on September 26, 2008.

We have revised down our GDP growth and inflation forecasts for China, apparently below the consensus for 2008-2009.

We now expect significant interest rate cuts (150-200 bp), a more expansionary fiscal stance, and less CNY appreciation (only 3% annualized) to take place in the next 12 months.

Two reasons for our forecast changes:

1. Rising downside risks to domestic demand, resulting from spreading weakness in the property sector.
2. Continued and rising risks to China's exports demand.

With the help of supportive policies, and subsiding commodity price inflation, we expect China's growth to trough in 1H2009 and gradually recover in 2H2009.

We have lowered our 2008-2009 GDP growth and inflation forecasts for China (see Exhibit 1) on the back of rising downside risks to domestic demand, particularly in the property sector, as well as weakening external demand for Chinese exports. Although the slowdown we envisage is likely to entail some real growth pains in terms of declining corporate profits, we believe it will not be a "hard landing" of the sort in 1998. Both corporates' and financial institutions' balance sheets are much stronger today compared with that period.

As a result of easing inflation pressures and weaker external demand, we expect macro policies to become more supportive of growth in the next 12 months. Therefore, we have changed our policy calls significantly. We now expect significant interest rate cuts (150-200 bp), a more expansionary fiscal stance, and less

CNY appreciation (only 3% annualized) to take place in the next 12 months.

With the help of significant monetary policy easing, modest counter-cyclical fiscal policy initiatives, and other growth-enhancing structural policy changes (such as those aimed at boosting rural demand), we expect China's growth, particularly domestic demand, to trough in 1H2009 and begin to rebound in 2H2009. Therefore, much of the slowdown we envisage relates to the transition pains as the economy is switching away from an exports-led to a more domestic-demand-driven growth model. However, if the global growth environment turns to be worse than expected, or policy responses fall short, the growth pains could be deeper and longer.

Exhibit 1: Our revised annual forecasts

	2007	2008E		2009E	
		Old	New	Old	New
GDP by expenditure	11.9	10.1	9.8	9.5	8.7
Domestic Demand	9.4	9.9	9.8	10.2	8.5
Total Consumption	9.4	9.7	10.0	10.4	8.7
Household Consumption	9.3	9.6	10.0	9.9	9.0
Government Consumption	9.5	10.0	10.0	11.8	8.0
Investment (GCF)	9.5	10.2	9.5	10.0	8.2
Fixed Investment (GFCF)	10.6	10.5	9.8	10.0	8.5
Net Exports (ppt contribution to GDP growth)	3.2	1.2	1.0	0.3	1.1
Exports	19.0	12.0	11.8	9.0	6.5
Imports	16.8	12.0	12.0	9.8	6.0
Trade Surplus (% of GDP)	8.0	5.3	5.7	6.9	6.2
CPI	4.8	6.8	6.3	3.8	1.5

Source: CEIC, Goldman Sachs Economics Research.

Growth and inflation downgraded

We have lowered our real GDP growth forecasts for 2008 to 9.8% from 10.1%, and for 2009 to 8.7% from 9.5%. These forecasts are, currently, below the consensus expectations of 9.9% growth for 2008 and 9.1% for 2009.

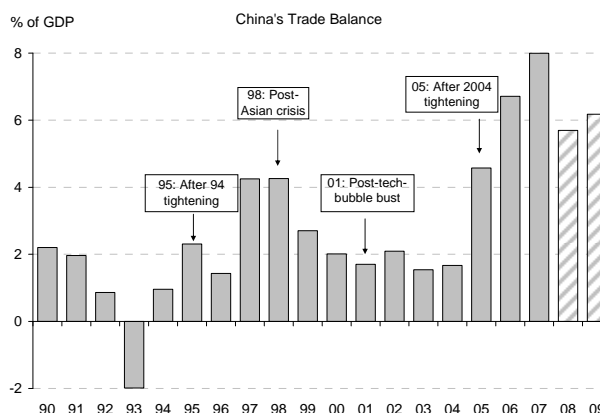
Besides continued dark clouds on external demand, we see **increasing downside risks to domestic demand growth, primarily due to risks to domestic fixed asset investment**. The latest sales and inventory situation in domestic property markets have raised significantly the downside risks to real estate activities in the coming quarters (see *No sustainable recovery in sight, cut TP/earnings; initiate two co's*, China: Real Estate Developers, September 19). In addition, we are concerned that consumer demand will also likely face downward pressures from slower, though still firm, real income growth and a significant negative wealth effect from the corrections in asset markets, even though recent retail sales data remain strong.

As a result of the weakness in domestic demand, we are concerned that China's trade surplus (both its level and as a percent of GDP) may slow its decline or might even stop falling altogether, and for a while, might actually increase. That is, China's imports demand strength may fall faster than that of external demand, leading to a higher contribution to growth from net exports than what we have seen since 2H2007. Exhibit 2 highlights that China's trade surplus as a percent of GDP tends to rise in the years of negative external shocks or right after a major domestic demand tightening. If our concerns turn out to be true, it will be very disappointing news for global rebalancing.

Consistent with a weaker growth path, we have lowered our CPI inflation forecasts to 6.3% for 2008 and 1.5% for 2009, down from 6.8% and 3.8% respectively (see Exhibit 3). These forecasts are below the consensus expectations of 6.8% for 2008 and 4.6% for 2009. In our view, the dissipation of the underlying inflationary pressures was mainly driven by the government's curtail of bank credits, which has effectively restrained final demand, and thereby firms' pricing powers. Therefore, if the government allows energy prices to go up in the coming months (which we still expect them to do), it will likely only result in a relative price adjustment rather than any overall price pressures.

With inflation risks finally easing unmistakably, we expect policymakers to have more room to initiate growth supportive policy measures.

Exhibit 2: Share of trade balance in GDP



Source: CEIC, Goldman Sachs Economics Research.

Exhibit 3: Quarterly CPI path



Source: CEIC, Goldman Sachs Economics Research.

Policy to shift to an expansionary mode

In response to a weakening economy, we expect:

1. **The central bank to cut benchmark interest rates by 150-200 bp by the end of 2009.** Both lending and deposit rates will be cut, although we see more downward pressures likely to be on the lending rates. Most of the cuts will likely take place in 4Q2008 and 1H2009. The reserve requirement ratio (RRR) is also likely to be cut by a few times. We see the need for aggressive interest rate cuts to mainly come from a potential sharp weakening in demand, leading to a fast rise in real interest rates when inflation and asset inflation fall quickly. The effectiveness of RRR cuts or/and the abolishment/loosening of lending quotas alone may be limited when banks begin to worry about corporates' earnings outlook.

2. **Meanwhile, the pace of CNY/USD appreciation will likely slow to a mere 3% over the next 12 months**, compared with the 10% appreciation taken place over the past 12 months (more on this topic in the following section).
3. On the fiscal side, we expect the government's fiscal position to shift to a modest deficit (likely around 2% of GDP) in 2009 from a close-to-balanced budget this year. A large chunk of the deficit will likely come from weaker revenue receipts (the so-called automatic stabilizer) and the rest from tax cuts and spending increases. Specifically, the government is likely to cut personal income tax and broaden the investment expenditure related value-added tax (VAT) relief to more industries and geographic areas. In the meantime, the government will likely modestly increase its expenditures in the rural areas. However, these extra investments will likely (at least partially) be at the expense of other government consumption expenditures, and therefore, the net impact on the overall economy is likely to be smaller than first meets the eye.

With the help of supportive policies, and if commodity price inflation continues to abate, **we expect China's growth to trough in 1H2009 and gradually recover in 2H2009** (see Exhibit 4).

On the other hand, we believe the speed and sustainability of China's growth recovery will hinge critically on how effective the overall policy mix is in stimulating domestic demand. China clearly has a lot of room to stimulate growth in the short run with its close-to-balanced budget, a low government debt-to-GDP ratio, a large current account surplus, and more than US\$2 trillion in official holdings of FX assets. But to put its economy back on a *sustainable* low-inflation-high-growth path, we believe China needs to undertake some comprehensive, and potentially more difficult, policy changes.

The challenge for China in the short to medium term remains to be how it can generate 2-3 percentage points (ppt) of additional growth from domestic demand (to make up the shortfall from falling exports) without creating either an inflation boom-bust or asset bubbles. In our view, such a successful rebalancing will require comprehensive changes in fiscal and exchange rate policies, as well as structural reforms in the financial sector. In this context, counter-cyclical monetary and fiscal easing can only serve as a short-term fix to ease some of the pain when the economy is in transition towards a more domestic-demand-driven economy.

