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Goldman Sachs
133 Fleet Street
London EC4A 2BB
England

Sandra Lawson
Senior Global Economist
Roopa Purushothaman
Research Assistant

<http://www.gs.com/ceoconfidential>
(44) 20 7774 8736
sandra.lawson@gs.com

Post-War Germany's Lessons for Post-War Iraq

The personal views of Robert Hormats, Vice Chairman, Goldman Sachs (International)

Presenting his vision of post-war Iraq, President Bush compared reconstruction in Iraq to that of Germany and Japan after World War II. The comparison is apt. In particular, the allies' experience in Germany offers valuable lessons for today's planners.

Then-Secretary of State James Byrnes described the allies' aims: 'to win the German people . . . it was a battle between us and the Russians over minds.' This time, the battle over minds will be with Islamic radicalism. The coalition's success or failure in Iraq will have a crucial impact on that battle throughout the Middle East and around the world.

The war has also forced the US and the UK to grapple with the right balance between 'winning the war' and 'winning friends.' US, British and Australian forces have fought the war with tactics designed to minimize civilian casualties and damage to infrastructure—while still destroying strategic targets and undermining the military structure of the Saddam regime. This is a difficult challenge; achieving the right balance will be critical to the future of Iraq and the region.

Differences between post-war Germany and post-war Iraq are as instructive as the similarities. Unlike Iraq, Germany had a modern economy and democratic institutions before the rise of the Nazis. Germany also was far more homogeneous ethnically and culturally than Iraq. The country already had close commercial and diplomatic links to many western nations and long-standing ties of immigration, culture and trade with the US. Not so Iraq, a culture and society that few westerners on either side of the Atlantic are very familiar with. This will make post-war reform cooperation between coalition countries and Iraqis a lot more difficult.

Allied forces entered Germany as occupiers. This time the coalition wants its forces to be received by Iraqis and seen by others as liberators. Therefore, US and coalition authorities may be less willing than 50 years ago to press for wholesale political and social reengineering. Enlisting UN and multilateral support could sustain the pressure for reform and increase the perception of legitimacy in

the eyes of the Iraqi people and others in the Islamic world. Also, US forces in the 1940s were largely draftees; many had expertise in civilian governance and economic management. In today's armed forces, such skills are largely among reserves, increasing the need for help from private and UN agencies.

Despite obvious differences, many of the post-war challenges are similar. In 1945, Germany suffered wretched hunger, sickness and poverty. Millions roamed in search of shelter, food and jobs. In Iraq, millions already face shortages of food and medicine. War could make these worse, especially by disrupting the oil-for-food distribution system on which 16 million Iraqis depend for subsistence. If Iraq's fragile electric power infrastructure is damaged, hospitals, sewage systems and water treatment plants will fail. Wars with Iran and Kuwait, and Saddam's own brutality, have created many displaced persons and refugees. This war, plus score setting and retribution, could add more.

Germany had to be de-Nazified, demilitarized and purged of war criminals. Iraq will have to be de-Baathified, its military thinned and war criminals punished. But disqualifying too many civilian officials could be counterproductive. Allied authorities needed skilled and experienced Germans to help run the country; one of the chief reasons for the German economic and political recovery was the abundance of skilful and experienced Germans to set the country on a new course. The current coalition must find and support a similar group of Iraqis.

The allies pressed the Germans to create a new government structure that would prevent authoritarian power from re-emerging, yet be strong enough to avoid disintegration. In Iraq, the coalition will want to see authority diffused, but not so much that Baghdad cannot maintain Iraq's territorial integrity. A security architecture was built to provide Germany a place in Europe that did not threaten its neighbors. The same will be needed in the Gulf region. Cooperation with other regional powers, especially Turkey, will be needed to ensure a stable post-war regional environment.

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Post-War Germany's Lessons for Post-War Iraq

Continued from page 1

What Can Be Learned From the Occupation of Germany That Will Help in Iraq?

The allies were unprepared for the widespread hunger, disease and malnutrition that staggered Germany after the war. Much of Europe and Asia experienced similar conditions, so Germans got little sympathy. Today, the coalition will be judged harshly if a comparable humanitarian disaster befalls Iraqis. Immediate and massive assistance for the malnourished, wounded and uprooted will be required.

