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Next Month:
An Interview with European Competition Commissioner Mario Monti

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Enhancing Financial Transparency

Concerns about data quality have harmed confidence in US business leaders and raised investors' risk aversion. Commentators often fail to distinguish between the sources of accounting confusion, compounding the loss of confidence. Abby Joseph Cohen addressed a symposium hosted by the Federal Deposit Insurance Corporation in June 2002 on the topic of 'Enhancing Financial Transparency.' The following is a synopsis of her remarks

Dissecting the Accounting Issues: A Four-Part Taxonomy

Unpleasant revelations by some US corporations have called considerable attention to a variety of accounting issues. Previously viewed as 'technicalities,' accounting details have now become the stuff of newspaper headlines. These are of consequence to all users of financial statements: equity investors, fixed-income investors, bankers, credit rating agencies and others. To shed light, rather than heat, on the subject of financial transparency, we must first identify the problems and distinguish among them. There are four broad areas of attention: fraud; 'Spin City'; 'Cliff's Notes'; and changing 'Rules of the Road.'

Fraud. This is the most clear-cut and least common of the categories. Violators should be prosecuted to the fullest extent of the law. Their activities harm not only their own enterprises, but also the smooth functioning of the overall economy and financial marketplace.

'Spin City.' Some companies have opted to provide their own, typically favorable, 'spin' to quarterly reports, often through the use of pro forma earnings comments that are released prior to audited financial statements. In extreme cases, these pro forma results can be characterized as 'earnings before all the bad stuff.' Income statement information is sometimes released without the accompanying balance sheet data.

Unfortunately, pro forma earnings are frequently inconsistent with US GAAP accounting. And, because companies develop their pro forma data without standard guidelines, there is little comparability between industries or within industries. Yet many users of financial statements have increasingly focused on pro forma earnings, and stock price movements have shown stronger correlation to these data than to US GAAP results.

Financial statement users have emphasized speedy access to information, not the ultimate accuracy of

that information. Data vendors have also opted for speed over accuracy and have typically rushed to post results, regardless of consistency with GAAP. This has also been the case for many publications and the financial news media, which have sometimes prepared commentary on corporate results well before complete and audited data were released.

'Cliff's Notes.' Some financial statement users have taken unfortunate shortcuts. The increased reliance on pro forma announcements is indicative of the desire of some to cut easily through the thicket of detailed reports, and to do so without intense effort. The presumption has been that company managements were providing a shorthand guide to the company accounts, not offering a misleading view of company results. For many companies, this is indeed the case. Even so, financial statement users often overlook the depth and breadth of available information.

By digging through 10Qs, 10Ks, footnotes and the like, it is possible to construct far more accurate views of corporate performance and position than are typically available. But the 'Cliff's Notes' approach suggests that many users of financial statements have not had either the time, ability or inclination to do so. This has also afflicted the quality of data in several computerized databases of company data.

'Rules of the Road.' Some of the current confusion on corporate data is directly linked to desirable changes in accounting standards. For example, the implementation of FAS 141 and FAS 142, both helpful new guidelines, has led to data discontinuities. These discontinuities have been a source of confusion to many, and have led some data vendors to engage in their own attempts to smooth the data between time periods.

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Enhancing Financial Transparency

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Adjustments and charges precipitated by new guidelines can have a notable, negative, effect on reported results for the period in which the change is made. Even so, the charges reflect on **prior** overstatements and suggest that the **previously** reported earnings were of questionable quality. The arithmetic brunt of these adjustments is borne in a subsequent period during which the data quality may be quite high and in which reported earnings understate reality.

Six Recommended Steps

1. Allow the FASB to Do Its Job. Those who are knowledgeable, such as the FASB members and staff, should formulate the details. This is not an area for political interference or non-experts, and the due process of the FASB provides opportunities for input from financial statement providers and users. No accounting system will ever be 'perfect.' But even if US GAAP was perfect yesterday, the fluid nature of our economy and corporate sector suggests that accounting standards must evolve over time. A silver lining to the dark cloud now over the markets is that the accounting authorities currently enjoy much support and are benefiting from a popular tailwind.

2. Eliminate the 'Tower of Babel' on Earnings Per Share. Companies need clear guidance on the proper way to define earnings, and financial statement users should not need to develop their own preferred approaches. Data vendors often disagree with one another on accounting treatment of already-reported results; just imagine the confusion on this year's earnings. In some cases, data vendors remove estimates from the sample that notably deviate from the mean, even if the 'deviants' are the ones using the cleanest accounting assumptions. We had that distinction a few months ago when the Goldman Sachs' estimate for S&P 500 EPS was several dollars below the mean.