Exhibit 4: Quarterly GDP path



Source: CEIC, Goldman Sachs Economics Research.

CNY appreciation remains the key for a successful rebalancing, although we see less of it in the short run

We have written extensively in the past 5 years that a key element of the “global rebalancing” of growth, as well as China's rebalancing of growth patterns revolves around a meaningful appreciation of the CNY. The real costs of China's resistance to CNY appreciation are now becoming more apparent. Not only is there less domestic demand to buffer a global downturn, a repressed domestic demand (because an undervalued currency is a tax on domestic demand) has also hindered the needed global rebalancing adjustments.

As for now, global imbalances seem to have fallen on their own weight, and the imbalances in the Chinese economy will likely cause some real growth pains in the short run. Although China's burgeoning balance of payment (BOP) surpluses (expected to be above 10% of GDP even in 2009) continue to support the case for a substantial CNY appreciation even now, we believe the optimal cyclical (and politically feasible) window for a significant CNY/USD appreciation is likely to have been closed for the next 6-12 months. In our view, with weakening exports and domestic demand and little inflation, coupled with potential real pains in the corporate sector, our forecast of a 3% annualized CNY/USD appreciation (no depreciation!) has already factored in both the BOP surplus and external political pressures on the currency.

Nevertheless, we believe CNY appreciation pressures will come back (potentially even more massively through capital flows) once policymakers fix the short-term

growth/domestic demand story. In a 2-3 year horizon, the risk remains to be that China would become more confident next time that they would let the CNY to appreciate much more and much quicker once domestic inflation pressures re-appear.

What about risks to our views?

We see risks to our forecasts as slightly tilted towards the downside. These risks include 1) a weaker or sharper-than-expected decline in external demand growth; and/or 2) policies to stay behind the curve for too long. On the other hand, we will become more optimistic if policymakers make a swifter-than-expected shift in its overall policy mix, particularly if they allow a faster CNY appreciation while loosening their domestic demand policies to buttress growth.

Hong Liang
Yu Song

Real GDP growth came in at 9.0% for 3Q2008, CPI inflation moderated to 4.6% in September

This comment was first published on October 20, 2008.

1. GDP growth moderated

Real GDP growth came in at 9.0% yoy in 3Q2008 from 10.1% yoy in 2Q2008 (our estimate: 9.1%, market consensus 9.7%). This is the lowest reading since 2Q2003. On a quarter-on-quarter (qoq) basis, GDP growth also decelerated to 1.7% from 3.1% in 2Q2008 (see Exhibit 1). The moderation in yoy GDP growth was mainly driven by a declining contribution from domestic demand, as the nominal trade surplus grew by 13.8% yoy in 3Q versus -12.1% yoy in 2Q.

2. September industrial activities weaker than expected

Year-on-year industrial production growth came in at 11.4% yoy (our estimate and market consensus: 13.4%) in September, compared with 12.8% yoy in August. The implied sequential growth moderated to 3.7% qoq. sa. in September, from 9.0% qoq. sa. in August. Fixed asset investment growth came in at 29.0% yoy in September (our estimate and market consensus: 26.0%), up from 28.1% yoy in August. Nominal retail sales growth reported 23.2% yoy growth in September despite lower consumer inflation (our estimate: 22.0%, market consensus: 22.8%). Real retail sales growth continued to accelerate to 17.1% yoy in September, from 16.8% yoy in August.

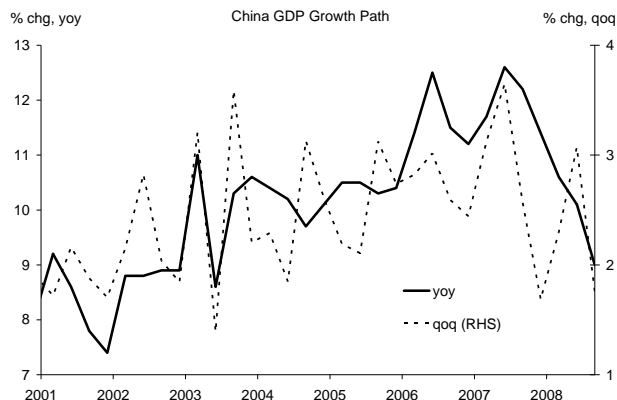
3. CPI moderated to 4.6% and PPI softened to 9.0% in September

Headline CPI inflation moderated to 4.6% yoy in September (our estimate: 4.8%, market consensus: 4.6%), compared with 4.9% yoy in August (see Exhibit 2). Its sequential momentum moderated to 0.6% qoq from 1.9% qoq. Meanwhile, the yoy reading of PPI inflation in September moderated to 9.1% yoy from 10.1% yoy in August (our estimate: 9.0%, market consensus: 9.7%). Its sequential momentum moderated to 9.4% qoq from 10.0% qoq. The moderation in the PPI was driven by lower prices in a wide range of commodities including oil and steel.

4. Policy to be loosened further

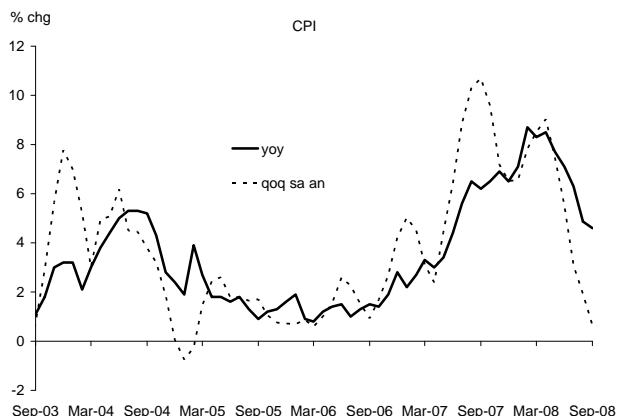
We expect the Chinese government to continue to loosen policies on the back of fast slowing activity growth and dissipating inflationary pressures.

Exhibit 1: Growth moderating further in 3Q2008



Source: National Bureau of Statistics, CEIC, Goldman Sachs Economics Research.

Exhibit 2: CPI inflation continued to moderate in September



Source: National Bureau of Statistics, CEIC, Goldman Sachs Economics Research.

Over the past weekend, the government announced broad directions for rural reforms. We view these proposed reforms as beneficial to China's long-term growth, though the short-term impact on growth may be limited.

In addition, the government announced that it would:

- Lower the property transaction tax.

- Raise export tax rebates for the textile and electric machinery industries.
- Increase the level of fixed asset investments, in particular in infrastructure building and the rebuilding of the Sichuan earthquake-affected areas.

There are, however, limited details on the size and timing of these policy changes at this time.

Going forward, we expect the government to:

- Cut benchmark interest rates further by 120-170 bp by the end of 2009 and the reserve requirement ratio by a few times. Most of the cuts will likely to be front-loaded.
- Announce further policy changes to support the property sector.

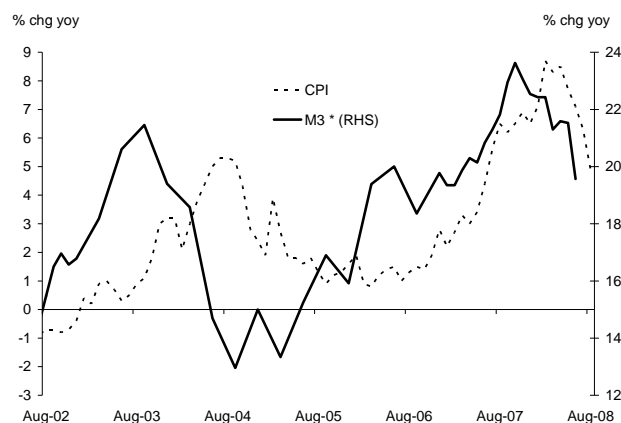
Hong Liang
Yu Song

Why China's inflation will soon head towards the 3%-4% range

This article was first published on September 10, 2008.