Fortunately, a great deal of planning and propositioning of food and medicine has taken place, and supplies are already entering southern Iraq. Relief will likely be required for a long time. That will require cooperation among the coalition, the UN and private relief agencies. Non-coalition countries have an interest in joining this effort to build a prosperous and free Iraq. Indeed, cooperation in the rebuilding effort provides an opportunity to heal many of the deep rifts that developed in the pre-war period.

According to noted US diplomat and historian George F. Kennan, US forces embittered Germans by 'camping in luxury amid the ruins . . . inhabiting the same sequestered villas that the Gestapo and SS had just abandoned, and enjoying the same privileges.' As coalition forces establish a presence in Iraq, they must remember and not repeat that experience.

Important Nazi leaders escaped prosecution, while needed German teachers, doctors and health workers were dismissed. The perceived arbitrariness and

length (five years) of de-Nazification left some Germans asking whether allied justice shared some of the ousted government's characteristics. Swift, fair and transparent prosecution—with international legitimacy—can avoid that charge in Iraq.

Even with Germany's skilled and democratically experienced population, a new government structure had to be constructed from the bottom up. First, elections were held in the states (Länder). Then governors (minister presidents) in the western occupation zones met to fashion broader administrative institutions. A German Economic Council was elected to oversee reconstruction. Four years after the war, state delegations met to draft a West German constitution (Basic Law). Only then did parliamentary elections take place. The US, the UK and France worked closely together to support German reformers during this lengthy process.

A similar approach could lead to the creation of an Iraqi federal government representing geographic rather than ethnic or communal interests. In the absence of democratic experience, this should start with discussions about the responsibilities of voters and elected officials. Electing an Iraqi Economic Council representing the various regions of the country, to work with the coalition partners and international agencies on reconstruction and oil matters, would help dispel the idea that the war was fought to control oil.

Secretary Byrnes insisted that 'large armies of foreign soldiers or alien bureaucrats . . . are in the long run not the most reliable guardians of another country's democracy.' Even as they maintained responsibility for maintaining order and stability, allied authorities gave able and trusted Germans 'primary responsibility for running their own internal affairs.' The US commander, General Lucius Clay, supported the decision of Ludwig Erhard, top German economic official in the western zones, to eliminate price controls and introduce a stable currency. Hoarding stopped, and food appeared on shop shelves.

Economic change in Iraq will require coalition support for similarly bold moves and ambitious reformers. Just as the success of the occupation of Germany depended on the will and capability of many highly skilled and dedicated Germans—so will the success of the rebuilding and reform of Iraq depend on a similar group of Iraqis. The potential for finding them is considerable; Iraq is one of the most secular countries in the region, with a strong tradition of education and a skilled middle class.

Exports of factories and equipment as reparations jeopardized German reconstruction, so General Clay ordered them to be cut back. Massive reparations and debt repayments could cripple recovery in Iraq. Large-scale rescheduling or forgiveness will be needed. The US, other coalition nations, the World Bank and the IMF should lay the groundwork now.

Oil revenues should be used for key priorities, such as humanitarian assistance and reconstruction. There is a tendency to overestimate the size of oil revenues (which have been about \$15 billion annually) and the ability to quickly increase oil exports. Using oil revenues to support coalition forces or pay war costs would undermine reconstruction and public good will—as did German reparations.

If the peacekeeping and reconstruction are done well, and a moderate, progressive government takes root, Iraq will be a far better place—as Germany is today. And a successful, prosperous and peaceful Iraq will be of considerable benefit to its neighbors, just as a successful, prosperous and peaceful Germany has been to Europe and the rest of the world. Failure, on the other hand, would undermine American and British credibility and influence in much of the world—as it would have in Germany 50 years ago. ■

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

Contributors: Ben Broadbent, Bill Dudley, Robert Hormats, Fiona Lake, Binit Patel, Dominic Wilson

Reaching Deeper Into the Monetary Policy Tool Kit

The US Federal Reserve has only 125 basis points of conventional monetary easing available. We consider three nonconventional options

US Federal Reserve officials are undoubtedly making contingency plans for a shift to nonconventional monetary policy easing. The US economy is slowing sharply, and core measures of inflation continue to fall, but there is little conventional ammunition left—only 125 basis points.