Standard & Poor's recently introduced a conceptual framework that provides guidance on 'core earnings.' This is a commendable first step, aimed at offering a uniform approach. Goldman Sachs was

pleased to participate in this project, and we note that many of the suggestions made by Gabrielle Napolitano, based on her long experience working with these data, were incorporated in the S&P proposal. But several questions remain. First, reasonable people may differ on some of the specifics in the S&P plan. Second, and quite importantly, it is not clear how this new framework will be implemented. Standard & Poor's is an unlikely 'data cop' and has no regulatory responsibility. There is no legal requirement that companies comply with the particulars of the recommendations, nor is there a clear timetable. Perhaps this brings us back to the first recommendation, that is, to allow the FASB to do its job in a timely manner.

3. Let the SEC Do Its Job. For decades, the SEC has been responsible for regulating the US financial markets. Given recent events, perhaps it should be dubbed the 'Department of Homeland Securities.' In any event, the increased demands on this agency were not fully reflected in the original budget proposals introduced by the President, and this has now been somewhat addressed. The SEC has already stepped up its investigation and enforcement actions, which have approximately doubled over the comparable period a year ago. The SEC may also play an important new role in regulating the auditing profession.

In addition to moving on cases of fraud, the SEC has thrown down the gauntlet on the improper use of pro forma earnings announcements. In a well-publicized case last December, the SEC made clear that pro forma earnings that are not consistent with GAAP should not be released.

4. Consider Elements of International Accounting Standards. We should consider improvements in the US accounting system, perhaps borrowing from best practices available elsewhere. Increasingly global capital markets require increasingly global accounting standards. Some of the current discussion centers on the relative benefits of a principles-based system, rather than the rules-based approach that is more typical in the US.

Several accounting topics have attracted much attention and cynicism. These include accounting for employee stock options, pensions and consolidation. Goldman Sachs has published reports reviewing these accounting standards and offering detailed analysis based on company data for each of these. Improvements to the guidelines may be in order, but let me stress that we were able to prepare these analyses because there **are** accounting guidelines already in place; this is **not** the case in most other nations. Indeed, there are few international accounting standards yet established in any of these categories. It may be reasonable to conclude that US GAAP is a good system, and recent problems are more closely linked to implementation failures, rather than design.

5. Self-Compliance by Financial Statement Providers. Many companies have moved quickly to clean their accounting slates. The combination of adverse public attention, the pressures of economic recession and the end of the long-lasting expansion have created an environment in which companies seem anxious to adopt more conservative approaches to their accounts. Self-compliance in this form is ultimately more effective than external data cops and is more consistent with our market-based economy.

Massive accounting adjustments have already been taken in recent quarters, and we believe that this process is nearing its end. The first quarter of 2002 may have been the high-water mark of such adjustments. Charges have been equivalent to 30% to 40% of reported earnings, similar to the ratio in the early 1990s, a period of notable corporate restructuring and recovery from recession.

6. Increased Discipline by Financial Statement Users. Finally, we believe that chastened users of financial statements will show increased discipline. As noted earlier, these users could have dug more deeply into company reports for information on employee stock options, pension assumptions and off-balance sheet items, but many did not.

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Bubble Trouble

Bill Dudley, our chief US economist, sees a prolonged aftermath to the bursting of the equity-market bubble

We are becoming more pessimistic about the economic outlook. This reflects mainly the weakness of the US equity market. I am not arguing that the equity market is forecasting a bad economic outcome—I don't buy the idea that the stock market is prescient. As Paul Samuelson once noted, stock market declines have predicted nine out of the past five recessions. If the stock market could foresee the future, then how does one explain the Nasdaq reaching 5000 in the first place?

Instead, the equity market decline worries me because it is unprecedented. Never in the post-World War II period has the stock market been this weak during this stage of the business cycle. In fact, in the 12-month period from six months prior to six months following the end of recession, the worst previous post-WW II performance was up 20%. Compare that with the 18% decline in the S&P 500 in the 12 months ending June. Only 38 percentage points less than the previous poorest outcome!

The magnitude of this shortfall confirms that the deflating bubble was big, not small. It also implies that the impact of the bubble's demise is likely to be more powerful than is generally anticipated.

When a bubble is being created, most of the ripple effects are favorable, and these effects act to sustain and extend the boom. The investment boom drives up profits. The boom encourages the inflow of foreign capital, which drives up the value of the dollar and helps to dampen inflationary pressures. The stock market rise generates capital gains and options-related income, boosting tax revenue and improving the budgetary outlook.

