US Economics Analyst

Issue No: 06/45
November 10, 2006

US Economic Research Group
GSUSEconomicsResearch@ny.email.gs.com

FOR THOSE PERMISSIONED:

GS GLOBAL ECONOMIC WEBSITE
Economic Research from the GS Institutional Portal
at **https://portal.gs.com**

Fiscal Policy: Marking Time until the Tax Cut Sunsets

Jan Hatzius
jan.hatzius@gs.com
212 902 0394

Bill Dudley
william.dudley@gs.com
212 902 3394

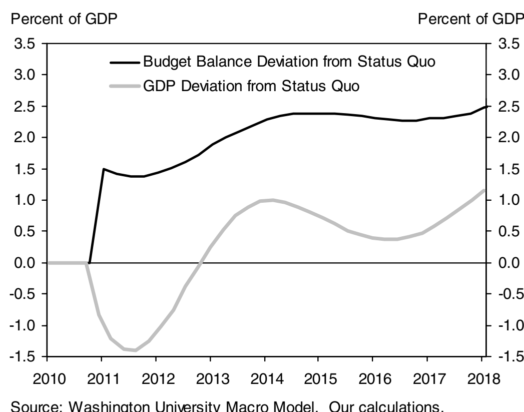
Ed McKelvey
ed.mckelvey@gs.com
212 902 3393

Andrew Tilton
andrew.tilton@gs.com
212 357 2619

Seamus Smyth
seamus.smyth@gs.com
212 357 6224

- Near-term changes in US fiscal policy are unlikely despite the shift in control of the Congress. Key decisions on extending tax cuts are not forced until 2010, after the next election, while efforts to roll back these cuts before then would surely trigger a veto.
- As the tax cut "sunsets" approach, the Congress regains power, as legislation will then be needed to extend the cuts. The choice will not be easy given the magnitude of the tax increase—about 1½% of GDP—that would occur if the tax cuts all expired and its likely impact on near-term growth.
- In a simulation exercise, we confirm that this "do nothing Congress" scenario would quickly balance the budget but at the cost of a sharp hit to growth in the short term. Farther out, the benefits are higher output and lower inflation and interest rates, at the expense of less consumption—an inevitable price for this decade's tax cuts.
- The Democratic Party has regained control of both houses of Congress with a surprisingly strong showing in the mid-term election. Although the new leadership will clash with President Bush on many issues, several areas appear ripe for compromise, including immigration policy, a minimum wage hike, and Iraq policy. Each could have significant impact on the economy.
- Third-quarter real GDP growth could be revised up to about 2% (annualized), but the fourth-quarter prognosis remains murky. Early reads on retail sales suggesting that October spending was weak, and the factory sector must begin to work off an inventory overhang. The labor market continues to impress, though we expect the jobless rate to begin trending higher soon as the housing correction triggers more job losses.

Expiring Tax Cuts Fix Budget, But Cause Recession



Source: Washington University Macro Model. Our calculations.

Both Houses See Shift in Control

* Allocates undecided seats to current leaders.
Source: Associated Press.

Important disclosures appear at the back of this document.

I. Return to Divided Government

The Democratic Party has regained control of both houses of Congress with a surprisingly strong showing in the mid-term election. Although the new leadership will clash with President Bush on many issues, several areas appear ripe for compromise, including immigration policy, a minimum wage hike, and Iraq policy. Each could have significant impact on the economy.

Third-quarter real GDP growth may have been a bit stronger than first reported, with data in hand suggesting an upward revision to about 2% (annualized). However, the fourth-quarter prognosis is murky, with early reads on retail sales suggesting that spending was weak in October, and a substantial inventory overhang in the manufacturing sector. The labor market continues to impress, though we expect the unemployment rate to begin trending higher soon as the housing correction triggers more job losses.

Exhibit 1: Both Houses See Shift in Control

* Allocates undecided seats to current leaders.
Source: Associated Press.

Democrats Retake Congress

With surprisingly strong mid-term election gains, the Democratic Party has retaken a majority not only in the House of Representatives, but also in the Senate with a much thinner 51-49 edge (counting two independents who will caucus with the Democrats). This marks the first time that Democrats have controlled both houses of Congress since 1994; the size of the net changes (6 in the Senate, about 30 in the House) approaches those of previous "landslide" mid-term elections, especially given the relatively small number of competitive races.

With Democrats setting the agenda, the initial focus of Congress next year is likely to be on the six issues highlighted in the campaign: (1) reinstatement of PAYGO budget rules; (2) repeal of tax preferences for integrated oil companies; (3) reductions in student loan rates; (4) direct negotiation of Medicare prescription drug prices; (5) an increase in the minimum wage, and (6) implementation of the September 11th Commission recommendations.