Contingency plans for nonconventional monetary policy tools are appropriate because of the ‘zero bound’ constraint that bedevils monetary policy. Once the target federal funds rate has been lowered to zero, the Fed cannot move any further with conventional federal funds rate targeting. If inflation keeps falling after that point, real interest rates rise, making monetary policy progressively less stimulative.

Three Nonconventional Options

The goal in using nonconventional monetary policy tools is to make financial conditions more accommodative. This can be done by pushing down long-term interest rates and/or by taking actions that lift equity prices or weaken the dollar. This can be done in three different ways:

- **Precommitting** to keeping short-term rates low for an extended period. Long-term rates equal expected future short-term rates plus a risk premium. If the market expects short-term rates to remain low, longer-term rates are likely to fall. For a precommitment strategy to pull down long-term rates, the fall in expected future short-term rates has to exceed the rise in the risk premium. For this reason, we believe it is better to commit to an explicit inflation objective rather than to a set period of low short-term rates.
- **Adding excess reserves** by purchasing Treasury bills or notes beyond what would be needed to push the federal funds rate to zero. As long as the yield curve is upward sloping, banks would have incentives to use these reserves to purchase Treasury and private-sector securities and to make loans; this would pull down long-term rates.

- **Buying long-dated Treasury securities** and other permissible assets, either in tandem with a precommitment strategy or alone. The Fed could target the yield on a given maturity range of Treasury securities explicitly. By affecting expectations, this could reduce the amount of Treasuries that the Fed might actually have to purchase to achieve its objective. Or the Fed could purchase longer-dated Treasuries without announcing an explicit target rate. Although the Fed is permitted to purchase other securities, we doubt—with the exception of Ginnie Mae obligations—that it would wish to do so. The Fed could either sterilize the reserve additions, to support a federal funds rate target above zero, or not, which would lead to a zero rate.

Purchase of Treasuries the First Step

There are pros and cons to each choice. The precommitment strategy is attractive because it works on expectations. The Fed does not have to do much beyond precommit to bring down longer-term rates. Drawbacks include the risk that the precommitment might not be credible and/or that Fed officials might be unhappy with the outcome.

We do not believe the Fed will use the precommitment strategy in any binding sense. Fed officials have historically conducted monetary policy on a meeting-to-meeting basis, with no strong judgement about the future path of short-term rates. To move to a binding precommitment strategy would represent a major shift in policy-making. A precommitment strategy would also go against Chairman Greenspan’s desire to maintain flexibility.

Adding excess reserves to the banking system is attractive because the private sector, rather than the Fed, would decide which longer-dated securities to buy. The problem is that no one knows how well this channel would work. In a sharp economic deterioration, commercial banks might

simply hold on to the excess reserves—as Japanese banks have done.