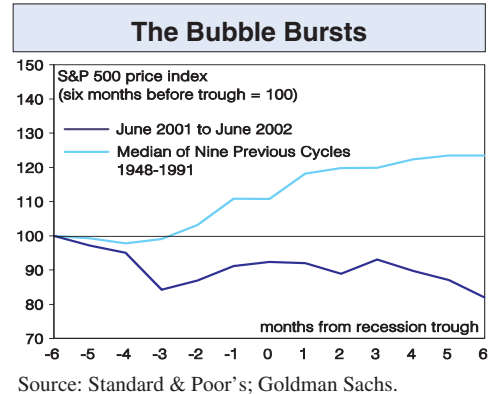
Further information on the topics in this report is available on the GS Financial Workbenchsm. For access, please go to www.gs.com/ceoconfidential

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When the bubble bursts, all of these forces move in the opposite direction. The weakness of the equity market hurts confidence and spending, reduces the demand of foreign investors for dollar-denominated assets, thereby weakening the currency, cuts tax revenue and so on. The downward dynamic becomes self-reinforcing, just as the upward dynamic created the original overshoot in investment and expectations.

Might we already be at the end of these bubble dynamics? I doubt it. That is because it takes a long time for all the negative consequences associated with the bubble's demise to become fully apparent. Consider three brief illustrations:

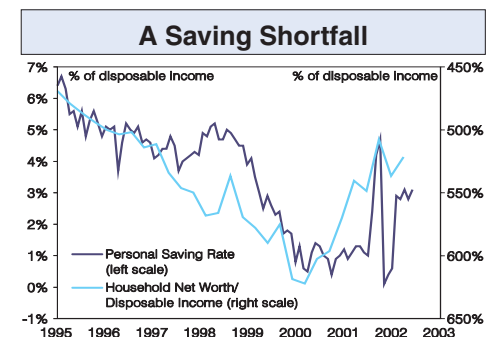
- **Budgetary restraint.** The stock market decline has resulted in tax revenue shortfalls that only now—more than two years after the stock market peaked—are forcing state governments to cut spending and raise taxes.
- **Household saving.** Despite the big stock market decline, the household saving rate has risen only slightly. Surely a greater rise is likely as investors' expectations of future asset returns are gradually forced lower. If one assumes that sustainable equity market returns are roughly 7% a year (5% earning growth plus 2% dividends and share buybacks), this implies an equilibrium household saving rate of at least 8% (5 percentage points higher than it is currently.) To get there, consumer spending will have to rise more slowly than income, dampening income growth and the momentum of the economic recovery.
- **Deleveraging.** As the stock market declines and we find that the 'true' level of earnings is lower than originally reported, it becomes apparent that many US corporations are too leveraged. This leads to forced asset sales, equity issuance and cutbacks in capital spending. Net equity issuance has again turned positive. The supply of equities is now increasing just as demand is falling. In contrast, during the boom, demand

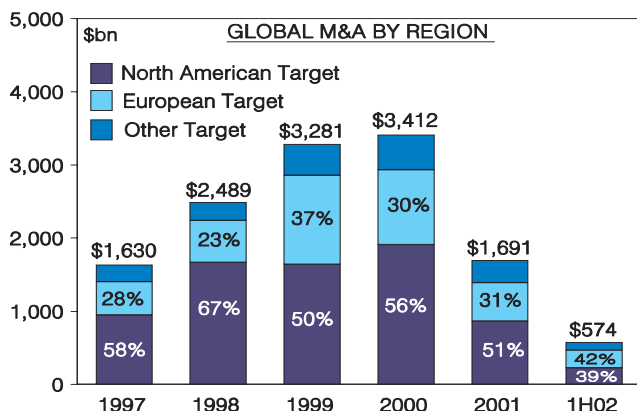


was high and supply was shrinking due to aggressive share buybacks.

The consequences also take time to play out because expectations adjust slowly. The nearly 20-year bull market in US financial assets was the greatest in US economic history. Is it any wonder that many investors still anticipate outside returns, not fully recognizing that returns over that period were boosted by the one-time transition from the horrible economy of 1982 to the great economy at the end of the 1990s? The equity risk premium has shrunk. That implies lower, not higher returns in the future.