- China's CPI inflation came down to 4.9% in August, from 6.3% in July and 7.7% 3 months ago. Our forecast of 3.8% CPI inflation in 2009, which was highly contentious even just a few months ago, now looks about right. Why did inflation go up and how did it come down so sharply? The right answers to these questions, in my view, hold the key to the understandings of the policy challenges that lay ahead for China.
- Although being criticized by many fronts as being pure monetarists, our China Economics Team has kept its eyes on money supply growth to track the ups and downs of the inflation impulse in China. In addition, we have ignored the food vs. non-food inflation issues. This framework, coupled with identifying the right money supply series to track, has enabled us to foresee inflation as a real and present danger for China since 2H2007. It has also led us to believe that policymakers would be able to quickly bring inflation down once they can effectively control money supply growth.
- However, a self-imposed constraint in China's monetary framework has also led us to become very cautious on China's cyclical outlook since late last year: China's unwillingness to allow its currency to appreciate quickly to free up resources from the external sector will expose its domestic demand to greater downside risks than otherwise the case. As a result, with massive foreign exchange inflows continuing to pour in, the only policy choice the central bank has to control money supply growth is to squeeze domestic credit growth. And the causality of such a credit squeeze will be domestic investment demand, particularly the real estate sector, even as external demand risks continue to loom large.
- By imposing blunt credit controls, the central bank has indeed been successful in bringing down money supply growth, and as a result, inflation as well, despite its constraints on interest rate and currency policies (see Exhibit 1). On a positive note, the decisive move by the authorities has allowed China to avoid an inflation bust as in the case of Vietnam. On the negative side, the disinflation has resulted in a more severe slowdown in domestic demand than should be the case. However, the latter is the inevitable cost China has continued to pay by keeping its exchange rate policy.

Exhibit 1: M3 versus CPI



* Broad money supply only contains M2 before 2003, since non-M2 components in M3 supply take up very small weight back then. We used a "M3 proxy" for broad money supply after 2003. M3 proxy includes net foreign assets and domestic credits, and the only item in M3 that is not included in the M3 proxy is "other assets", whose level is only attainable since 2006, however, it should not have much impact on the growth rate of M3 due to its small share and very stable growth.

Source: CEIC, Goldman Sachs Economics Research.

- The inflation-disinflation process this time is very similar to that in 2004-2005: inflation went up on the back of booming investment demand and exports, and went down after a sharp squeeze on domestic credit. The main differences are 1) inflation was allowed to run much higher in 2007-2008 than in 2004-2005, and therefore the "landing: this time would likely be more painful for corporates; and 2) the downside risks on global demand are much higher now compared with back then.
- Therefore, despite a welcome relief from pressing inflation risks, concerns for domestic demand have moved to the forefront. In particular, with a weakening G-3, can China incrementally become more as a source of demand for others? Or should investors worry that, as domestic demand in China weakens because of its own policy missteps, China's formidable manufacturing capacity would become more a source of supply, as they did in 2005? If so, that would help global disinflation, but would not help global rebalancing, or China's own demand rebalancing. Softening imports growth and a pickup in the trade surplus growth in August may indicate weakening domestic demand, as they did in 2005 and 1995, one year after the credit tightening began.

7. How should and will policy adjust going forward, needless to say, is of crucial importance. We do expect monetary policy to move to a neutral stance as inflation risks subside, and fiscal policy will be more of a help to domestic demand some time in the next 6 months. However, before that, we see adjustments in energy prices as a critical step to be taken before meaningful macro policy shifts. We will discuss more on China's policy dilemma in the next China Views. Please stay tuned.

Hong Liang

Further thoughts on China's rate and reserve requirement ratio cuts

This article was first published on September 16, 2008.

1. The surprise cut in interest rates and the reserve requirement ratio (RRR) for smaller banks has clearly signalled the central bank's intention to support growth (and the market) after a weak set of August data and the turmoil in global financial markets. Such a move is likely to be welcomed by the market, and could provide some badly needed boost to investors' confidence, at least in the short run.
2. On the other hand, the interest rate and RRR cuts were also designed carefully so as to only provide some targeted relief rather than an across-the-board easing. For example, only the lending rates were cut, not the deposit rates, and the short-term lending rates were reduced more than those for long-term loans, while the RRR cuts do not apply to the big-five banks. These nuances in the policy details have likely reflected the lingering concerns of inflation by the central bank.
3. Does this signal the beginning of a policy easing cycle? Probably yes, although we believe the room for monetary easing will likely stay constrained in the near term given the remaining inflation pressures in the economy. For example, real deposit rate as measured by the current inflation rate is still negative, and utility prices still need to be raised significantly. As more slack emerges (because of weaker demand), and if oil prices stay subdued, more room for policy easing would gradually open up.
4. Therefore, the speed and duration of the easing cycle should and will be data dependent. The weaker the demand, the faster inflation risks subside, the faster and longer policy would be relaxed to help reflate the economy. In other words, policy easing tends to come only in response to worsening economic fundamentals, and initially tends to be "behind the curve" as well.
5. Ironically, yesterday's rate cut has formally put the People's Bank of China in the same easing camp as with the US Fed, an ultimate "re-coupling" from the policy perspective. In our view, China's unwillingness to truly de-peg from the US dollar has led it to miss the opportunities to decouple from the US when its domestic demand was booming (see *Why China's inflation will soon head towards the 3%- 4% range*, China Views, September 10).
6. China clearly has a lot more potential and policy flexibilities to decouple compared with many of its counterparts in the world. With a close-to-balance budget, a low government debt-to-GDP ratio, a large current account surplus, and more than US\$2 trillion official holdings of FX assets, China can do a lot to boost its growth in the short term. However, to put its economy back on a sustained low-inflation high-growth path, we believe China needs to undertake some comprehensive, and potentially more difficult, policy changes.
7. The challenge for China in the short to medium term will be how it can generate 2-3 percentage points of *additional* growth from domestic demand (to make up the shortfalls from falling exports) without generating either an inflation bust or asset bubbles. In our view, such a successful rebalancing will require comprehensive changes in the fiscal and exchange rate policies, as well as structural reforms in the financial sector. In this regard, the monetary easing announced yesterday is at best a small step to limit downside risks in the short run.

Hong Liang

Power shortage and the growth bottleneck induced by price controls

This comment was first published on August 8, 2008.

1. **Shandong province, the second largest province in GDP terms in China, is reportedly to be experiencing the worst power shortage in a decade**, despite the province's relatively rich coal endowment and large power producing capacity. Power supply is said to be about one third short of demand, and the provincial government is urging sufficient power supply for the local residents to watch the Olympic opening and closing ceremonies. Understandably, power supply to industrial users would be rationed and curtailed as a result.
2. **The worsening power shortages in China have highlighted the urgency for policymakers to address energy price distortions in China.** Electricity price controls have left many power producers in the red, even in some cases running cash loss if they keep producing. Therefore, it is not surprising to see even provinces with abundant coal endowment, such as Shanxi and Shandong, are also suffering from power shortages.
3. **Policy-induced power shortages will likely result in further slowdown in the economy** by their directly negative impact on activities but also through the damages they incur on corporate earnings. **If the price controls have resulted in a bottleneck of energy supply, policy easing through credit expansion would not lead to higher growth, but rather higher energy prices.** Consequently, equity market would likely remain worried about the macro and earning outlook, and therefore unlikely stabilize.
4. As the Olympic Games starting date draws closer, the hope of another round of energy price adjustments in the near term would likely fade. If the earliest China could take on the challenges of getting the distorted energy prices right is after the Games, it could be an awfully "cold" summer for many companies and their investors. The prayer is for global oil price or coal price to come down. But without the right price signal, how would relative supply and demand adjust in the right direction?

Hong Liang

The Olympic Games will likely lead to a slowdown in economic activity in the short term

This comment was first published on August 8, 2008.

While the long-term economic impacts of the Olympic Games are likely to be minimal (see *Beijing 2008 Olympics: Fears of a boom and bust*, Asia Economic Flash, June 16), it increasingly looks like the games' short-term economic impacts are likely to be negative, because China has implemented a series of measures restricting certain economic activities during the Olympic/Paralympic Games, aiming to 1) improve air quality in host cities and 2) prevent major work safety accidents during the games.

These measures include suspending or restricting production of pollution-intensive industries, as well as various restrictions on travel and transportation.

Sectors that are likely to be most affected include:

- Pollution-intensive producers, in particular, cement, steel, chemical and small power generators.
- Construction and demolition activities, especially those close to Olympic venues, will be suspended.
- Motor vehicles in Beijing are currently allowed to be driven on alternating days but more vehicles can be taken off the road if the pollution level is regarded as too high. Motor vehicles can only enter Beijing on stringent terms including stricter-than-usual emission tests.