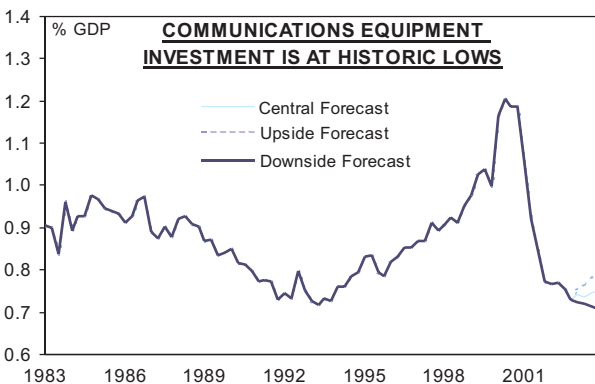
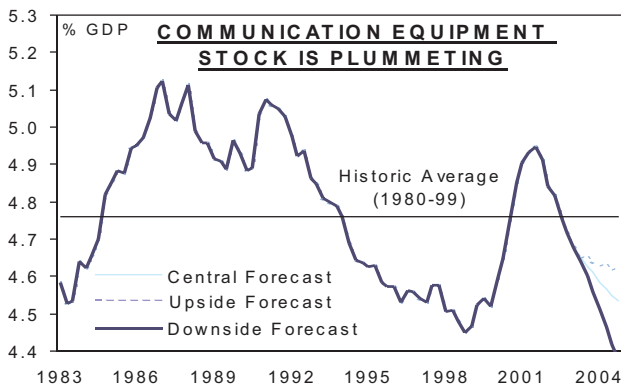
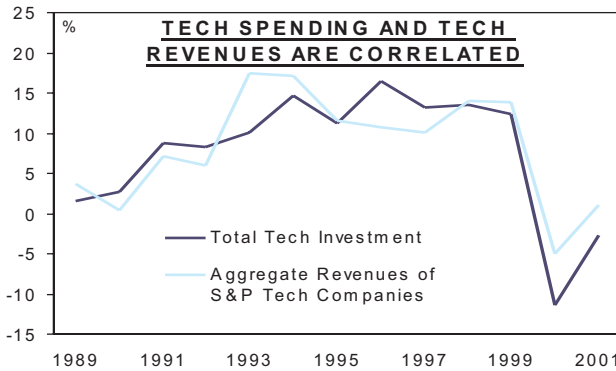
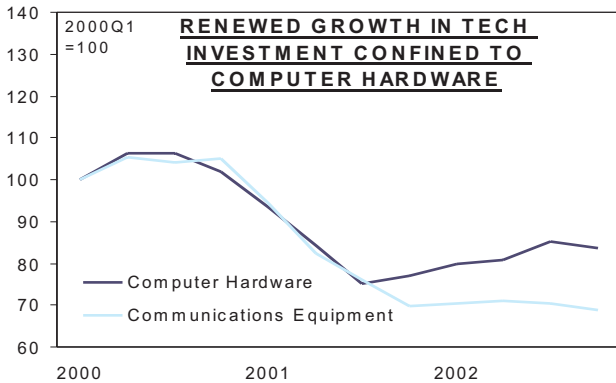
This strategy also requires that the federal funds rate be zero, which could have a large impact on the money market and money market mutual funds. The yield on these funds would fall to zero—or negative—if the funds did not waive their fees, potentially leading to large outflows into depository institutions. Credit concentration could become an issue, and reintermediation could hurt the availability of corporate credit. While it is difficult to evaluate the seriousness of this problem, it might be a concern to the Fed.

The strategy of pegging longer-dated yields is less daunting. The Fed can be confident that it can achieve any given interest rate objective for longer-dated Treasuries if it is willing to purchase sufficient quantities. Moreover, there is a historical precedent; from 1942 to 1951, the Fed formally committed to keep Treasury yields below explicit ceilings. The major shortcoming of this approach is that pegging Treasury yields may not push private-sector rates much lower. And implementation might generate perverse effects.

A Higher Hurdle

We do not currently think the economy will be weak enough to provoke the Fed to shift to nonconventional monetary policy tools. Another 50 to 75 basis points of traditional easing is still available before such a shift becomes likely. The threshold will be high, especially given the lack of experience with the efficacy of such measures.

If the Fed does move, efforts to push down long-term rates are likely to be tried first. Whether Fed officials will decide to sterilize the reserve additions or not is unclear at this point. ■



Better—But Not Bright—Prospects for Tech Spending

In recent months, optimists have looked to investment spending to brighten the dreary global economic landscape. They tend to point to recent signs that US technology spending is recovering, suggesting that global investment spending could assume the baton from consumer spending and drive a global economic recovery.

According to US national accounts, business spending on information technology (IT) troughed during the second half of 2001 and rose throughout last year. In the fourth quarter of 2002, business spending on computer hardware was up 8% year-on-year; software investment was up 4.4%. Investment in communications equipment has remained in the doldrums, however. After a drop of 33% over the previous year, this spending fell a further 1.6% in the year to the fourth quarter of 2002.