This does not mean that the US economy must descend back into a recession. After all, massive fiscal stimulus and lean and falling inventories mean the economy does have important sources of support. But it does suggest that subpar growth, low interest rates and financial asset returns are likely to be the watchword until the bubble dynamics play themselves out. ■





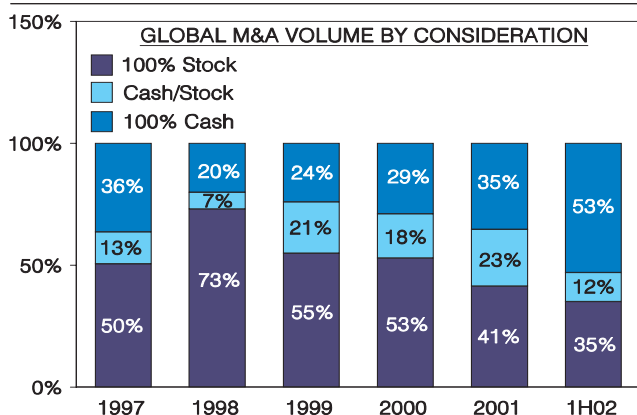
European M&A: A Growing Share of the Global M&A Pie

- Second quarter global M&A activity picked up significantly in 2002, outpacing first quarter volume by 28%. The first half of 2002 has seen \$574 billion of announced merger volume.
- While overall M&A volume is down by 35% year-to-date, European merger volume has been relatively steady. As a result, European activity, which exceeds North American M&A for the first time, accounts for 42% of announced activity in 2002. Five of the ten largest deals announced this year involve a European target.



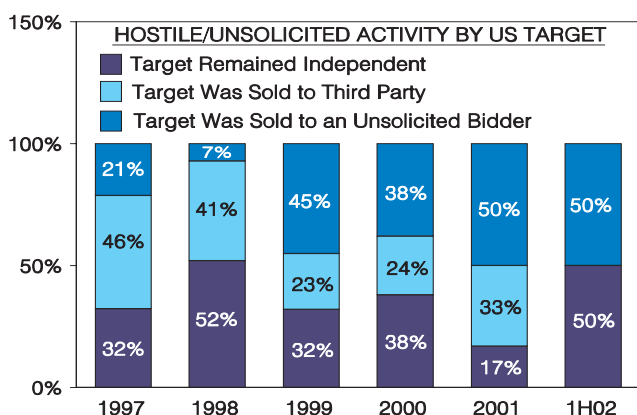
Cross Border M&A: A Sluggish First Half

- So far this year, cross-border activity has reached \$190 billion, or one-third of total merger volume. While slower, cross-border activity continues to be driven by privatization, deregulation and consolidation.
- Two of the ten largest transactions announced in 2002 year-to-date are cross-border transactions: Telia / Sonera (\$8.9 billion), and RWE / Innogy (\$7.4 billion).



Global M&A By Consideration: Cash is Still King

- In 2001 and 2002 year-to-date, there has been a general shift towards cash consideration, with all-cash deals accounting for approximately 60% of billion-dollar transactions and 53% of deal volume this year.
- In general, type of consideration is largely dependent on the size of deal. Mega-deals over \$10 billion have tended to be stock deals; the recent prevalence of smaller transactions has led to an increase in cash consideration.



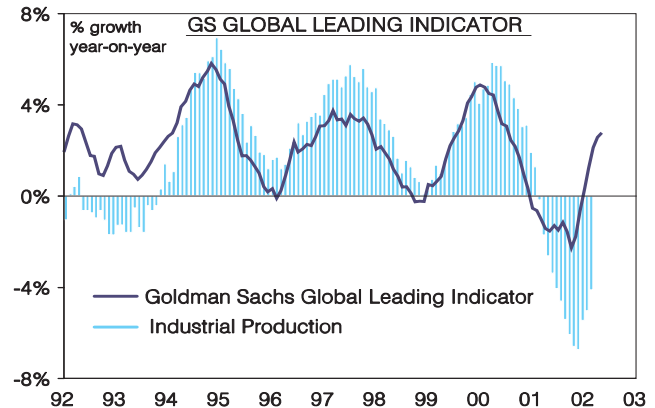
Hostile/Unsolicited Activity Maintains a Steady Trend

- On average, over the past five years, 30% of targets of unsolicited or hostile initiatives have remained independent. From 1997 to 2001, US companies have been sold to unsolicited bidders an average of only 30% of the time, compared to 45% for non-US companies.
- US companies have remained independent in 36% of unsolicited or hostile situations from 1997 through the first half of 2002. This independence ratio is significantly higher than that of non-US companies, who on average, remained independent only 26% of the time.

Source: Thomson Financial Securities Data; Goldman Sachs.