Duration of the restriction measures

Most air-quality-related restrictions came into effect on July 25 when the Olympic Village opened and are expected to last until September 20 when the Paralympics Village closes. However, work-safety-related restrictions, especially with regard to mines, can last even longer as in principle, suspended mines will only be allowed to resume production after passing new inspections which effectively means after the week-long October 1 National Day holiday.

Geographical coverage

Work-safety-oriented restrictions, in particular suspension of mines, are being implemented nationwide.

The air-quality-oriented restrictions are mainly implemented in Beijing and its 5 surrounding regions of Tianjin (which is a co-host city), Shandong (which has one co-host city: Qingdao), Hebei (which has one co-host city: Qinhuangdao), Shanxi, and Inner Mongolia.

These 6 provinces/cities accounted for:

- 26% of China's GDP, industrial, electricity and chemical production (2007 data).
- 40% of China's steel production (2007 data).
- 19% of cement production (2006 data).

Effects on the economy

These measures will likely lead to a visible slowdown in real economic activities (both production and consumption) in August and September, though the degree of the impact is difficult to estimate because of the lack of more detailed information and the fact that the magnitude of restrictions will be weather dependent. Consequently, we believe activity growth is likely to stage a rebound in October after the end of these restrictions. Therefore, it would be difficult to get a "clean" reading of the underlying economic trend (as well as price trend) probably until after October. We expect a gradually softening economic growth path in 2H2008, which would alleviate the inflation pressures in the economy and eventually allow the government some room for policy easing if needed.

Yu Song
Hong Liang

China raised tax rebate rates for textiles/garment

This comment was first published on July 31, 2008.

The Ministry of Finance (MOF) announced a series of adjustments to the export tax rebate rates (see Exhibit 1). Effective August 1, rebates on export taxes for a number of garments and apparel products will be raised to 13%, up from 11% currently, and a number of bamboo products to 11%, up from 0%-5% currently. Meanwhile, the existing rebates for a number of energy and/or pollution-intensive products, in particular, some battery products, silver and high-grade zinc, will be abolished.

We believe these policy adjustments reflected 1) concerns of some in the government on the health of certain exporting sectors; and 2) the desire of the government for a less-energy/pollution-intensive growth model. However, **we believe raising the tax rebates for some key exporting sectors is detrimental to the economy since it prolongs China's transition to a more balanced growth path. Furthermore, we believe frequent adjustments in tax rebate rates increases regulatory risks** (the last time China adjusted rebates rates was on July 1, 2007).

Exhibit 1: Summary of export tax rebate adjustments

Key commodity categories	Rebate Rate Adjusted		
	to %	from %	Change %
Textile	13	11	+2
Apparel	13	11	+2
Some bamboo products	11	5	+6
Chemicals & chemical products	0	5~13	-(5~13)
Silver	0	5	-5
Zinc	0	5	-5
Some battery products	0	13	-13

Source: Ministry of Finance, Goldman Sachs Economics Research.

We believe further policy adjustments are likely to be made to deal with various micro-complaints such as closures of exporting factories and falling property prices in coastal regions. These measures may include further supporting policies targeting struggling exporting industries, providing better financing to small- and medium-sized companies, and broadening the value-added tax reduction scheme for fixed asset investments. However, **given the still elevated inflation level and still solid headline activity growth levels, the overall policy stance will likely remain tight in the near future.**

Hong Liang
Yu Song

The People's Bank of China cut benchmark interest rates and the reserve requirement ratio

The People's Bank of China (PBOC) made a series of adjustments to benchmark interest rates and the reserve requirement ratio (RRR) over the past two months:

1. On September 15, the PBOC cut the 1-year lending rate by 27 basis points (bp) (other rates by various degrees) and the RRR for regional banks by 100 bp. All commercial banks classified as "severely damaged by the Sichuan earthquake" had their RRR cut by 200 bp. However, benchmark deposit rates were left unchanged.
2. On October 8, the central bank cut benchmark lending and deposit rates by 27 bp each and the RRR by 50 bp. Meanwhile, the State Council abolished the interest income tax (5%).
3. On October 29, the PBOC cut the 1-year benchmark lending and deposit rates by 27 bp each. The RRR was left unchanged.

We view the relatively high frequency of the adjustments as a positive sign that the government is willing to take necessary measures to minimize downside risks in the domestic economy and from unprecedented uncertainties in the international financial markets.

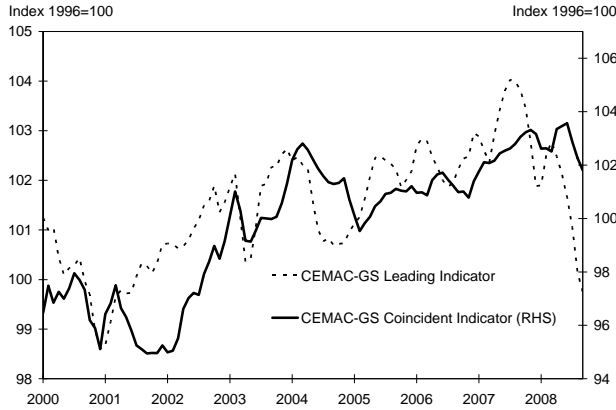
We expect the central bank to cut benchmark interest rates further by 100-150 bp by the end of 2009, in response to the weakening growth momentum and falling inflationary pressures. We maintain our view that most of the cuts will likely take place in 4Q2008 and 1H2009. Meanwhile, the RRR is also likely to be cut further by a few times.

Hong Liang
Yu Song

Charting China

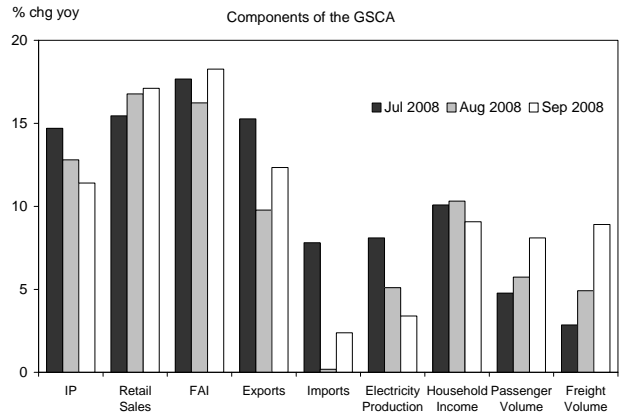
Monthly Activity Indicators

Exhibit 1: The Coincident Indicator and the Leading Indicator continued to soften in 3Q200



Source: CEIC, Goldman Sachs Economics Research.

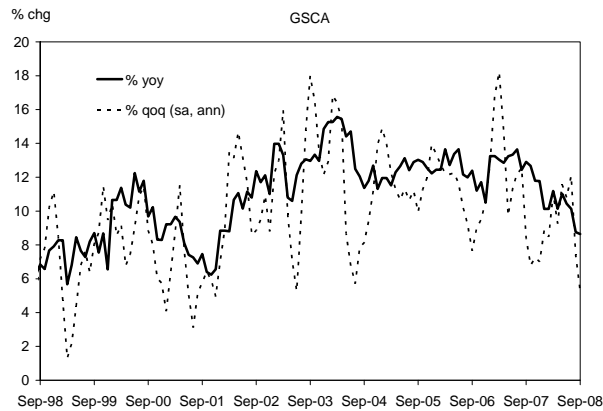
Exhibit 3: ...driven by slower growth in IP, electricity production and trade



Note: these variables are measured in real terms.

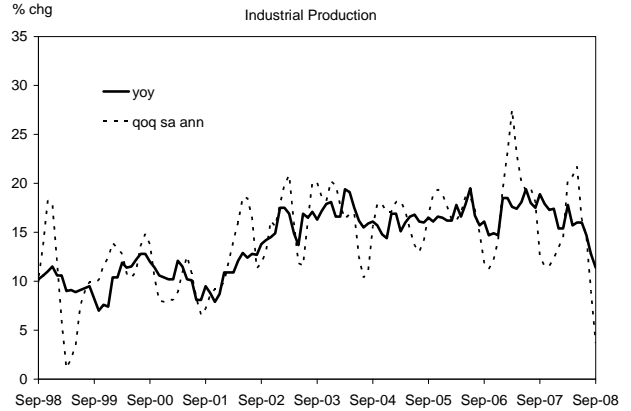
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 2: The GSCA softened as well...