Although President Bush and the Democratic Congress are likely to clash on many fronts, several major issues with ramifications for the economy appear ripe for compromise:

1. Immigration. Continued large inflows of undocumented immigrants and bipartisan acknowledgement that current policies are insufficient to address the situation have created fertile ground for legislative progress. A potential compromise on immigration policy would likely involve a combination of increased quotas for legal immigration, tougher enforcement of those quotas, and some sort of procedure through which illegal immigrants could eventually apply for US citizenship.

2. Minimum wage. As noted above, Democrats have targeted a significant increase in the national minimum wage, to $7.25 from $5.15 per hour, as part of their initial agenda. A majority in both houses of the current Congress had already supported an increase even before the election, but the deal was never consummated. More than half (26) of the states already have higher minimums, covering a significant portion of the US labor force.

3. Iraq. Iraq policy could see a fundamental shift, with Donald Rumsfeld's departure as Secretary of Defense an indicator of possible changes ahead. The upcoming report by a special commission chaired by former Secretary of State James Baker and former

Congressman Lee Hamilton (who also co-chaired the September 11 Commission) could offer both parties political cover for a change of course. This might ultimately reduce the drain on the federal budget from Iraq-related expenditures.

However, compromise is less likely on many other issues. The White House appeared to be considering making entitlement reform its top priority in Bush's last two years in office, but this now seems unlikely given the huge political obstacles and the likelihood that lawmakers' focus will soon turn to the 2008 presidential election. Federal spending is unlikely to be dramatically different, though divided government historically has meant more controlled spending—about in line with GDP growth (-0.02 points per year) versus slightly faster (+0.23 points) when government was under control of a single party.

Tax policy seems unlikely to change either. Most important tax cuts don't expire until 2010, and there is little Democrats in Congress can do to alter tax policy, given the likelihood of a Bush veto. In addition, Democrats appear far from unified on repealing many of these tax cuts, and the resulting fiscal tightening would pose temporary downside risks to the economic outlook. There is a small risk that tighter budget rules could force the cost of extending these cuts to be offset by tax increases elsewhere. Most likely, these would come from the closing of corporate "loopholes" or other business-related revenue raisers. Relief from the Alternative Minimum Tax (AMT) will be extended, but plans to require the cost of any tax cuts to be offset could put two of the Democrats' priorities in conflict (see this week's center section for a fuller discussion of the fiscal outlook).

More Growth Then, Less Now?

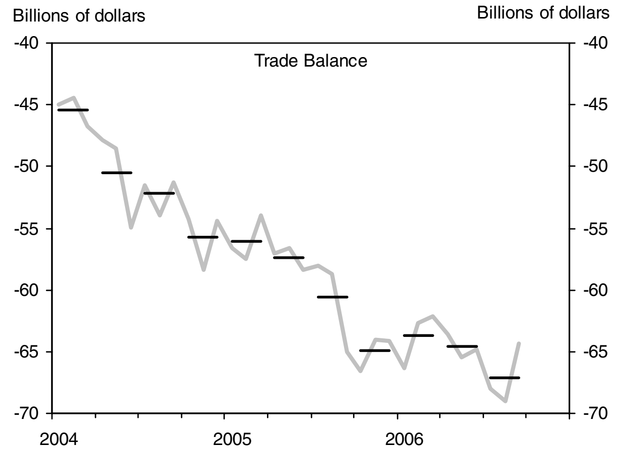
Economic news this week implied that third-quarter growth might turn out to be a bit stronger than initially estimated. In particular, better export performance and lower oil imports resulted in a substantially narrower trade deficit for September—$64.3 billion versus August's downward-revised $69.0 billlion shortfall. This, combined with more inventory building than Commerce officials assumed, puts our best guess for third-quarter real GDP growth slightly above 2% (annualized). Upcoming reports on retail sales and inventories could still swing this figure.

However, the market's focus is on the outlook, and here we remain cautious. In theory, the sharp drop in energy prices over the past three months should boost consumer spending in the fourth quarter, but this acceleration has yet to materialize. Early reads on retail sales activity—the official government data are due out Tuesday—suggest that October spending was weak. In fact, we have trimmed 0.2 points from our retail sales estimates, to -0.4% overall and -0.3% excluding autos. Meanwhile, the manufacturing sector will have to begin working off a significant inventory overhang.