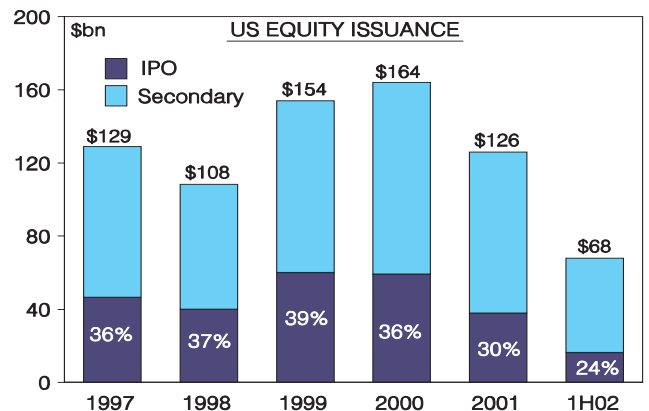
GS GLI Suggests A Continued Global Economic Recovery

- Since its initial release in April, the Goldman Sachs Global Leading Indicator (GLI), which is designed to signal the risks of a double dip in the global economic cycle, has continued to show solid improvement.
- According to the most up-to-date data, the latest reading for June was 3.2% year-on-year growth, up from 2.9% in May. This indicates a robust pickup in OECD industrial production on a two-to-three month horizon.



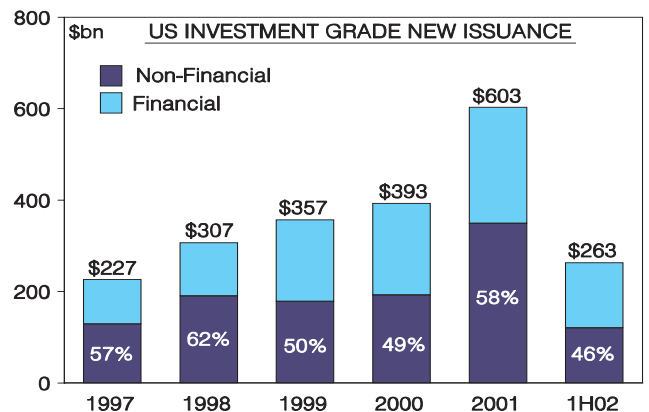
US Equity Issuance Remains Flat

- Year-to-date equity issuance is flat compared with the same period in 2001. Over three-quarters of 2002 year-to-date equity issuance has been secondary issuance, driven in large part by overnights and block trades.
- While still two of the top five contributors to volume, technology and telecom issuance have continued to drop significantly from peak activity in 1999 and 2000. The financial services, real estate, and retail sectors have seen the most growth over the past twelve months.



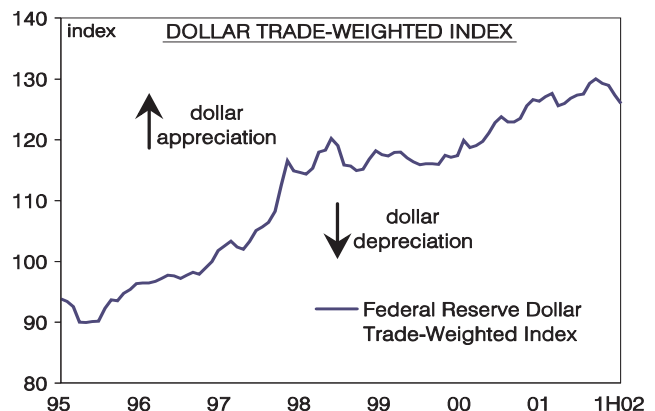
US Investment Grade Issuance Continues Its Healthy Pace

- At \$263 billion, 2002 year-to-date investment grade issuance volume will most likely outpace average issuance over the last five years.
- While Treasury yields have increased since December, corporate yields have remained low. As a result, year-to-date issuance has been healthy as companies seek to reduce reliance on commercial paper and take advantage of attractive funding levels.



Is This the Start of the Dollar's Fall Back to Earth?

- We have revised our forecasts to reflect the fact that the dollar has finally started to behave as fundamentals suggest. Our new 3-, 6- and 12-month forecasts are 1.03, 1.08, 1.12 for EUR/\$, and 118, 115, 115 for \$/Yen.
- The dollar remains significantly overvalued against European currencies and modestly overvalued against other important currencies. On a trade-weighted basis, we estimate the dollar now to be overvalued by 14%.



Source: Thomson Financial Securities Data; US Federal Reserve Board; Goldman Sachs.

