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The Aftermath of September 11

Robert Hormats, Vice Chairman, Goldman Sachs (International), discusses the implications of September 11 for the US economy and the outlook for globalization

Historians are likely to describe the 1990s by borrowing a phrase from Federal Reserve Chairman Alan Greenspan: 'irrational exuberance.' They will do so not only because of the dramatic rise in Internet and high technology stocks, but also because of the euphoria and sense of triumphalism that followed America's successes in the Cold War and the Gulf War. With the US the sole remaining superpower and the originator of the booming New Economy, Americans came to feel that nothing could threaten the country's security or prosperity.

For a while it looked as if this exuberance was, in fact, quite rational. The world was moving toward greater use of market forces. Democracy was an increasingly accepted form of political organization in many developing countries. The US was enjoying the longest economic expansion in its history—one that had created millions of new jobs and made a lot of people very rich very quickly. The 'American way' of running an economy and the Silicon Valley style of entrepreneurialism became compelling models abroad. The 'Washington Consensus'—consisting of market- based economic reform, deregulation, privatization and greater openness to global trade and investment—appeared to be gaining traction throughout the world.

Some of this was beginning to change even before September 11. The 'exuberant' technology investment boom had given way to an investment bust. Over-optimism about the durability and vigor of the country's future economic growth had led many US corporations to accumulate too much debt, amass too much inventory and build too much capacity. These imbalances needed to be brought back into line, as did excessive household borrowing and inadequate household savings.

Countries whose economies had been disrupted by the financial crises of 1997-1998, or that felt threatened by imports, had become skeptical about rapidly exposing themselves to the volatility of international financial markets or intensified competition. Some in transition from communism were having difficulty adapting to democracy and free-market systems. The new administration in Washington pulled back from several controversial treaties agreed to by its predecessor, generating criticism from America's friends and allies.

On September 11 the US suddenly looked more vulnerable and the world more fragile. The country now had to fight terrorists abroad and confront unknown numbers of their cells at home. It was struggling to overcome a weak economy, now exacerbated by fears among Americans about their personal security in airplanes, office buildings, malls and public arenas—as well as in simply opening their mail.

In the immediate aftermath of September 11, Americans demonstrated a remarkable sense of national unity and patriotism that cut across racial, ethnic, religious and economic divisions. American society proved robust, its political institutions stable and its market economy resilient. On national-security matters (although not on domestic economic issues), Washington replaced partisan bickering with bipartisan harmony. The administration enlisted many nations from around the world to support US actions in Afghanistan. It also became more supportive of the United Nations and multilateral economic institutions, pursuing the war against terrorism on several military, political and economic fronts. Post-Cold War issues with Russia shrank in significance compared to common interests in fighting terrorism; new cooperative initiatives were launched on intelligence sharing, trade and energy. A similar change occurred in relations with China.

The past few months have seen significant political and economic shifts within the US and abroad. Pearl Harbor and World War II altered in fundamental and enduring ways the relationship between government and society in the US and American attitudes toward the rest of the world. Whether historians will perceive September 11 as a similarly seminal event remains to be seen. Much will depend on what happens in coming months and years. Below are some initial thoughts on the economic and financial implications of September 11—on how long the impact will last and how profound it will be. ■

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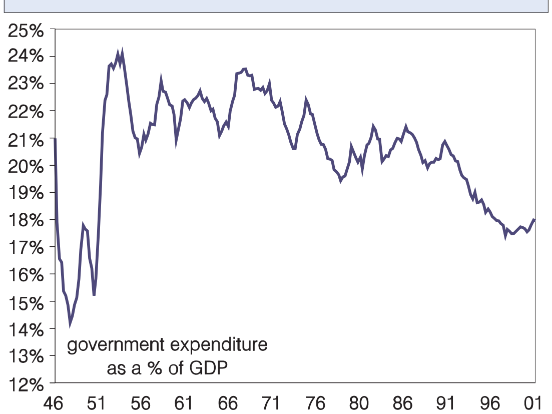
The Domestic Impact
Bigger Government in the US: How Big and for How Long?

For two decades before September 11, the influence of the US government on Americans' lives and economic activities had been declining. Since the Reagan era, government had taken a back seat to the market on grounds of efficiency and compatibility with a more conservative national political philosophy.