The labor market continues to impress. For example, initial jobless claims moved back down near the 300,000 level, implying that last week's rise was a head fake and reinforcing the generally strong tone of the October employment report. Although the labor market is clearly tight at present, we expect job losses—particularly from the housing sector—to begin pushing up the unemployment rate within the next few months.

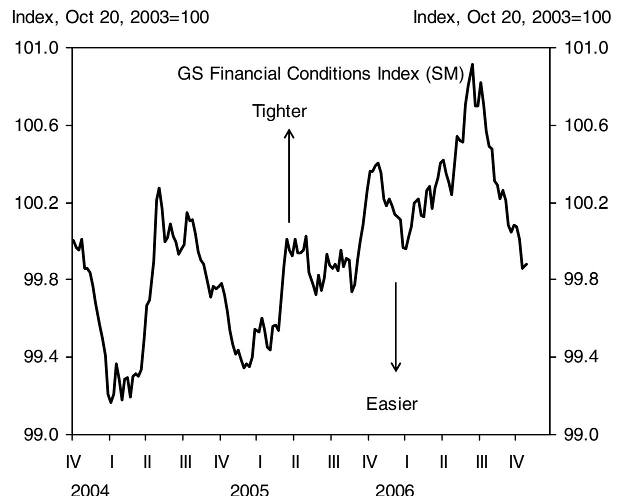
Chuck Berwick Alec Phillips Andrew Tilton

Exhibit 2: Trade Deficit Narrower For Now



* Horizontal lines denote quarterly averages.
Source: Department of Commerce.

Exhibit 3: Dramatic Easing in Financial Conditions in Recent Months



Source: Goldman Sachs.

II. Fiscal Policy: Marking Time until the Tax Cut Sunsets

Near-term changes in US fiscal policy are unlikely despite the shift in control of the Congress. Key decisions on extending tax cuts are not forced until 2010, after the next election, while any efforts to roll back these cuts before then would surely trigger a presidential veto.

As the tax cut "sunsets" approach, the Congress regains power, as legislation will then be needed if the tax cuts are to be extended. The choice will not be easy given the magnitude of the tax increase—about 1½% of GDP—that would occur if the tax cuts all expired and its likely impact on near-term growth.

In a simulation exercise, we confirm that this "do nothing Congress" scenario would quickly balance the budget but at the cost of a sharp hit to growth in the short term. Farther out, the benefits are higher output and lower inflation and interest rates, at the expense of less consumption—an inevitable price for this decade's tax cuts.

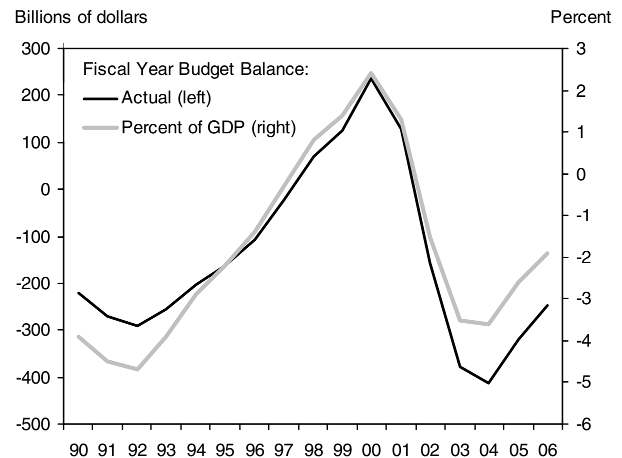
Near-Term Fiscal Policy: No Major Shift

Talk of imminent change in fiscal policy, focused on tax hikes, has surfaced as Democrats have regained control of the Congress. They netted about 30 more seats in the House of Representatives, giving them a comfortable margin. In the Senate, the Democratic margin is much thinner—a 51-49 edge.

However, this shift in control of Congress does not translate into an immediate shift in fiscal policy for four reasons. First, the budget deficit has narrowed sharply over the past two years, as shown in Exhibit 1. This may reduce the sense of urgency in the minds of many lawmakers, and therefore their willingness to strike deals even though the longer-term imbalance remains serious and unresolved. Second, the main components of President Bush's signature tax cuts—enacted with "sunsets" to contain their budget impact—do not expire until the end of 2010.[1] Hence, the thorny issue of extending these cuts need not be addressed until after the next Congress (and president) is elected in 2008. Third, any effort to roll back these cuts before their scheduled expiration would almost surely trigger a presidential veto, which the Congress could not override, and it would provide the GOP with an election issue to boot. Therein lies the fourth reason, that the impending 2008 presidential election will limit the time and scope for meaningful progress.