THE GLOBAL ECONOMY

	Outlook	Key Issues
United States	Although US growth is slowing sharply, a double dip—which we define as a return to recession—does not appear likely for several reasons: 1) growth is still positive; 2) fiscal policy is stimulative; 3) Fed officials can ease further if needed; and 4) lower inflation and interest rates help to insure against a return to recession. A double dip would require some further shock to the economy, such as an oil price shock or further terrorist attacks.	A moderate US recovery will not provide a sufficient return on capital to attract the capital inflows necessary to sustain the dollar's current value. Recent comments by President Bush imply that the US administration is reconsidering its so-called 'strong dollar' policy. A weaker dollar will favor Euroland government bonds relative to Treasuries, lead to a steeper US curve versus core Europe, and lessen the risk premium on US corporate bonds.
Japan	Although the deflationary trend continues, the pace of price declines remains extremely stable. Stable deflation (of around -1%) is not uniformly negative for the economy, as it increases consumers' real purchasing power. At the same time, the decline in price sensitivity could become a constraint for the BOJ given that the stated condition for terminating quantitative easing is positive growth in core CPI.	Although the chances are remote, a US double dip will hurt Japanese production and corporate earnings over the next two years. In the second year in particular, a global economic slowdown of -1% would lower production by -0.5% and corporate earnings by -1%, and yen appreciation of 10% would lower production by -1.7% and corporate earnings by -2.4%.
Europe	Leading indicators point to rapid growth in Euroland economic activity in the next few months. We forecast real GDP to grow 1.5%-2% in the second quarter and 3% in the third quarter of this year. The stronger euro has largely removed the need for further tightening and we now expect the ECB to raise rates by only 25bp during the first half of 2003 rather than the 50bp we previously expected.	We expect a 5% rise in the trade-weighted euro over the next year. This rise will not significantly affect 2002 GDP growth, but the downside risks in 2003 have increased. GDP growth would be curbed by around 0.7% in 2003 and inflation would be 0.6% lower, helping to explain why our forecasts are below consensus. This should limit the upside for Euroland rates to around 4% over the next year.
Non-Japan Asia	Taiwan's June export data show continued growth, indicating a sustained recovery. Asia is still ahead in terms of external demand, with US shipments continuing to rise while exports to Europe are still slipping. In China, fears of massive further competitiveness gains under dollar weakening are overstated, but still provide ample reason for China to adopt greater exchange rate flexibility.	Comparing the current situation with the Plaza Accord era, we believe that a weaker dollar should not pose a significant threat to Asia. A trend reversal in the dollar does not imply a relapse in the global economy. As long as global recovery continues, Asian exports should continue to do well; growth in the global economy has a greater impact than the exchange rate on Asian exports.
Latin America	Continued deposit outflows, political uncertainty and failure to secure an agreement with the IMF have continued to plague Argentina. The government still lacks a consistent program to restore confidence, improve fiscal solvency, and stop the run on banks. We believe negotiations with the IMF will remain tough, and are likely to be protracted, possibly going beyond President Duhalde's term.	Brazil is likely to avoid a payments crisis, but markets will remain volatile ahead of the fall presidential elections. Worries about the quality of economic policies under a government of the opposition candidate have led to a drop in FDI and debt inflows. The next government will have to pursue strong fiscal adjustment and reforms to reconcile higher growth with price stability and debt sustainability.
Transition Economies	Inflation is likely to stay low in Poland, implying a potential for further cuts in short rates and further yield convergence. In South Africa, we expect any negative impacts from a potential double dip to be limited given the tighter monetary policy already in place, the continued prudence in fiscal policy, little need for external financing from the market and the healthier state of the current account.	Given a moderate global recovery, the reasonably solid fundamentals in the region should make several of the region's assets attractive again once market jitters subside. Five key global risks to the region include: a global double dip; a default on Brazilian debt; an escalation in the Middle East crisis; a dollar that continues to weaken; and a serious obstacle in the EU enlargement process.