Many analysts have been surprised by—and skeptical of—the strength of these national accounts estimates, particularly those for IT hardware. With suppliers reporting relatively weak earnings growth for 2002, it is odd to see aggregate spending apparently recovering so strongly. We point to two factors to explain this discrepancy. First, the tech recovery is more dramatic when measured sequentially rather than annually. Because the starting point for 2002 was so low, relatively strong sequential growth since then does not equate to equally strong annual growth rates. Second, it appears that overseas sales have suffered more than US sales, at least for computer hardware. Since a good part of US tech company revenues are earned overseas, this tends to depress revenues relative to domestic spending.

Because much of the excess capacity installed during the boom appears to have been worked off, the medium-term outlook for tech spending is favorable. The near-term trend, however, looks broadly flat. One good leading indicator is the seasonally adjusted tech subcomponent of the durable goods orders series, published by the US Census Bureau; it shows a lead time of three to six months between orders and actual deliveries. Orders grew 0.7% quarter-on-quarter between the third and fourth quarters of 2002. Taking January and February of this year together, orders were 2.6% higher than the average level in the last quarter of 2002. Though we should keep a close eye on the orders series in the next several months, the evidence so far suggests that we can expect broadly unchanged spending on tech goods—IT hardware and communications equipment together—in the first half.

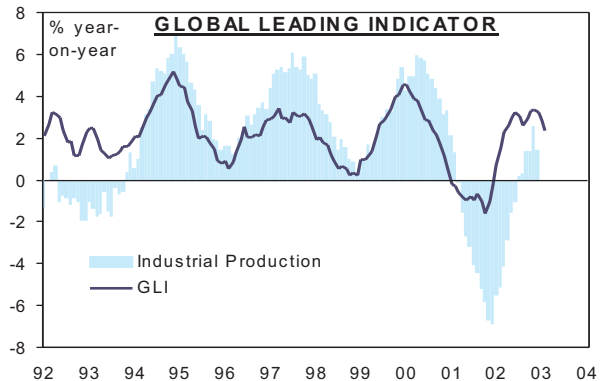
The View From Equity Research

Our equity research analysts hold broadly similar views, although they are generally more pessimistic than our top-down projections. In communications equipment, they expect spending to stabilize only next year, after another sharp decline in investment spending in 2003. This would undoubtedly mean that the value of installed capacity would decline to an all-time low relative to GDP. But operators' margins remain under pressure, and worries about feasibility have delayed investment in new wireless technologies.

In IT, our analysts report that consumer spending priorities remain focused on rationalizing IT investment, attacking especially the maintenance portion of IT budgets. Analysts expect aggregate IT budgets in the US to be flat this year, against our capital-stock-based projection of over 5% combined growth in software and hardware. The analysts' numbers include spending on IT services, considered the most vulnerable to restrictions on 'maintenance' spending. ■

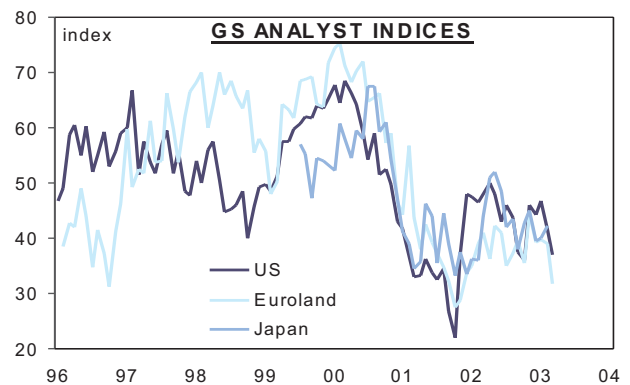
GLI Rises Again in March, But Momentum Is Slowing

- Although our Global Leading Indicator (GLI) was up 0.2% month-on-month in March, the pace of growth has clearly slowed since December. The year-on-year reading fell to 1.7% from 2.4% in February.
- The slowing momentum in March primarily reflects weaker consumer and business confidence. The GLI also indicates that the global industrial sector has begun to stall, after a temporary surge at the start of the year. This is consistent with messages from our internal analysts surveys and recent economic data.