[1] Although the cuts in tax rates on dividends and capital gains were originally set to expire at the end of 2008, the tax law enacted last year (The Tax Increase Prevention and Reconciliation Act of 2005) pushed these sunsets back to 2010.

Exhibit 1: A Smaller Deficit Lately



Source: Office of Management and Budget.

Similar logic applies to the spending side of the ledger, where any efforts to trim outlays for defense or homeland security would be fraught with political risk. Our working assumption is that total spending on national security will not change much, although the composition might shift; for other discretionary spending we expect gridlock between a Democratic majority that would like to restore some programs and a Republican president whose veto pen will suddenly be full of ink. The same probably holds for Democrats' announced intention to push for direct negotiation of Medicare prescription drug prices.

One issue the new congressional leadership will face is how to handle the various tax measures whose renewal has become an annual ritual in recent years. By far the largest of these is the temporary fix of the alternative minimum tax (AMT), without which the number of taxpayers affected by this obscure tax calculation would soar.[2] Although renewing the AMT would boost the deficit by an estimated $65 billion for fiscal year (FY) 2008, it enjoys bipartisan support. This is because many of its unsuspecting victims live in "blue" states. Hence, the new Congress will probably find some way to make it happen and pass most of the other ones (another $16 billion) as well.

[2] The AMT is a parallel tax system, with different exemptions and rates, designed to ensure that high-income taxpayers cannot use various deductions to avoid substantial federal tax liability. Changes in the conventional tax code, and a lack of indexation of the AMT to inflation, have increased its scope far beyond its original targets. Under current law, the number of households subject to the AMT in 2010 soars to 33 million from around 3-4 million currently.

In doing so, the Democrats risk compromising another objective they have championed in recent years, namely to reinstate pay-as-you-go (PAYGO) rules for federal budget legislation. Unlike the administration and the current congressional leadership, who favor PAYGO only for outlays, Democrats have pushed to have these rules apply to taxes as well. Notably, the decision to resurrect PAYGO does not require the president to sign off, as it can be implemented simply as part of the budget resolution. Hence, an early test of the Democrats' resolve to control the budget deficit will be whether they restore PAYGO or something similar and, more critically, whether they adhere to it.

2010: A Year of Wreckoning?

On balance, our expectations for significant change in fiscal policy during the next two years are low. Thereafter, the calculus changes radically as the 2010 sunsets approach. Absent legislative action, the tax code essentially reverts to its pre-2001 provisions on January 1, 2011. Marginal tax rates on ordinary income rise significantly, dividend income loses its special treatment, the capital gains tax rate goes back to 20%, the marriage penalty reappears, the child tax credit drops, and the estate—oops, death—tax springs back to life.

One implication of this situation is that the initiative reverts to Congress, specifically the one to be elected in 2008. It can opt for fiscal balance simply by doing nothing and letting the tax cuts expire, or it can pass legislation to extend any or all of the cuts. Although the president—whoever that may be—obviously still has the right of veto, he/she obviously cannot reject a bill that has not reached his/her desk.

More importantly, the stakes are high, as the sunsets potentially telescope into one year the reversal of tax cuts implemented in various stages between mid-2001 and early 2004. According to Congressional Budget Office (CBO) estimates, tax revenue would rise by $236 billion between FY 2010 and FY2012 if all of the tax cuts were to expire.[3] Scaled to the estimated size of the economy at that time, this is a fiscal drag of about 1½% of GDP.

Even the most die-hard fiscal hawks are apt to think twice about the implications of this for the near-term performance of the economy. After all, a tax increase of this magnitude, imposed all at once, would likely throw the economy into recession. How bad would it be, and what would the benefit be in terms of budget improvement and longer-term economic performance?

[3] We compare FY 2012 to FY 2010 because the sunsets occur partway into the intervening fiscal year. Also, some of the increased liabilities would not be paid until the following tax season.

Costs and Benefits of Letting Tax Cuts Expire

To provide some perspective on these questions, we simulated the effects of allowing all the tax cuts to expire as scheduled—or, to twist Harry Truman's famous phrase, a "do nothing Congress" scenario. Specifically, using the Washington University Macroeconomic Model (WUMM), we reset taxes to their 2000 levels, grossed them up slightly to match CBO's estimate of the revenue impact of letting the tax cuts expire, and allowed for appropriate monetary policy response. On the latter, we assume that the Fed follows a rule calling for rate cuts when output falls below its trend and rate hikes when inflation is above its "comfort zone."[4]

Exhibit 2 illustrates the main results of this exercise, showing how key variables would diverge from a *status quo* forecast in which the tax cuts are extended. The results are as follows:

Reversing the tax cuts quickly closes most, if not all, of the fiscal deficit. The immediate effect is to cut the deficit by about 1½% of GDP, as shown in the top panel of Exhibit 2. This is about three-fifths of the shortfall we currently project for FY 2011, based on assumptions we consider realistic.[5] Under the more restrictive assumptions underlying the CBO's baseline projections, the budget comes very close to balance, as indicated in that agency's latest budget update as well as its estimates that extending the tax cuts would boost the deficit by 1.6% of GDP relative to its baseline.