KEY FORECASTS

	GDP (%)	Consumer Prices (%)	3M Rate Forecasts* (%)	Bond Yields** (%)	Exchange Rate Forecasts	Equity Market		
						Index	Current***	12m Target
US	2002: 2.5 2003: 2.8	2002: 1.6 2003: 1.9	3m: 2.0 12m: 2.1	Current: 4.7 12m: 4.9	-- --	S&P 500	927	1350
Japan	2002: (0.6) 2003: 0.9	2002: (1.0) 2003: (0.5)	3m: 0.1 12m: 0.1	Current: 1.3 12m: 1.7	3m \$/Yen: 118 12m \$/Yen: 115	Topix	1017	1200
Euroland	2002: 1.0 2003: 2.4	2002: 2.2 2003: 1.5	3m: 3.5 12m: 3.9	Current: 5.0 12m: 5.2	3m EUR/\$: 1.03 12m EUR/\$: 1.12	Dax CAC40	4908 3746	5200 4600
UK	2002: 1.8 2003: 3.1	2002: 2.0 2003: 2.4	3m: 4.4 12m: 5.4	Current: 5.1 12m: 5.1	3m GBP/\$: 1.56 12m GBP/\$: 1.58	FTSE 100	4230	5500
Non-Japan Asia	2002: 6.2 2003: 6.5	2002: 0.9 2003: 1.9	3m: 4.9 12m: 5.0	Current: 7.4	3m \$/KRW: 1150 12m \$/KRW: 1100	KOSPI	722	1100
Latin America	2002: (0.4) 2003: 2.9	2002: 10.9 2003: 14.4	3m: 8.5 12m: 9.1	Current: 9.5 12m: 10.1	3m \$/MXN: 9.60 12m \$/MXN: 9.80	Mexico IPC BOVESPA	6390 10806	9400 13500
Central and Eastern Europe	2002: 2.7 2003: 3.8	2002: 8.0 2003: 8.0	3m: 8.0 12m: 7.5	Current: 8.5 12m: 7.5	3m EUR/PLN: 4.20 12m EUR/PLN: 4.23	-- --	-- --	-- --

* 3-Month Rates: Euroland: average of Germany and France; Non-Japan Asia: Korea; Latin America: Mexico; Emerging Central Europe: Poland.
 ** Bond Yields: US: 10-year Treasury note; Japan: 10-year JGB; Euroland: average of Germany 10-year Bund and France 10-year OAT; UK: 10-year Gilt; Non-Japan Asia: Korea 5-year sovereign; Latin America: Mexico 5-year sovereign; Emerging Central Europe: Poland 5-year sovereign.
 *** Equity-market close as of 11 July 2002.

Roundtable: The Outlook for the Euro

Continued from page 8

MD: We must be very careful, because if we have countries flatly disregarding the pact, that could destroy the credibility of the euro and the whole monetary union project. But yes, flexibility based on the sounder criteria of a cyclically adjusted deficit can be helpful, as long as the credibility of the euro is not impaired.

AB: A more active fiscal policy, without any efforts on the structural issues, might very easily lead to a recurrence of inflation which would be destructive to the euro and to European cohesion. The euro has had such a successful—or rather uneventful—initial three years because there have not been major policy disagreements nor any major public opinion against a monetary union. Any serious episode of inflation might change this and draw us into some very serious problems.

PS: Within the eurozone, the different domestic policies pursued by different governments have had widely differing consequences in terms of stimulating productivity and growth. The startling success of some countries operating within the bounds of the pact underscores the fact that the real problem is restructuring in France, Germany and Italy.

I would also note that the accession or otherwise of the UK is important to the development of the correct policy mix needed within the eurozone. It's extremely

important for the development of the European economy as a whole that Britain be in the eurozone, not least because some policies which would be certainly advocated by the UK are likely to drive structural reform forward. I have no doubt that the EU's economic policy would be strengthened by Britain's accession to EMU, and I think it's equally true that Britain outside the eurozone acts as an inhibition to the sort of changes we need.

AB: I strongly agree. When I was a central banker, Britain was still very much part of the project, and their contribution was always one of the most positive, enlightened, market-orientated and influential. Not having Britain at the table during the discussions is extremely damaging for the rest of Europe. I also think it is not good for Britain, because the British are losing an opportunity to influence the progress of Europe which will have an enormous impact on them.

JON: Do you agree that some accession countries should be encouraged to join EMU at the same time that they join the EU, in part because their productivity rates are higher than those of France, Germany and Italy?

PS: One or two may be able to live within the disciplines that have been agreed, but I view the whole accession process as being a huge challenge in itself, without adding on the problems that would stem from immediate accession to EMU.

AB: This is probably one of the most difficult questions we will have to deal with. When you join the euro you have a much stronger macroeconomic discipline, and that is extremely positive for all countries, but you also gain an extraordinary increase in credibility. With this you can go too far and generate excessive spending, and you risk embarking on a consumption spree that hurts productivity growth and generates long-term imbalances.

MD: The new entrants must be confident that they can be robust trading partners with the rest of the euro group. Argentina provides a tragic example of a country paying the price of excessive monetary rigidity. In Europe, we would collectively pay the price of such a mistake. ■

Financial Transparency

Continued from page 2

In coming quarters, corporations are likely to make their statements easier to parse, and users are likely to spend more time checking the details. Pro forma results are expected to fade in importance as users of financial data insist on using audited, final results rather than preliminary peeks at selected data items. Data vendors should also become more finicky with their sources. Publishing poor data quickly is not a worthy goal. ■

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Roundtable: The Outlook for the Euro

Four former policymakers in Europe and the US debate the prospects for the euro and for European structural reform

Jim O'Neill: Is the euro's recent strength the start of something more substantial in the world's foreign exchange markets?