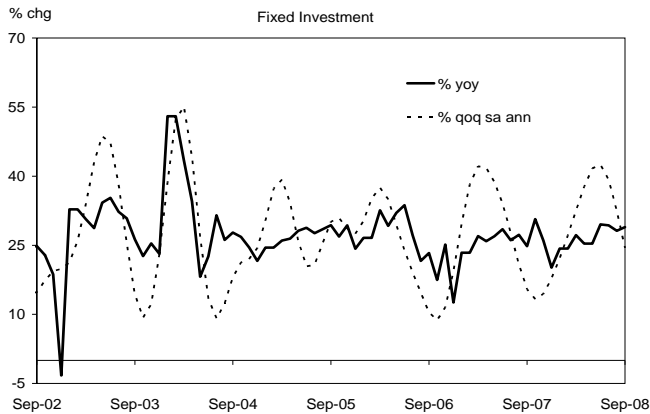
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 4: Industrial production trending down



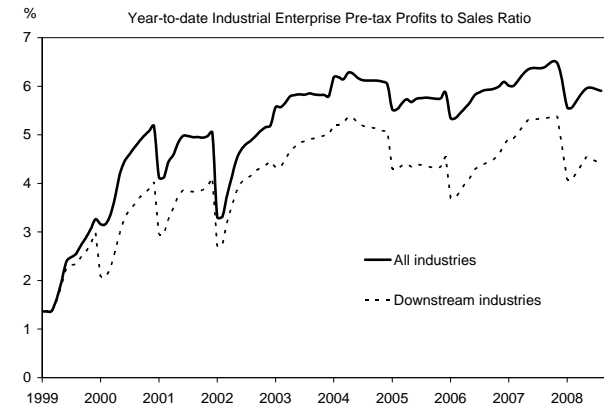
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 5: Nominal fixed investment growth remained flattish



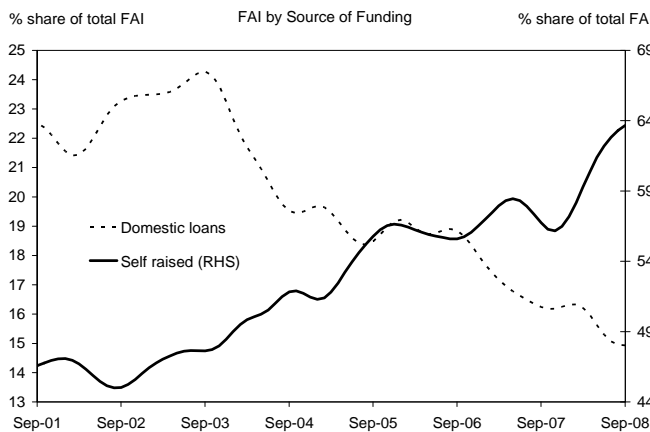
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 8: Corporate profits worsened slightly during May-August period



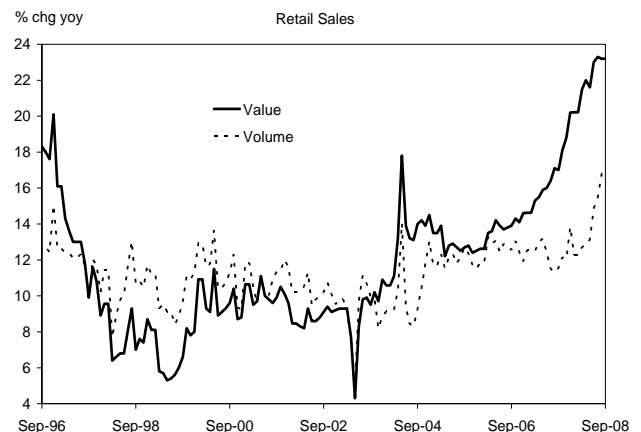
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 6: The share of fixed assets investment financed by retained earnings has been rising



Source: CEIC, Goldman Sachs Economics Research.

Exhibit 9: Retail sales growth accelerated both in nominal and real terms



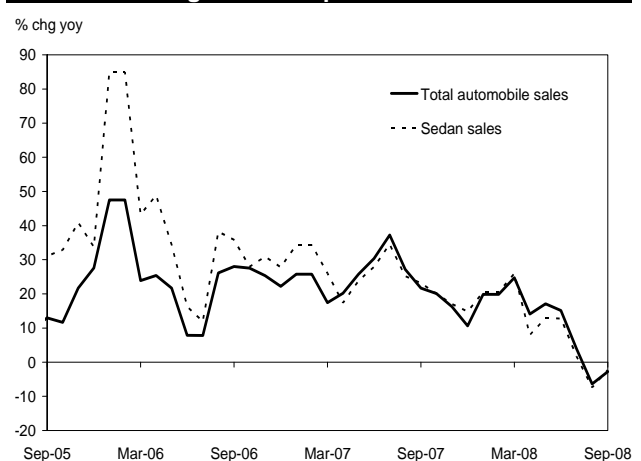
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 7: Growth of investment in the pipeline softened

	Investment Under Construction			New Investment Projects		
	Rmb tn. (ytd)	% mom	% yoy	Rmb tn. (ytd)	% mom	% yoy
Jan-05	7.0	—	21.4	0.5	—	-6.6
Feb-05	7.0	—	21.4	0.5	—	-6.6
Mar-05	9.4	34.3	29.4	1.0	117.0	7.3
Apr-05	10.8	14.7	26.2	1.6	52.4	13.5
May-05	11.9	10.6	28.7	2.1	35.2	24.9
Jun-05	13.2	10.7	28.6	3.0	40.5	24.8
Jul-05	14.1	7.3	26.1	3.5	17.9	28.5
Aug-05	14.8	4.7	29.7	4.0	13.5	28.4
Sep-05	15.2	2.9	27.9	4.5	13.0	27.9
Oct-05	15.9	4.2	27.8	5.1	11.8	28.5
Nov-05	16.5	4.3	28.8	5.5	9.7	28.4
Dec-05	17.8	7.9	29.7	6.5	16.9	32.4
Jan-06	9.8	—	39.8	0.6	—	33.4
Feb-06	9.8	—	39.8	0.6	—	33.4
Mar-06	12.2	25.0	30.1	1.5	131.1	42.0
Apr-06	14.2	13.9	29.2	2.1	41.8	32.2
May-06	15.1	8.6	26.9	2.6	26.4	23.6
Jun-06	16.6	10.2	26.3	3.7	38.9	22.2
Jul-06	17.4	4.3	22.8	4.2	15.1	19.3
Aug-06	18.0	3.6	21.6	4.5	5.9	11.4
Sep-06	18.8	4.6	23.6	4.9	9.1	7.5
Oct-06	19.4	3.3	22.6	5.3	8.6	4.4
Nov-06	20.1	3.2	21.3	5.7	9.9	3.7
Dec-06	21.7	8.0	21.4	6.7	16.6	3.4
Jan-07	10.7	—	9.3	0.4	—	-35.9
Feb-07	10.7	—	9.3	0.4	—	-35.9
Mar-07	14.2	32.7	16.0	1.3	210.2	-13.9
Apr-07	16.4	15.8	18.0	2.0	61.0	-2.2
May-07	17.5	6.9	16.1	2.8	37.2	6.1
Jun-07	19.3	9.8	15.8	3.9	39.2	6.4
Jul-07	20.3	5.5	17.2	4.8	23.9	14.6
Aug-07	21.2	4.2	17.9	5.2	7.9	16.7
Sep-07	22.2	4.9	18.2	6.0	16.1	24.2
Oct-07	23.1	3.7	20.6	6.7	10.6	26.5
Nov-07	24.1	4.4	20.1	7.4	10.3	28.9
Dec-07	26.1	8.5	28.7	8.6	17.2	28.7
Jan-08	13.0	—	22.2	0.4	—	-2.6
Feb-08	13.0	—	22.2	0.4	—	-2.6
Mar-08	16.9	29.8	19.5	1.2	204.4	-4.4
Apr-08	19.2	13.3	16.9	1.9	59.8	-5.1
May-08	20.6	7.5	17.6	2.7	41.0	-2.5
Jun-08	21.6	4.5	17.3	3.9	44.9	1.5
Jul-08	23.9	5.7	17.4	4.7	18.6	-2.9
Aug-08	24.9	4.4	17.7	5.3	13.9	2.5
Sep-08	26.3	5.3	18.1	6.1	15.2	1.7

Source: CEIC, Goldman Sachs Economics Research.