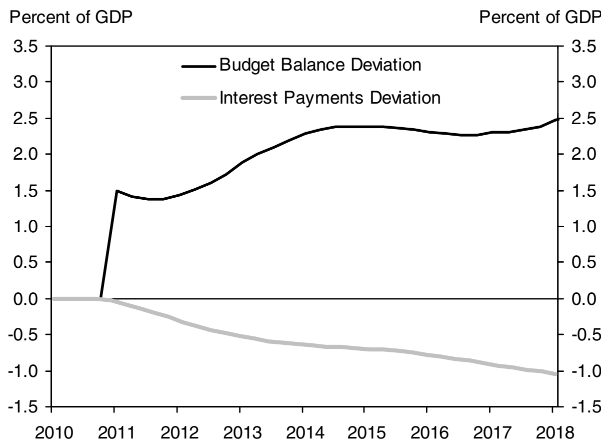
More budget progress occurs in the out years. The budget improvement persists and even increases over time without further changes in tax law. This reflects the beneficial effects of a sharp reduction in interest expense, which results both from reduced borrowing and lower interest rates. Five years out, the budget improvement swells to about 2½% of GDP, covering about three-quarters of our projected deficit and putting the budget into modest surplus under the CBO assumptions.

The economy suffers a lot of short-term pain. The jump in taxes on January 1, 2011 squeezes disposable income and hence consumption. This feeds through to the rest of the economy, sharply curtailing growth and prompting an aggressive easing in monetary policy. The lower two panels of Exhibit 2 lay out the major elements of the macroeconomic story.

[4] As noted in the text, the analysis was prepared using Macroeconomic Advisers, LLC's Model of the U.S. Economy. However, Goldman, Sachs & Co. is solely responsible for all assumptions and conclusions.

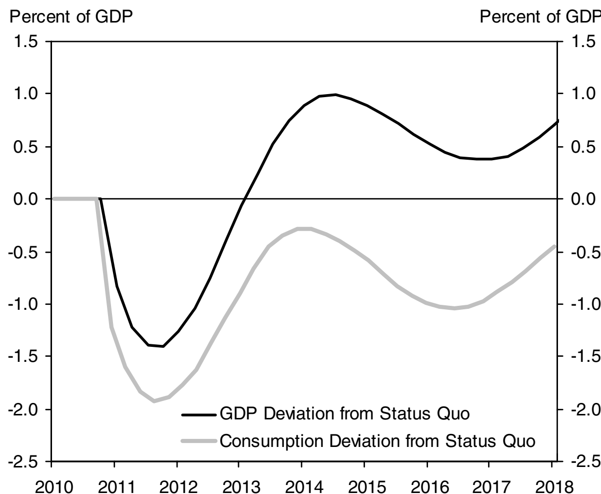
[5] See "The Budget Outlook: No Lasting Improvement" *US Economics Analyst*, September 22, 2006.

Exhibit 2: Expiring Tax Cuts Help the Budget Balance (Duh!)



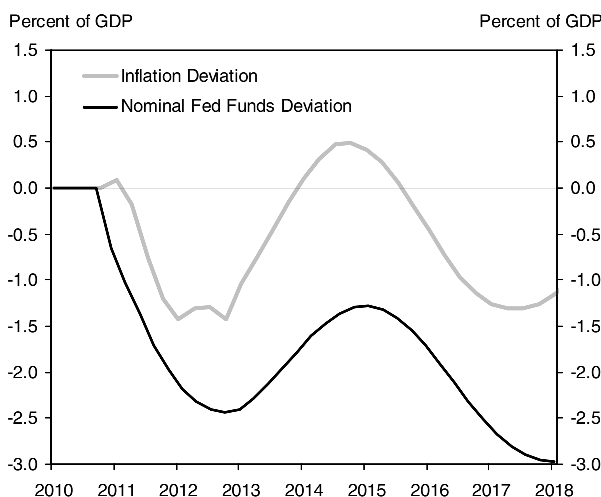
Source: Washington University Macro Model. Our Calculations.