In a world where the country did not appear threatened, few Americans saw defense expenditures as a high priority. Fewer still seemed to care that the country's dependence on foreign oil was growing, even as stability in the Middle East seemed ever more precarious. Those who warned of terrorism and urged major programs to avert it were virtually ignored. President Clinton summed up the period by stating that 'the era of big government is over.'

Within a matter of days, all that changed. Big government is back. Americans now look to the government to fight terrorism at home, rout out terrorists abroad and restore strong economic growth. Most Americans now see a more activist federal government, with extensive powers, as vital in the period ahead. If the government spends more, regulates civil liberties more and is more involved in the economy, that is fine with most citizens. In this environment the Enron bankruptcy further increased public acceptance of more vigilant and active government regulation of accounting practices, pension-fund management and financial dealings.

US Government Spending as a Share of GDP



Source: US Department of Commerce.

If the war against terrorism is, in fact, a long one, as US leaders compellingly insist it will be, the government's role will remain large for a long time. And even if the war on terrorism winds down more quickly, restoring fiscal discipline and 'smaller government' will take time.

This shift toward more expansive government has enormous economic implications. In the near term it means more fiscal stimulus than would have been available before September 11—notwithstanding the failure of the Senate to reach agreement on a stimulus package at the end of last year. In the medium term it increases the likelihood of a string of annual budget deficits, and a considerably greater role for government in many parts of the economy.

Interest groups that in recent years have not looked to the government for support—or have not received it if they have—are now lobbying Washington for financial help in the form of new programs, tax breaks, subsidies and favorable regulation. Immediately after September 11, the airline industry received a mix of direct grants and loan guarantees going forward. The property and casualty insurance industry is looking for a provision that would make the government the insurer of last resort for any future terrorist event.

Many requests being made of Washington are essential to national security; others are genuinely stimulative. Some, however, are simply old ideas, old ideologies or old pieces of parochial legislation that proponents have dusted off, relabeled and lobbied for as vital to economic recovery or to the war effort.

Nothing much is new about this; it happens in all wars. The key difference is that in most wars the government only increases spending, and the added spending usually is limited to what is needed during the war. Rarely are taxes reduced in wartime, because the government's need for resources takes precedence over the private sector.

2001 saw both legislation to significantly cut taxes and legislation to substantially increase resources for the military, intelligence and homeland defense. Significant portions of the cuts in the 2001 tax bill are likely to extend well beyond the current period of economic weakness. Nearly 75% of the 2001 tax bill's effects will be felt over the next nine years—most toward the end of that period. Only 25% of the cuts took effect in 2001—mostly via the income-tax rebates.

Early last year the cumulative budget surplus for 2001-2011 was projected to reach \$5.6 trillion; recent projections have lowered that figure to \$1.6 trillion due to last year's tax cuts, the recession, lower capital gains receipts due to the weak stock market, and additional government spending. These factors, plus possible new tax cuts and likely large new spending increases, threaten to further reduce that surplus.

The series of annual multi-billion dollar budget surpluses accumulated in the late 1990s had put the US in excellent fiscal shape, providing the country with the financial resources needed to respond effectively to the terrorist attacks of September 11 and to fight the recession. Unless substantial surpluses can be restored later in the decade, the country's ability to pay for any future war, combat any future recession or meet the enormous financial costs of the tens of millions of Baby Boomer retirements in coming decades will be diminished.

Traditionally, an underlying public aversion to large deficits, coupled with traditional American skepticism toward big government and its often inefficient involvement in the economy, have shifted the political balance back toward smaller government once the financial requirements of fighting a war or a recession receded. Such shifts have generally taken place throughout American history.

Continued on page 3

Bigger Government in the US: How Big and for How Long?