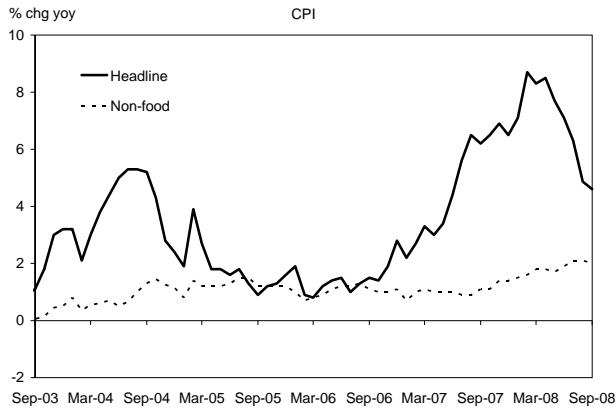
Exhibit 10: Automobile sales growth reached negative territories in August and September



Source: CEIC, Goldman Sachs Economics Research.

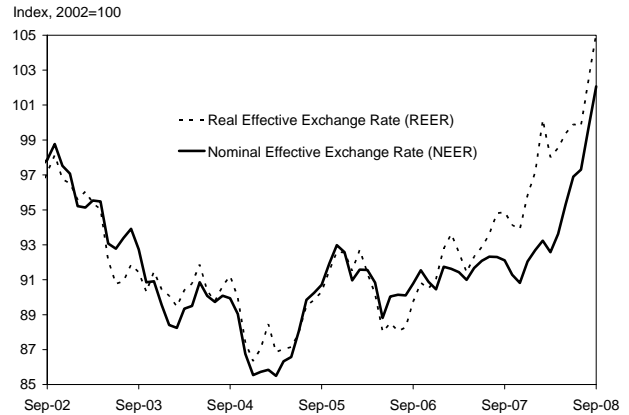
Price Indicators

Exhibit 1: CPI inflation moderated to 4.6% in September from 8.7% in February



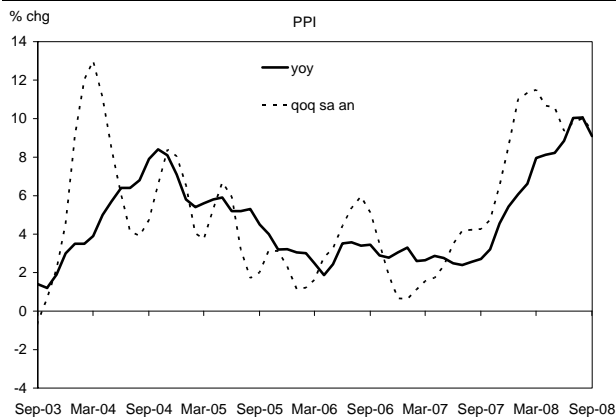
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 4: Both the REER and NEER appreciated



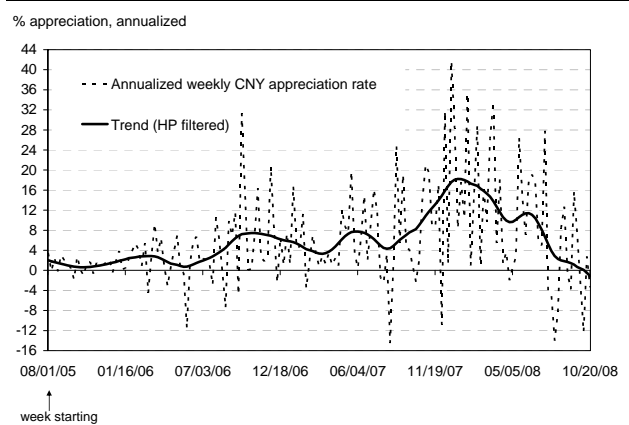
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 2: PPI inflation started to moderate in September



Source: CEIC, Goldman Sachs Economics Research.

Exhibit 5: CNY/USD exchange rate stopped appreciating...



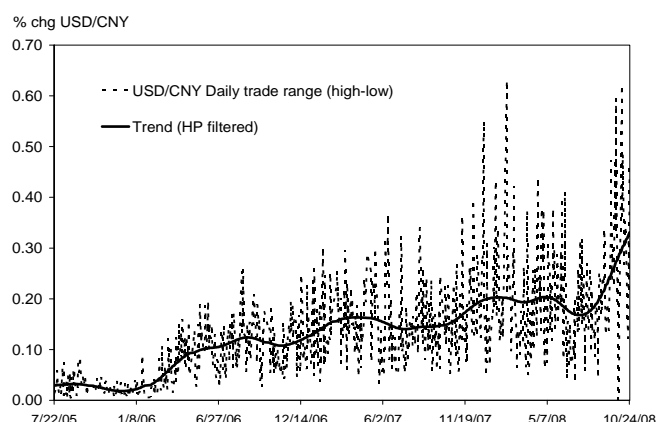
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 3: Real estate prices trending down



Note: quarterly data before July 2005, monthly since then.
Source: CEIC, Goldman Sachs Economics Research.

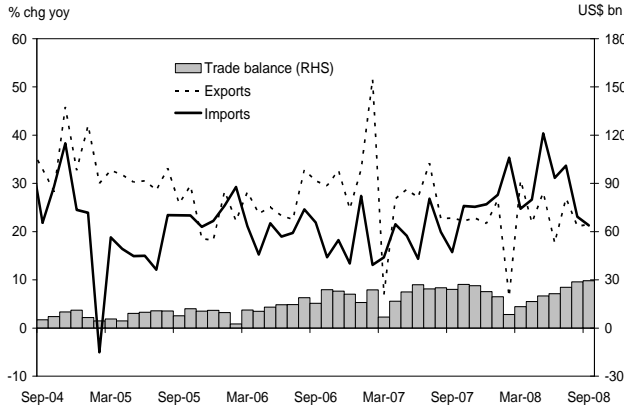
Exhibit 6: ...but its daily volatilities increased



Note: quarterly data.
Source: CEIC, Goldman Sachs Economics Research.

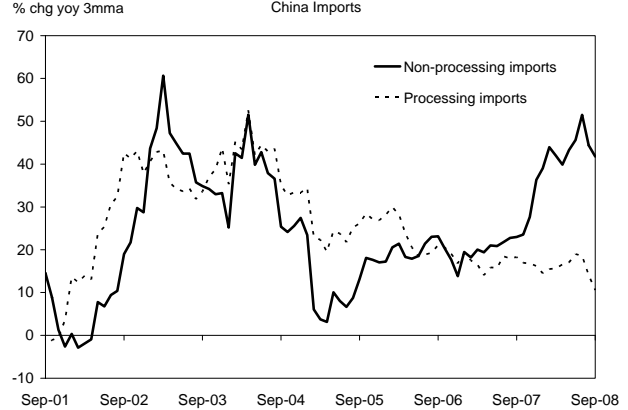
Trade Indicators

Exhibit 1: Imports growth softened significantly, resulting in a record level trade surplus



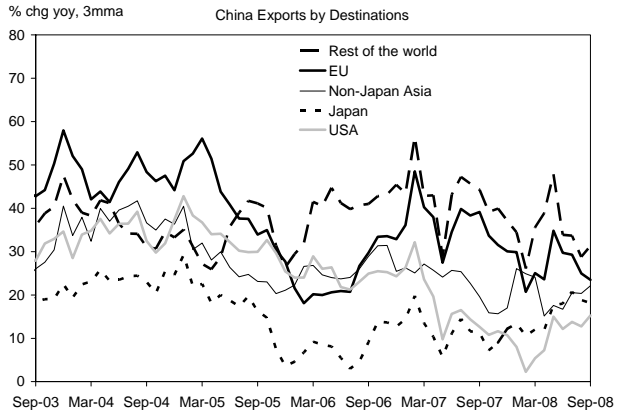
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 4: Processing and non-processing imports growth both softened



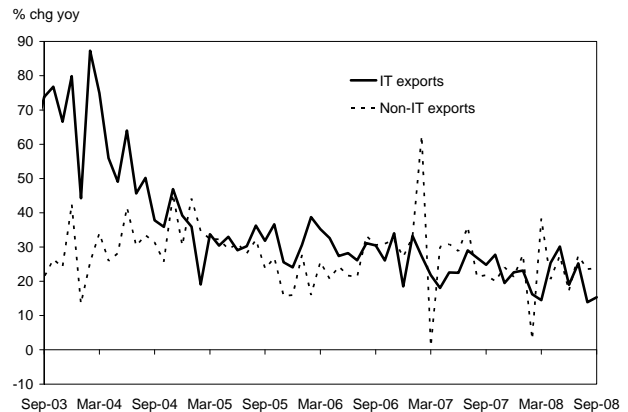
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 2: Exports growth to the US and Asia holding up while growth to other markets weakened