… Growth Sags in the Near Term, With Less Consumption Throughout …



Source: Washington University Macro Model. Our Calculations.

… Inflation and Interest Rates Decline



Source: Washington University Macro Model. Our Calculations.

In the first quarter of 2011, real GDP growth drops more than 3 percentage points below what it would otherwise be. Absent a strong tailwind to growth from some other source, this would almost surely mark the onset of a recession. In an effort to resuscitate demand, the Fed immediately cuts the federal funds rate, bringing it 250 basis points (bp) below the *status quo* level over the next year and one-half, as shown in the bottom panel of Exhibit 2. Despite this, output growth remains well below trend over that period, putting downward pressure on inflation as slack in the economy increases. Inflation drops by 150 bp during the sag in growth before coming back up as the monetary stimulus pushes output back toward, and eventually above, trend.

In the longer run, economic growth benefits from "crowding in." When the government runs a large deficit, "crowding out" occurs in the capital markets: Its borrowing, backed by the power to tax, takes priority over private borrowing and therefore denies some companies the funds they need for investment that is usually more productive than the government's use of the funds. As a result, growth suffers and real interest rates rise.

The opposite occurs in our simulation. Restoring better balance to the government's books reduces the deficit and hence the growth in its debt. This frees funds that now flow to the private sector allowing the capital stock to grow more rapidly and pushing down interest rates. As shown by the gap between the lines in the bottom panel, real interest rates end up substantially lower. This, eventually, raises output by about 1% above the level that would have prevailed without the tax increase.

At first glance, this seems like a straightforward case of short term pain (recession) leading to longer term gain (higher output). Unfortunately, this assessment is a bit too optimistic. Although output is higher than it otherwise would be, consumption is lower. Since the 2001 tax cuts helped thrust the budget back into deficit, the federal government has borrowed to fund its spending and, via the tax cuts, some consumer spending as well. A reversion in 2011 to higher taxes simply recognizes that fact and starts paying off the debt. If instead Congress chooses to maintain the cuts, they just push the due date for the 2000s spending bill even further into the future. In that case, the ultimate payment—the drop in consumption—would be even higher.

Ed McKelvey **Seamus Smyth**

THE US ECONOMIC AND FINANCIAL OUTLOOK

(% change on previous period, annualized, except where noted)

	2005	2006 (f)	2007 (f)	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007 Q1	2007 Q2	2007 Q3	2007 Q4
OUTPUT AND SPENDING											
Real GDP	**3.2**	3.3	2.2	**5.6**	**2.6**	**1.6**	2.5	2.5	2.0	2.0	2.5
Year to year change	–	–	–	**3.7**	**3.5**	**2.9**	3.0	2.3	2.1	2.2	2.2
Consumer Expenditure	**3.5**	3.2	2.6	**4.8**	**2.6**	**3.1**	3.5	2.5	2.0	2.0	2.5
Residential Fixed Investment	**8.6**	-3.7	-12.7	**-0.3**	**-11.1**	**-17.4**	-15.0	-15.0	-10.0	-7.5	-5.0
Business Fixed Investment	**6.8**	7.8	5.9	**13.7**	**4.4**	**8.6**	7.5	6.0	5.0	4.0	3.5
Industrial Production, Mfg	**3.9**	4.9	2.8	**5.3**	**5.1**	**3.8**	1.5	3.0	2.5	2.5	3.0
INFLATION											
Consumer Price Index	**3.4**	3.3	2.5	**2.2**	**5.0**	**2.9**	-0.6	4.4	2.6	2.3	2.0
Core Indexes (% chg, yr/yr)											
CPI	**2.2**	2.6	2.7	**2.1**	**2.5**	**2.8**	2.9	3.0	2.7	2.6	2.4
PCE*	**2.1**	2.3	2.3	**2.0**	**2.2**	**2.4**	2.4	2.5	2.4	2.3	2.1
Unit Labor Costs (% chg, yr/yr)	**2.0**	4.8	2.6	**3.6**	**5.1**	**5.3**	5.1	3.5	2.7	2.2	2.0
LABOR MARKET											
Unemployment Rate (%)	**5.1**	4.6	4.9	**4.7**	**4.7**	**4.7**	4.5	4.7	4.8	5.0	5.1
FINANCIAL SECTOR											
Federal Funds** (%)	**4.16**	5.25	4.00	**4.59**	**5.00**	**5.25**	5.25	5.25	4.75	4.25	4.00
Treasury Yield Curve** (%)											
2-Year Note	**4.40**	4.75	4.30	**4.73**	**5.12**	**4.77**	4.75	4.70	4.30	4.20	4.30
5-Year Note	**4.39**	4.75	4.60	**4.72**	**5.07**	**4.67**	4.75	4.60	4.40	4.40	4.60
10-Year Note	**4.47**	4.75	4.75	**4.72**	**5.11**	**4.72**	4.75	4.50	4.50	4.60	4.75
Profits*** (% chg, yr/yr)	**5.5**	18.9	0.0	**21.0**	**17.4**	22.5	15.0	-3.0	2.0	2.0	0.5
Federal Budget (FY, $ bn)	**-319**	**-248**	-300	–	–	–	–	–	–	–	–
FOREIGN SECTOR											
Current Account (% of GDP)	**-6.4**	-6.7	-6.6	**-6.6**	**-6.6**	-6.8	-6.8	-6.7	-6.6	-6.6	-6.5
Exchange Rates											
Euro ($/€)**	**1.19**	1.29	1.32	**1.20**	**1.27**	**1.27**	1.29	1.30	1.32	1.32	1.32
Yen (¥/$)**	**118**	117	105	**117**	**114**	**117**	117	115	115	110	105