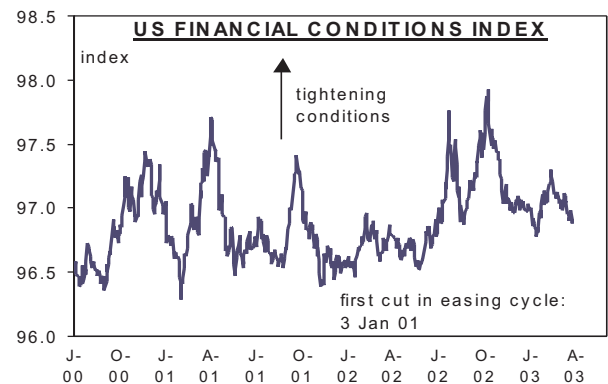
GS Analyst Indices Are Still Weak

- The US analyst fell to 37.1 in March from 41.5 in February. Although just above the recent trough (36.9 in October 2002), this probably understates the underlying weakness of the economy.
- The Euroland March survey plummeted to just above the historic lows seen in late 2001, suggesting that confidence and anemic demand growth are inhibiting business decisions and dampening economic activity. The Japanese GSAI rose slightly but remained below 50 for the tenth consecutive month.



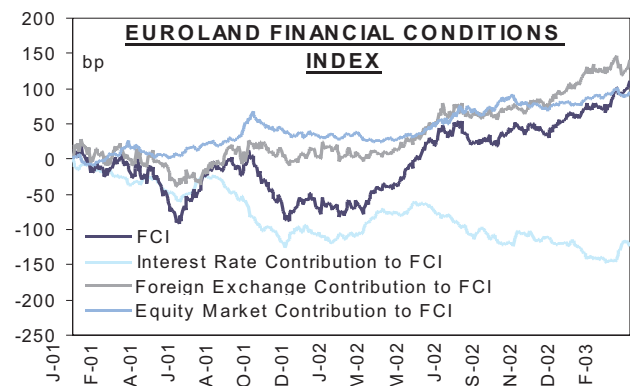
US Financial Conditions Fail to Ease Significantly

- Although financial conditions are not high on a historical basis, they have failed to ease significantly since the Fed first began to cut interest rates in January 2001. Sticky financial conditions suggest that much of the impact of prior rate cuts has been spent, particularly via the housing and consumer channels.
- The other two channels through which monetary policy operates, the equity market and dollar, are not working properly, due to equity market weakness and a persistently strong dollar (down only 5% on a broad trade-weighted basis).



Euroland Financial Conditions Are Still Tightening

- Euroland financial conditions have tightened considerably since September 2001, with our indicator rising 115bp—despite a 175bp rate cut. The main driver has been the appreciation of the trade-weighted euro; weak equity markets and the lengthy transmission of lower rates to consumers and companies have not helped.
- We expect the ECB to cut rates 50bp by the end of the summer. Although continued euro appreciation will likely tighten financial conditions over the next few months, we expect some stabilization of conditions by year-end, as this will be at least partially offset by improved equity markets and the lagged effects of the rate cuts.



Source: Goldman Sachs.