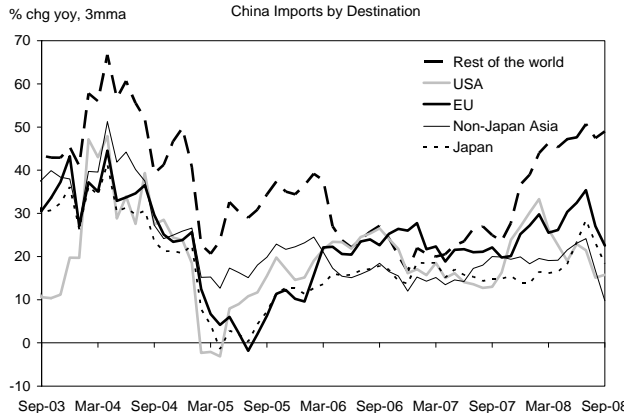
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 5: IT vs. non-IT exports growth



Source: CEIC, Goldman Sachs Economics Research.

Exhibit 3: Only import growth from non-traditional markets remained robust



Source: CEIC, Goldman Sachs Economics Research.

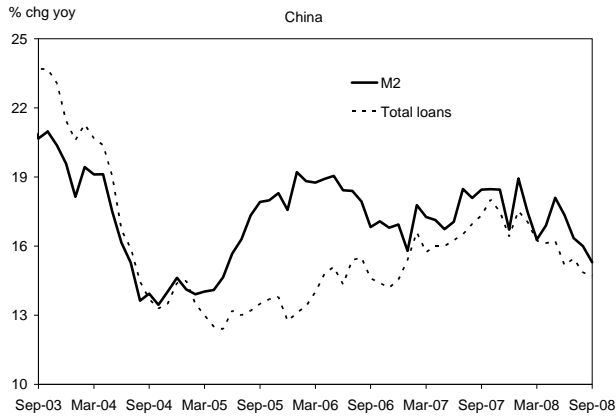
Exhibit 6: China's exports becoming less dependent on the US



Source: CEIC, Goldman Sachs Economics Research.

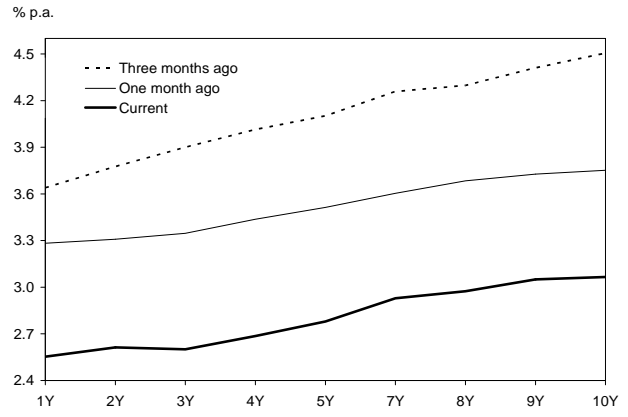
Financial Indicators

Exhibit 1: Money and credit growth continued to slow



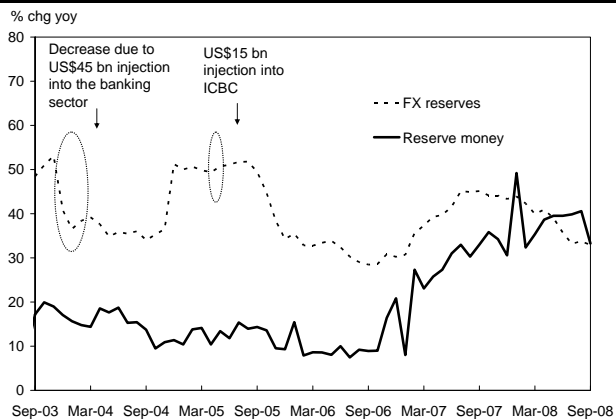
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 4: Bond yields shifted down with three interest rate cuts in the past two months



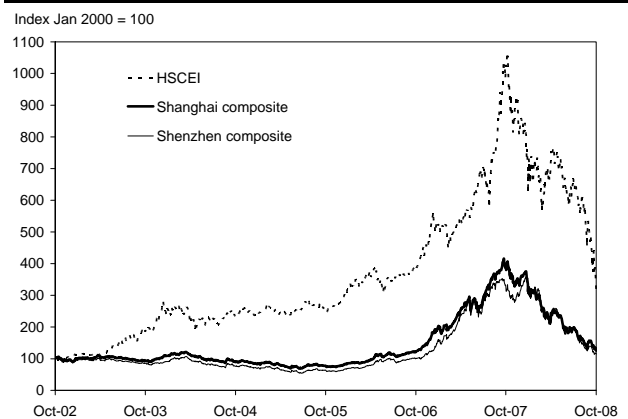
Source: Bloomberg, Goldman Sachs Economics Research.

Exhibit 2: FX reserve growth remains at a high level



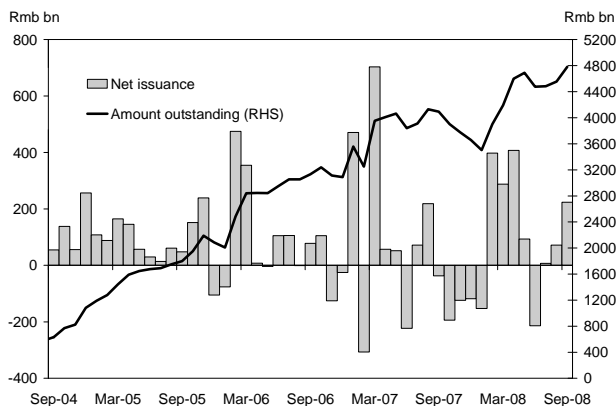
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 5: Further corrections in the stock market...



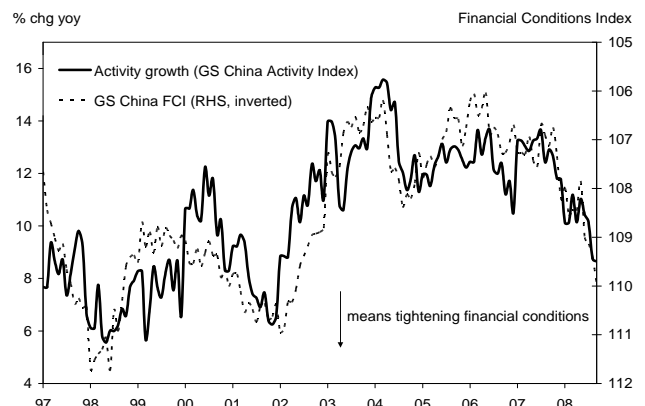
Source: Bloomberg, CEIC, Goldman Sachs Economics Research.

Exhibit 3: The sterilization by PBOC bill issuance increased slightly in 3Q



Source: Bloomberg, Goldman Sachs Economics Research.

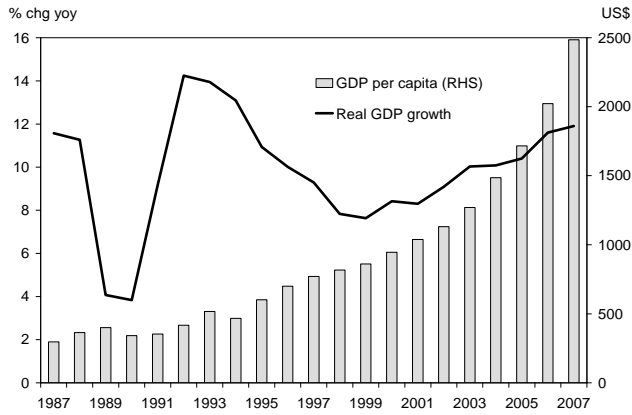
Exhibit 6: The China Financial Conditions Index has tightened by 320 bp since October 2007



Source: CEIC, Goldman Sachs Economics Research.