* PCE = Personal consumption expenditures. ** Denotes end of period. *** Profits are after taxes as reported in the national income and product accounts (NIPA), adjusted to remove inventory profits and depreciation distortions.

NOTE: Actual figures are in bold

For more detailed forecasts, please email GSUSEconomicsResearch@ny.email.gs.com.

©2006 The Goldman Sachs Group, Inc. All rights reserved.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of clients of The Goldman Sachs Group, Inc. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice. The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide to future performance. Future returns are not guaranteed, and a loss of original capital may occur. The Goldman Sachs Group, Inc. does not provide tax advice to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment. Certain transactions — including those involving futures, options, and other derivatives as well as non-investment-grade securities — give rise to substantial risk and are not suitable for all investors. This report is based on public information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavor to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so. We and our affiliates, officers, directors, and employees, excluding equity analysts, will from time to time have "long" or "short" positions in, act as principal in, and buy or sell the securities or derivatives (including options and warrants) thereof of companies mentioned herein. For purposes of calculating whether The Goldman Sachs Group, Inc. beneficially owns or controls, including having the right to vote for directors, 1% of more of a class of the common equity security of the subject issuer of a research report, The Goldman Sachs Group, Inc. includes all derivatives that, by their terms, give a right to acquire the common equity security within 60 days through the conversion or exercise of a warrant, option, or other right but does not aggregate accounts managed by Goldman Sachs Asset Management. No part of this material may be (i) copied, photocopied, or duplicated in any form by any means or (ii) redistributed without The Goldman Sachs Group, Inc.'s prior written consent. This material is distributed in the United States by Goldman, Sachs & Co., in Hong Kong by Goldman Sachs (Asia) L.L.C., in India by Goldman Sachs (India) Securities Private Ltd.; in Korea by Goldman Sachs (Asia) L.L.C., Seoul Branch, in Japan by Goldman Sachs Japan Co., Ltd., in Australia by Goldman Sachs JBWere Pty Ltd. (ABN 21 006 797 897), in New Zealand by Goldman Sachs JBWere (NZ) Ltd., and in Singapore by Goldman Sachs (Singapore) Pte. (Company Number: 198602165W). This material has been issued by The Goldman Sachs Group, Inc. and/or one of its affiliates and has been approved for the purposes of section 21 of the Financial Services and Markets Act 2000 by Goldman Sachs International, which is regulated by the Financial Services Authority, in connection with its distribution in the United Kingdom, and by Goldman Sachs Canada, in connection with its distribution in Canada. Goldman Sachs International and its non-US affiliates may, to the extent permitted under applicable law, have acted on or used this research, to the extent that it relates to non-US issuers, prior to or immediately following its publication. Foreign-currency-denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of, or income derived from, the investment. In addition, investors in securities such as ADRs, the values of which are influenced by foreign currencies, effectively assume currency risk. In addition, options involve risk and are not suitable for all investors. Please ensure that you have read and understood the current options disclosure document before entering into any options transactions.