Gerald Corrigan: It does seem that some adjustment in the euro/dollar rate was inevitable, but I do not think we are on the verge of a sea change. I think we have a bit of a tug of war now. On one side, the US external deficits will probably get larger, even if we have a reasonably balanced global economic recovery. Against this, perhaps the most important reason why the dollar has been so strong for so long is the underlying character of the US economy, which has been a natural outlet for foreign investors. The US economy simply has outperformed all others for a fairly long period. The extent of that relative outperformance probably is narrowing, but I still think the comparative US economic fundamentals are quite strong.

Peter Sutherland: I agree that the euro's current strength is a reflection on the US rather than a positive assessment of the European prospects. I think the real issue in Europe has always been the perception of the market related to governments'

capacity to reform and provide a sufficiently unambiguous signal of a commitment to take the structural steps on mainland Europe that are required to give the sense of confidence.

Mario Draghi: I expect the euro to strengthen, largely because dollar depreciation has long been in the cards. In fact, one wonders why it has taken so long. Many of the factors behind dollar strength, including growth and interest-rate differentials and net equity flows, are much diminished now, and net service payments are becoming an issue again.

Antonio Borges: As long as the rest of the world has this appetite for US assets and US capital markets, the US will be able to fund its expected spending without difficulties. Investors' recent move away from stocks and rediscovery of bonds has helped the euro, since Europe can compete with the US a little better in bonds. But I think the long-run prospects for profitability will always be better in the US than in Europe, and people will move back to the US as their most attractive market for investment. In that context I cannot see the euro appreciating much more.

governments of some of the pressure for structural reforms, which are the only thing that can raise trend growth. So there is some good to be seen in a weaker dollar.

GC: I do not think it would be prudent for the US to embark on any effort, however subtle, to talk down the dollar. History tells us in unmistakable terms that that usually is a big mistake for virtually all countries. But over the past few years the rest of the world has probably been more economically dependent on the US than at any point since right after World War II. One critical variable in the US external-deficits equation is the extent to which other countries, not just Europe, are able and willing to shift toward domestic-demand growth instead of export-led growth.

AB: European policy has been driven to a very large extent by the weak euro, but the key question is whether there will be any willingness to undertake structural reforms. And while it is true that the world is extremely dependent on the US economy, it is even more dependent on US financial markets. The core of this problem is that the rest of the world finds it extremely attractive to invest in the US; for some, notably Japan, there is no option but to invest their huge surpluses there. This one-way flow will only change when there is some competition in capital markets, probably from Europe and hopefully one day from Japan as well.

JON: Some argue for more flexibility in the application of the fiscal stability pact, so that policymakers think more about the cyclically adjusted fiscal position than the headline one. Particularly if France and Germany did that, it could help European demand, reduce the dependency on the US and probably strengthen the euro.

PS: Obviously, increasing demand would have a positive effect, but it has to be done in a way which is clear and agreed by everybody. Crucially, it must not fundamentally suggest that we are prepared to induce inflation through a less-than-wholehearted application of agreed disciplines relating to the euro.

Who's Who

Antonio Borges is Vice Chairman and Managing Director of Goldman Sachs International. He was previously Dean and Professor of Economics at INSEAD and Vice Governor of the Bank of Portugal

E. Gerald Corrigan is a Managing Director at Goldman Sachs and the former President of the Federal Reserve Bank of New York

Mario Draghi is Vice Chairman and Managing Director, Goldman Sachs International. He was Director General of the Italian Treasury 1991-2001, Chairman of the European Community's Economic and Financial Committee and of the Working Party 3 (OECD), and a member of the G7 Deputies

Jim O'Neill, who moderated the discussion, is a Managing Director and Head of Global Economic Research at Goldman Sachs

Peter Sutherland is Chairman of Goldman Sachs International and former Director General of the World Trade Organisation

At the same time, the euro's early years have seen a lot of capital flows into acquisitions of US assets. Much of this process will now have terminated. We are now much more in equilibrium, and therefore we can see a less weak euro in the future.

JON: A common concern is the extent to which many countries, including many in Europe, depend on exports to the US for survival. One could argue that a much stronger euro would force European policymakers to focus more on Europe's role in the broader world economy, and that in this way dollar weakness could be good for the world.

MD: I would agree. Exports have played a big role in Euroland's growth over the past few years, and so have relieved European

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