Continued from page 2

But this time the shift back is less likely to occur:

- First, America's security will and ought to remain the nation's top priority. Modern technology and an open society mean that a very few fanatics can wreak enormous human and economic destruction in the US—as we witnessed in September. Afghanistan is just the opening round in the war against terrorism. So far that war has been less expensive than wars the US fought in the last century; the next stages may be much more costly, especially if they involve Iraq. And homeland defense is far from adequate; it too will require a lot more money going forward.
- Second, financial discipline, once lost, will be hard to restore, especially given the close balance between the two political parties in the Congress and the attendant desire of each to reward important constituencies. As each political constituency comes to Washington asking for more federal dollars for its priority project, others feel compelled to do likewise—and once one gets money it is harder to turn down another. Attempting to satisfy a string of parochial interests would impede the effort to restore substantial surpluses.
- Third, even if surpluses can be generated later in this decade, rising Social Security and Medicare costs will impose enormous new financial demands in decades ahead. ■

Slower Growth in Productivity: A New Security Tax?

Although overall US productivity will likely continue to grow as the result of new technologies, more efficient business models and highly skilled workers, productivity increases in some sectors will be restrained by higher security costs:

- Added security for buildings, airports, airplanes, power plants, water facilities, entertainment, sporting events, etc. is expensive.
- Corporations are spending more to hire additional private guards as well as to increase protection and backups for their data, computers and telecommunications.
- Rigorous screening at airports and buildings imposes greater time delays.
- Slowdowns in shipping goods across borders, and the threat of additional terrorist disruptions of supplies, force companies to shift from just-in-time inventory management to holding more 'precautionary' stocks.
- Insurance companies and reinsurers, hit hard by large payouts resulting from September 11, are likely to raise premiums substantially. Part of the burden will fall on households, but a far greater part will fall on businesses, for which property and casualty insurance costs will rise dramatically.

All of these added costs come at a time when businesses find it difficult to pass them along to customers.

Over time, new surveillance and detection technologies will reduce the costs and time delays of many of the new security measures. And if there are no additional acts of terrorism, added security outlays and premiums will decline as well. But serious security threats will remain. We still do not know how many terrorists are out there, what kinds of weapons they have or are prepared to use, and how many of them are willing to sacrifice their lives to kill Americans or citizens of other nations. No one can afford to be complacent. So all of us will have to pay a 'security tax' for years to come.

If there is a brighter side to this otherwise ominous picture, it is that in the highly adaptable US economy, new 'security entrepreneurs' will spring up, new businesses will be established to address these challenges and new security jobs will be created throughout the economy. Tens of thousands of people will need to be recruited and trained to run new screening and surveillance equipment and to expand a seriously inadequate public-health service.

A longer-term threat to US productivity comes from the impact of recent events on states and cities. Recession has led to a sharp drop in state and local sales- and income-tax receipts, along with a sharp increase in welfare and unemployment benefit payments. At the same time, they must pay more for security and emergency preparedness.

Many states and municipalities lack sufficient resources to shoulder the extra burden. Some cut taxes during the 1990s, reducing their revenue bases; several are now forced to cut resources for road and facility maintenance, new infrastructure projects and education. In the long run, these cuts will impose productivity costs. In the short run, they will impede the federal government's efforts at economic stimulus. ■

The International Impact
Globalization: A Temporary Setback?

The attacks of September 11 dealt a setback to globalization. But they by no means crippled it. In fact globalization has passed a daunting set of 'stress tests' in the last few years: the Asian financial crisis, the current synchronized multi-national recession and the shocks of the terrorist attacks in the US.

While suffering a number of hard blows, and much criticism, globalization has proven resilient. There has not been a breakdown of trade cooperation, a global financial crisis or a wholesale retreat by nations to beggar-thy-neighbor policies. Threats to globalization and to the expansion of free-market policies are, however, greater than they have been for a number of years.

Even before September 11, the perception had been growing in some quarters that closer integration with the rest of the world makes a country more vulnerable to events that originate from outside its borders and are therefore beyond its control.

In the US this vulnerability has been evident at an economic level for some time; it was most vividly demonstrated for Americans by the oil shocks in the 1970s. But it was not widely perceived to be true with respect to security issues—until now. For the US, a long-standing 'culture of openness' will have to make room for a newly compelling 'culture of vigilance.'

Financial, trade and immigration links among nations are likely now to be impeded or, perhaps, disrupted by intensified scrutiny, outright barriers or onerous regulatory hurdles with respect to visas and work permits, customs, communications, technology exports and money flows. Many of these measures are necessary to fight the war against terrorism. But they can also impose economic costs, by reducing the level and efficiency of international trade and financial activity as well as the movement of people.