THE WORLD IN A NUTSHELL

	Outlook	Key Issues
United States	Although recent indicators show that the economy continues to lose momentum, the Federal Reserve is likely to keep monetary policy on hold for now. The Fed thinks policy is already very accommodative; that geopolitical risks are mainly responsible for the economic weakness; and that the economy will recover sharply in the second half as such concerns abate. An inter-meeting move is unlikely, but when the cut does come, it is much more likely to be 50bp than 25.	With only 125 basis points of traditional monetary easing available, the Fed may be forced to turn to nonconventional monetary policy tools. A shift to nonconventional tools is still unlikely unless outright deflation becomes a greater risk. But we think the Fed would shift to nonconventional easing tools before the target fed funds rate falls to zero. The most likely strategy is a Fed purchase of longer-dated Treasury securities to flatten the yield curve.
Japan	Leading indicators signal that production is at considerable risk of another downturn in the first quarter, after a decline in late 2002. A correction to the production and inventory cycle would last only 3-4 quarters if an overseas recovery revives production in the second half. But if the rest of the world slows, we would expect a more protracted correction as long as domestic demand remains weak.	Monetary policy will remain focused on helping smaller companies obtaining financing, with the Bank of Japan's new leadership considering purchasing asset-backed securities. The BoJ is also weighing further quantitative easing strategies; markets are again discussing inflation targeting. The stimulative effects of the expected supplementary budget are likely to be limited.
Europe	Despite signs that the Euroland economy will stagnate in the first half of 2003, we think investors' pessimism is overdone. We see several good reasons for expecting above-trend growth in 2004, including unusually low real interest rates, particularly outside Germany; a stronger euro that will boost real household income growth; good investment fundamentals; and no constraints from fiscal policy.	Since 1995, German output per person has fallen from 10% above the EU average to just 4% above. If Germany is to maintain its position as one of Europe's most prosperous countries, the government's recently announced reforms must succeed. We see these announcements as a first step in the right direction. But the unions remain a major potential stumbling block.
Non-Japan Asia	The impact of SARS has already led us to reduce our 2003 Hong Kong GDP forecast to 1.7% from 3.0%. This assumes that the economic impact will be largely a temporary demand shock, with the supply side largely unscathed. Other countries in the region will be less badly affected. Separately, Chinese growth remains very strong, but we expect it to begin to slow slightly this quarter.	We see little near-term risk of a traditional banking crisis or collapse in China, despite big problems at the state banks. The real danger is a Japan-style misguided muddle-through. The only way out of the mess is to carve out bad loans; recapitalize state banks; complete the liberalization of the banking system; and bring in outside owners. Progress in 18 months is essential to our long-term growth outlook.
Latin America	The Brazilian administration is being rewarded for tightening financial policies, and the balance of payments has improved. IMF fiscal targets have been met, and inflation has eased, although it remains high. We expect the Real to strengthen over the coming 12 months. Financial assets could continue to rally if Congress approves the strong social security and tax reforms to be presented this month.	We have upgraded our economic outlook for Argentina, lowering the inflation and raising the real GDP and currency forecasts. The new IMF package for Ecuador represents a major victory for the administration, because it improves the country's financial outlook (as do higher oil prices). The key challenge will be to keep the program on track after June.
Central and Eastern Europe	Russia's opposition to the war has opened a new and significant rift in its relationship with the US, but we see little possibility of Russia drifting into the 'European camp' permanently. The risk of a Turkish invasion into northern Iraq has been averted, but a new \$8.5 billion package will not restore sustainability to the vulnerable Turkish accounts.	EU membership is now less than 13 months away for the 10 accession countries. Regional policymakers are finalizing strategies for monetary and exchange-rate policies in the runup to EU entry and ahead of the eventual adoption of the Euro. Most would like to join the Euro as soon as possible -- around 2007 -- implying ERM-II participation shortly after May 2004.

KEY ECONOMIC AND MARKET FORECASTS					
	GDP (%)	Consumer Prices (%)	3M Rate Forecasts* (%)	Bond Yields** (%)	Exchange Rate Forecasts
US	2003: 2.1 2004: 3.0	2003: 1.9 2004: 1.4	3m: 1.3 12m: 1.3	Current: 3.9 12m: 4.5	-- --
Japan	2003: 0.8 2004: 0.4	2003: (0.5) 2004: (0.3)	3m: 0.1 12m: 0.1	Current: 0.7 12m: 0.8	3m \$/JPY: 115 12m \$/JPY: 111
Euroland	2003: 0.9 2004: 2.7	2003: 1.7 2004: 1.7	3m: 2.2 12m: 2.7	Current: 4.1 12m: 4.9	3m EUR/\$: 1.12 12m EUR/\$: 1.18
UK	2003: 2.1 2004: 2.6	2003: 3.0 2004: 2.4	3m: 3.8 12m: 4.1	Current: 4.5 12m: 4.2	3m GBP/\$: 1.60 12m GBP/\$: 1.62
Non-Japan Asia	2003: 6.3 2004: 6.8	2003: 1.2 2004: 1.4	3m: 4.3 12m: 4.3	Current: 7.3	3m \$/KRW: 1325 12m \$/KRW: 1200
Latin America	2003: 0.7 2004: 3.2	2003: 12.0 2004: 11.9	3m: 8.5 12m: 9.1	Current: 10.1 12m: 10.1	3m \$/MXN: 11.25 12m \$/MXN: 11.15
Central and Eastern Europe	2003: 3.7 2004: 4.5	2003: 4.5 2004: 2.5	3m: 5.5 12m: 5.0	Current: 5.2 12m: 5.0	3m EUR/PLN: 4.10 12m EUR/PLN: 4.05