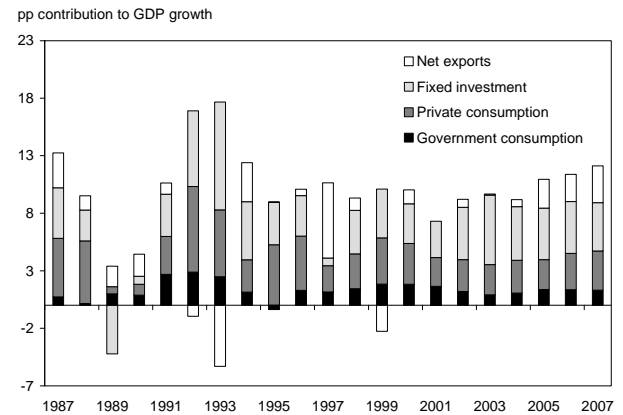
Annual Macroeconomic Indicators

Exhibit 1: GDP per capita rising steadily



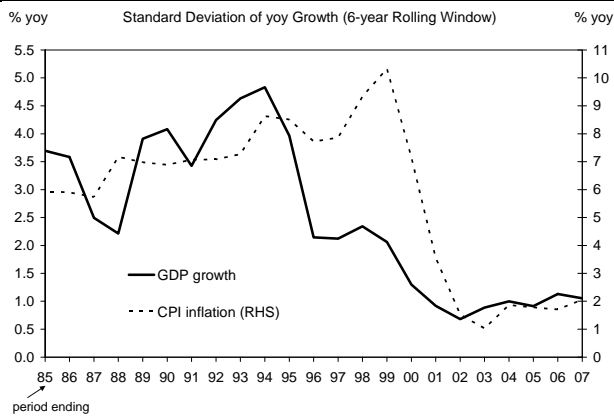
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 4: The contribution of external demand growth to GDP growth continued to rise



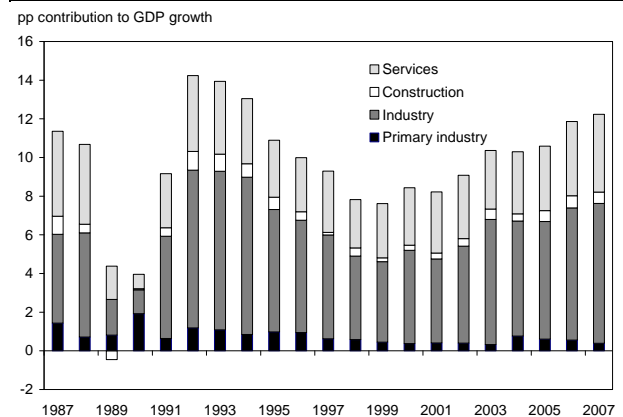
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 2: Cyclical volatility has been significantly reduced



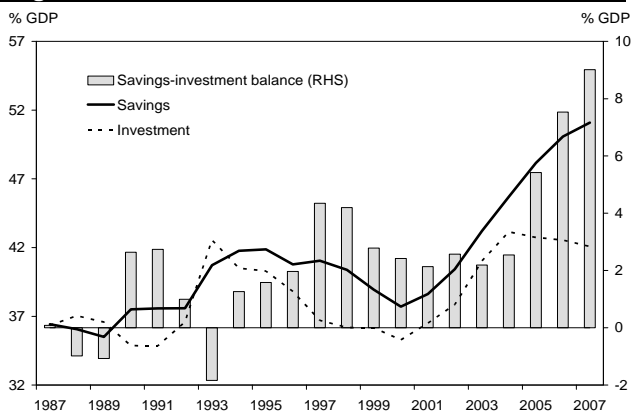
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 5: Industrial growth has outpaced other sectors



Source: CEIC, Goldman Sachs Economics Research.

Exhibit 3: The saving investment imbalance continued to grow



Source: CEIC, Goldman Sachs Economics Research.

Exhibit 6: Household income and expenditure growth remain robust



Source: CEIC, Goldman Sachs Economics Research.

Summary Indicators (Annual)

(percentage change, unless otherwise indicated)

Per capita GDP (2007): 2485 USD

Population (2007): 1321 mn

	2001	2002	2003	2004	2005	2006	2007	2008F	2009F
REAL SECTOR									
GDP by expenditure (at 1990 prices)									
GDP	8.3	9.1	10.0	10.1	10.4	11.6	11.9	9.8	8.7
Private consumption	5.7	6.5	6.3	7.1	6.7	8.4	9.3	10.0	9.0
Government consumption	11.1	7.9	6.0	7.3	9.7	9.7	9.5	10.0	8.0
Fixed investment	9.0	12.9	16.5	12.1	11.4	11.4	10.6	9.8	8.5
Domestic demand	8.8	8.8	10.5	10.0	8.3	9.9	9.4	9.8	8.5
Net exports (contribution to growth)	0.0	0.7	0.1	0.6	2.5	2.4	3.2	1.0	1.1
Exports (G&S)	7.1	24.7	26.9	27.7	22.4	19.6	19.0	11.8	6.5
Imports (G&S)	8.1	26.1	29.7	29.0	20.2	18.1	16.8	12.0	6.0
GDP by Industry									
Primary Industry	2.8	2.9	2.5	6.3	5.2	5.0	3.7	5.0	5.5
Secondary Industry	8.4	9.8	12.7	11.1	11.7	13.0	13.4	10.8	8.8
Industry	8.7	10.0	12.8	11.5	11.6	12.9	13.5	10.9	9.0
Construction	6.8	8.8	12.1	8.1	12.6	13.7	12.6	10.1	7.0
Tertiary Industry	10.2	10.4	9.5	10.1	10.5	12.1	12.6	9.7	9.4
Goldman Sachs China Activity Index (GSCA)	7.8	10.6	12.9	13.5	12.5	12.4	12.9	—	—
PRICES									
CPI inflation (period average)	0.7	-0.8	1.2	3.9	1.8	1.5	4.8	6.3	1.5
CPI inflation (period end)	-0.3	-0.4	3.2	2.4	1.4	2.0	6.6	3.9	1.8
GDP deflator (period average)	2.0	0.6	2.6	6.9	3.8	3.6	5.2	7.8	1.5
EXTERNAL SECTOR (USD bn unless otherwise indicated)									
Current account balance	17.4	35.4	45.9	68.7	160.8	249.9	371.8	363.7	412.1
(as percent of GDP)	1.3	2.4	2.8	3.6	7.2	9.4	11.3	8.5	8.4
Exports	318	388	520	701	904	1144	1468	1774	1933
Imports	301	352	474	632	743	895	1096	1410	1521
Capital and financial account	34.8	32.3	52.7	110.7	63.0	10.0	73.5	123.9	102.8
Foreign direct investment	37.4	46.8	47.2	53.1	67.8	60.3	121.4	138.9	152.8
Portfolio, net	-19.4	-10.3	11.4	19.7	-4.9	-67.6	18.7	-45.0	-80.0
Other capital flow	16.9	-4.1	-5.9	37.8	0.1	17.3	-66.6	30.0	30.0
Net errors and omissions	-4.9	7.8	18.4	27.0	-16.8	-12.9	16.4	0.0	0.0
Overall balance (as percent of GDP)	3.6	5.2	7.1	10.7	9.3	9.3	14.1	11.5	10.5
MONETARY & FINANCIAL SECTOR									
								Latest in bold	
Money Supply M2	17.6	16.9	19.6	14.5	16.3	17.0	16.7	15.3	(Sep)
Domestic Credit	7.1	37.5	19.5	9.2	10.8	15.7	17.6	12.5	(Aug)
Stock price index (Shanghai composite)	3.9	-19.9	-6.3	1.0	-22.2	41.3	160.0	-58.7	(Sep)
Lending rate (1y, %pa)	5.85	5.36	5.31	5.38	5.58	5.90	6.78	7.20	(Sep)
Deposit rate (1y, %pa)	2.25	2.00	1.98	2.05	2.25	2.36	3.28	4.14	(Sep)
Memo items									
Forex reserves (USD bn)	212	286	403	610	819	1066	1528	1906	(Sep)
months of imports	10.5	11.6	11.7	13.0	14.9	16.2	19.2	19.2	(Sep)
Exchange rate (end of period, USD/CNY)	8.28	8.28	8.28	8.28	8.08	7.81	7.30	6.77	6.53
Real Effective Exchange Rate Index (period avg)	102.0	98.3	91.0	88.3	87.7	88.3	92.0	—	—

Source: NBS, CEMAC, PBOC, CEIC, Goldman Sachs Economics Research.

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