The agreement at Doha last fall to begin a new round of international trade negotiations could provide an important counterweight to any weakening of global economic cooperation. There are also powerful free-trade constituencies that would seek to prevent a breakdown in the process of globalization. The cross-border integration of business, financial markets technology and personnel mobility runs deep:

- Roughly one-third of all international trade is intra-firm trade.
- Multinational corporations and international technology partnerships form rich and intricate outsourcing, production, sales, procurement and distribution networks that criss-cross borders.
- Companies around the world depend on foreign workers and need the freedom to move employees freely from country to country.

All would suffer were there to be extensive new restrictions on cross-border activity.

Economic interests around the world require a rational balance between tighter security on one hand and efficient global commerce and finance on the other. But, in the final analysis, a prolonged war against terrorism will likely mean that there will be numerous instances in which the latter will yield to the former.

Some Boost from September 11

The process of global cooperation also received a boost from the terrorist acts. Most nations now recognize that defeating international networks of terrorist cells embedded throughout Europe, Asia and the Americas requires a multinational solution. Without such a global approach, citizens of all nations are in peril.

Americans have been reminded that terrorism is only one of several interconnected global threats to US security. These include the development of weapons of mass destruction, the potential spread of infectious disease, the narcotics trade, international crime and money laundering. Collective international action—intelligence sharing, coordination among health officials, cooperation among military, legal and police authorities—is needed to deal successfully with all of these threats.

For years Americans had embraced the seductive myth that distance from the world's major trouble spots protected them from harm. Now Americans understand more clearly that their safety is bound up in alliances, coalitions and cooperative arrangements with nations that share similar aims, if not similar forms of government. These nations include former Cold War adversaries and newly emerging regional powers. Several (like Pakistan and Uzbekistan) are countries with which few Americans would have acknowledged common interests on September 10.

An Opportunity to Contribute to History

It remains unclear whether Washington's current 'internationalism of necessity' can be turned into a longer-term 'internationalism of conviction,' especially if there is friction between the US and its allies over the next stage of the war against terrorism, on how to deal with Iraq or on trade and other economic matters.

Unlike most other countries, the US frequently has had the option to engage in selective international cooperation or unilateral action to accomplish its military or political objectives. Although Washington's first choice is usually to mobilize a wide range of countries, there are times when US leaders conclude that this is not in the country's interest or is difficult to engineer. In such circumstances the US tends to reduce the scope of its cooperation to a very few allies or even go it alone. US officials also point out that the 'bandwagon' effect of American military successes is an argument for the US to act unilaterally when it needs to, expecting others to follow when Washington effectively exerts its leadership.

Continued on page 5

Globalization: A Temporary Setback?

Continued from page 4

In the future, if sufficient support abroad cannot be mobilized for the next stage of America's anti-terrorist effort, a go-it-alone option is likely to attract significant domestic support.

On the economic front, however, a go-it-alone option for the US is no longer feasible—and has not been for a number of years. Virtually no American objective in the global economy can be accomplished without a substantial amount of international cooperation. In this respect the current high level of international support for the fight against terrorism affords the US a rare opportunity.

President Truman used the period of close allied cooperation during World War II to build an enduring structure for post-war economic cooperation. He saw this as necessary to secure the peace and to enhance US and global prosperity in the post-war period. President Bush now has the opportunity to make a similar contribution to history. Launching an initiative for enhanced multilateral economic cooperation now could help to strengthen the current coalition and address some of the challenges that had threatened the stability of the global economy prior to September 11.

Step one is to recognize that neither the US alone nor the industrialized democracies together can successfully deal with many of the complex economic challenges now confronting the world. The Doha WTO meeting provided a stark example of why collaboration among industrialized and emerging economies is essential. In the past, a handful of industrialized democracies dominated high-level trade meetings. At Doha, success depended on cooperation with a number of increasingly influential emerging economies—and their role will only grow in the future, especially as China exercises its increasing economic power.