Further information on any of the securities mentioned in this material may be obtained on request, and for this purpose, persons in Italy should contact Goldman Sachs S.I.M. S.p.A. in Milan or its London branch office at 133 Fleet Street; persons in Hong Kong should contact Goldman Sachs (Asia) L.L.C. at 2 Queen's Road Central; persons in Australia should contact Goldman Sachs JBWere Pty Ltd. (ABN 21 006 797 897), and persons in New Zealand should contact Goldman Sachs JBWere (NZ) Ltd. Persons who would be categorized as private customers in the United Kingdom, as such term is defined in the rules of the Financial Services Authority, should read this material in conjunction with the last published reports on the companies mentioned herein and should refer to the risk warnings that have been sent to them by Goldman Sachs International. A copy of these risk warnings is available from the offices of Goldman Sachs International on request. A glossary of certain of the financial terms used in this material is also available on request. Derivatives research is not suitable for private customers. Unless governing law permits otherwise, you must contact a Goldman Sachs entity in your home jurisdiction if you want to use our services in effecting a transaction in the securities mentioned in this material.

Other disclosure information is available at http://www.gs.com/research/hedge.html or from Research Compliance, One New York Plaza, New York, NY 10004.

US Calendar

Focus for the Week Ahead

- October's price indexes will look remarkably like September's given the sharp further declines in energy prices that occurred during that month. In the PPI, we look for additional positive effect on core inflation from reduced auto financing incentives; in the CPI we see only a slight abatement in rental index trends (November 14 and 16).
- Retail sales remained anemic in October despite the decline in gasoline prices. Based on lackluster retailer reports and a setback in vehicle sales, we look for another month of declining retail sales. The estimates shown below have been marked down by 0.2 points relative to our preliminary shot on this report (November 14).
- We find ourselves in the unusual position of being less pessimistic than the consensus on housing starts, but all seem to agree that the decline resumed in October (November 17).
- Industrial production appears to have recovered modestly in October following a sharp setback in September (November 16).
- The Treasury is likely to report a slight deterioration in its budget balance for the first month of fiscal 2007. We now expect a $50-billion deficit, larger than our first ($30-billion) estimate (November 13).

Economic Releases and Other Events

			Estimate		
Date	**Time**	**Indicator**	**GS**	**Consensus**	**Last Report**
Mon Nov 13	**14:00**	**Federal Budget Balance (Oct)**	**-$50.0bn**	**-$49.0bn**	**-$47.4bn**
Tue Nov 14	7:00	GS Econ Derivs Auction for Retail Sales Less Autos			
	8:30	**Producer Price Index (Oct)**	**-0.4%**	**-0.5%**	**-1.3%**
		Ex Food & Energy	**+0.3%**	**-0.1%**	**+0.6%**
	8:30	**Retail Sales (Oct)**	**-0.4%**	**-0.4%**	**-0.4%**
		Ex Autos	**-0.3%**	**-0.2%**	**-0.5%**
	10:00	Business Inventories (Sep)	n.a.	+0.5%	+0.6%
	12:00	Fed Pres Poole spks to CFA Society; Wilmington, DE			
	12:00	Fed Pres Minehan spks to women in real estate; Boston			
	15:45	Fed Pres Yellen spks on community development; Fresno			
Wed Nov 15	8:30	Empire Manufacturing Survey (Nov)	n.a.	15.0	22.9
	8:30	GS Econ Derivs Auction for Crude Oil Inventories			
	14:00	Minutes of Oct. 24 FOMC Meeting			
	15:00	GS Econ Derivs Auction for EIA Nat'l Gas Storage			
Thu Nov 16	7:00	GS Econ Derivs Auction for Initial Jobless Claims			
	8:30	Initial Jobless Claims	n.a.	314,000	308,000
	8:30	**Consumer Price Index (Oct)**	**-0.4%**	**-0.3%**	**-0.5%**
		Ex Food & Energy	**+0.2%**	**+0.2%**	**+0.2%**
		NSA Index	**201.9**	**202.2**	**202.9**
	8:45	Fed Pres Pianalto gives welcome at Fed conf; Cleveland			
	9:00	Treasury TICS data			
	9:10	Fed Pres Kroszner spks at Cato Institute Conf; Wash, DC			
	9:15	**Industrial Production (Oct)**	**+0.3%**	**+0.3%**	**-0.6%**
	9:15	**Capacity Utilization (Oct)**	**82.0**	**82.0**	**81.9**
	9:45	Fed Pres Poole spks at Cato Institute Conf; Wash, DC			
	10:00	Fed Pres Bies spks on Basel II at banking conf; Wash, DC			
	10:00	Fed Pres Moskow spks on economic outlook; Chicago			
	12:00	Philadelphia Fed Survey (Nov)	n.a.	+5.3%	-0.7%
	13:00	Homebuilders' Survey (Nov)	n.a.	30	31
Fri Nov 17	**8:30**	**Housing Starts (Oct)**	**-2.5%**	**-5.4%**	**+5.9%**