Step two is to reorder key forums to improve international economic cooperation. Since 1975, the Group of 7 and the Group of 8 (including Russia) have served as a kind of 'board of directors' of the global economy. This arrangement was appropriate for the last years of the twentieth century; given the emerging realities of the new century, it has now become too restrictive. The G-8 needs to be expanded to include emerging powers such as China, India and Brazil in a more systematic dialogue on the interaction among political, security and economic issues.

Greater engagement between these nations and key Islamic countries will also be required to better integrate the latter into the world market economy. And more focused coordination with a broader group of developing nations in the World Bank and the IMF is needed to address compelling issues of global poverty and vulnerability to financial volatility.

Step three is to refocus the agenda. A joint initiative among multilateral economic institutions, developing-nation governments and the private sector to encourage a more fertile environment for entrepreneurialism and investor-friendly legal and economic reforms could lead to more dynamic growth and sounder flows of long-term capital. That effort would be enhanced by an agreement to reduce pressure on emerging nations to open their economies to flows of short-term capital, in favor of greater attention to strengthening their domestic financial institutions and corporate governance.

Technical cooperation to strengthen social safety nets is needed in virtually all emerging nations to provide a cushion against financial turbulence. And a global initiative to supply very low-income nations with the resources and technology to expand health and education services would go a long way toward overcoming desperate conditions there.

While the old Washington Consensus may be a bit tarnished, its pro-free market, pro-globalization principles remain valid and have been key to the success of many nations. These need to remain prominent items on any global growth and anti-poverty agenda. Although countries may differ on the sequencing and speed of reforms based on these principles, no country has succeeded without adopting some version of them. ■

The International Impact
New Focus on Islam: How Long? How Effective?

Given the focus of the US and other Western countries on defeating terrorism, there also is likely to be a broader security, political and economic dialogue with key Middle Eastern nations. On the economic front, there is likely to be greater emphasis on encouraging expanding economic opportunity and broader political participation in many parts of the Islamic world.

Significant economic and social progress in the Middle East and in the broader Islamic world could help to sustain longer-term stability within such nations, foster broader political and economic ties with Western democracies and eradicate conditions that could breed terrorists.

Genuine economic reform is profoundly secular in nature. It involves not simply providing additional foreign aid or increased trade opportunities, although both are needed, especially for low-income countries, but also more market-oriented economic decision-making. It will entail finding ways to allow religion and secularism to coexist—to integrate devotion to Islam with a greater role for secular authorities and activities in education, law and business.

Such changes cannot be imposed by the US or any outside power. First, deep suspicion and resentment of the US exists in many Islamic nations. Second, pressure from other Western nations is also likely to meet with resistance. In Turkey, for instance, secular reforms were the result of nationalist forces, not foreign ones.

International aid and technical support can be critical in Afghanistan and its low-income neighbors. It is vital to fight poverty and to deny terrorists fertile ground for establishing training bases or obtaining recruits. Moreover, US credibility would suffer badly if, having abandoned Afghanistan a decade ago, it reneged on its commitments this time. But outside assistance will be effective in the long run only if it can induce or complement local economic reforms, improve the environment for homegrown entrepreneurs and strengthen the forces of modernization (for example by providing support for education in economically useful subjects).

In many ways the outcome of future reform efforts will depend on the result of a struggle between moderate and radical forces in the Islamic world. To the extent that the West can help, it will be less through high-level pressure for economic reform and more through persuading leaders that broadening participation in their economic and political systems can help to stabilize their societies and regimes, rather than weaken them.

Few local leaders will want to risk dramatic reforms right away. Progress can be advanced by promoting a series of international exchanges of views and experiences on sound practices among groups of reform-oriented, middle-level officials within Islamic nations themselves. Separate sets of exchanges could be organized among, for example, school administrators, public-health experts, judicial authorities, etc. A similar dialogue could be carried on between these officials and experts from outside the region with hands-on experience in implementing market-oriented policies. In this way, leaders and officials can better understand the actual mechanics of implementing reforms and the practical effects of what they are about to embark on.

Often, national leaders who support reform will want to be seen by their citizens to be acting on their own, rather than bending to external pressure. But at the same time they will want to draw on foreign experience to improve their nations' practices.

China has embraced the concept of 'Socialism with Chinese characteristics'—its term for market reform. The West should recognize that, to the extent that governments in the Islamic world do seek to modernize their economies, they might pursue 'market reforms with Islamic characteristics.'

A recent example of how domestic and foreign interests can be balanced comes from Russia—for years itself a closed economy with a secretive decision-making process. As part of the country's reforms, the Russian Federal Securities Commission took what was an unprecedented step for that country. Before putting into place a new Corporate Governance Code, it invited comments from private-sector and foreign experts on what would constitute good international practice.

This kind of procedure would be a useful start in the Islamic world as countries seek to modernize their legal codes, regulations and corporate business practices—combining locally driven policy initiatives with their desire to draw on private-sector and foreign expertise.

US policies toward the Islamic world will have to factor in a range of diverse economic models and practices. Washington can point out the powerful successes of free markets and the enormous benefits of expanding opportunities for participation in the economy through wider access to secular education and greater scope for local investors and entrepreneurs. However, the pace and nature of reform among these countries is likely to differ considerably from one to another. The legitimacy and viability of domestic institutions and practices will, in the final analysis, depend on their having strong domestic roots—something reforms imposed from abroad rarely possess.

Ultimately, a genuine recognition of shared interests in a dialogue on economic modernization—as an integral part of broader security and political cooperation—will be necessary if there is to be reasonable hope for a better future in this region. ■

Combating the Anti-Globalization Trend: How Will the Private Sector Be Affected?

Emerging countries are becoming increasingly powerful actors on international security matters and are becoming more important to the West in the war against terrorism. As they do, they are likely to expect greater attention to be paid by Western nations to their particular economic requirements and to demonstrate greater muscle in their relations with foreign businesses.

In contrast to international trade and financial flows, which exert centripetal forces pulling nations together, a stronger desire to assert individual political, economic and cultural interests—and resistance to the notion that opening their economies rapidly to foreign money and goods is an unambiguous good—might create centrifugal forces that can push them apart.

Globalization and modernization have an impressive record of boosting growth and living standards. But they are often blamed for increasing inequality and poverty. There is substantial evidence that, far from being caused by globalization, these problems are often more directly the result of government policies that deny many of their people the benefits of globalization, participation in open markets or the opportunity to exercise personal initiative.

Focus on this divisive issue frequently directs attention away from finding real answers to the problems of poverty, income inequality and vulnerability to disruptions from shifts in global trade and financial flows. These issues pose enormous problems to hundreds of millions of people around the world. Failure to address them is a recipe for social and political instability. Terrorism, infectious disease, narcotics trade and other global threats can flourish in such an environment.

Growing numbers of people in low-income countries can see the benefits of prosperity abroad or in other parts of their own countries on television and in the movies, but lack the needed skills to achieve them—or are held back by repressive or ill-conceived government policies. Where large groups of low-income people do not benefit from globalization or modernization, are injured by it or feel left behind, frustration can become intense.

Frustrations can run deep even in higher-income countries, such as Argentina, if the middle classes for a time enjoy increased prosperity and then see it collapse. This can lead to intense populism. It can also breed resentment of local business and government leaders who are affiliated with foreign companies or externally induced reforms. And it can fuel resentment of American and other multinational corporations.

For multinational corporations, and for the major industrialized democracies, the challenge is to demonstrate that globalization and foreign investment can not only produce growth but can also address issues of social justice. There is much evidence that this is true, but many in the industrialized and developing worlds remain unconvinced.

Making the case for globalization cannot be left to governments alone. The response to the anti-globalization movement requires business leaders to explain and visibly demonstrate how companies' environmental, hiring, worker-relations and investment policies provide benefits to countries in which they do business.

It also means demonstrating how they can integrate the efficiency benefits of international markets, supply chains, technologies and flows of people with a stronger recognition of local identities, traditions and influences. Even that great driver of global economic integration, the Internet—once seen as an American technology, dominated by the English language—is now experiencing, around the world, demands for increased local content and use of local languages.

Corporations also will have to proactively address potentially negative reactions to their global activities by maintaining personnel policies that promote and reward more local employees, as well as by greater identification with local cultures and local values, and by product differentiation to suit local tastes. Globalization does not mean homogeneity. Companies that adapt to local markets, cultural requirements and values have demonstrated that they are likely to encounter less local resistance to them and to their products. ■