* 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.

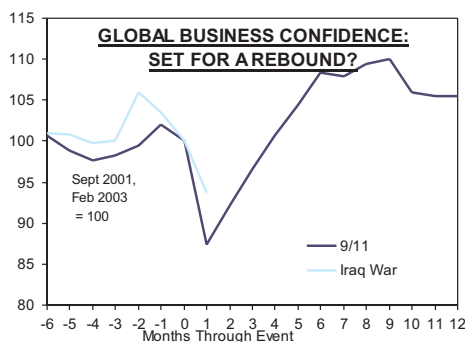
After the War: Parallels With September 11

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Markets Care About the Future

We may be in for a similar experience now. It would not be surprising to see declining risk aversion followed by improving data influence markets over the next few months. The first phase is already underway, as markets have begun to price out the worst-case scenarios from the war.

A smooth end to the war should help to reverse some of the recent sharp declines in confidence and to ease pressures on US spending. While the second quarter is likely to be soft, the third quarter could look noticeably better, and the improvement in data at the margin may sustain the more optimistic view that a recovery is taking hold. Just as September-October 2001 turned out to be the weakest point in the data at that time, so March-April 2003 may be the weakest patch now.



If so, the lesson from September 11 is that current market trends may persist for a while longer. Against a background of declining risk, even marginal improvements in the economic news are likely to be well received. Equities may fare well, bond yields could come under upward pressure and the dollar could continue to do better, even if the underlying outlook remains cloudy. Of course, if the data do not improve, that would be a very bad sign.

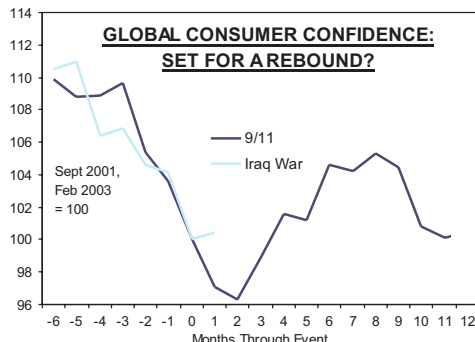
2004: Disappointing US, Surprising Europe?

None of this changes our view that prospects for the world economy remain muted. With the world still adjusting to persistent financial imbalances, the downside risks remain high, particularly in the US. Nor does it change our view that fundamental pressures for US dollar weakness will reassert themselves, even if

short-term moves in the other direction are powerful, and that short-term pressures for lower oil prices are likely to give way to fundamental pressures for higher prices.

What happens beyond the next six months depends on whether the short-term improvement can turn into a sustained recovery. We remain cautious. The US adjustment to financial imbalances is not complete. Even if short-term momentum improves, we expect growth to remain below its 3% trend rate into 2004, and we think recovery expectations are still much too optimistic. The consumer outlook remains the greatest risk.

Although we expect the Eurozone economies to remain sluggish over the next few months, we think the prospects for 2004 are brighter and expectations too negative. Our 2004 GDP growth forecast of 2.7% is significantly higher than both trend (about 2.3%) and consensus expectations. While we agree that Germany will be weak, we are more optimistic about a recovery in domestic demand in the rest of the Eurozone next year, as those countries benefit from low real interest rates.



Globally, the balance of risks still points to weaker growth. It may be some time before we can tell the difference between a sustained recovery and a temporary bounce. We fear it will be the latter. ■

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After the War: Parallels With September 11

Investor sentiment has followed the ups and downs of the Iraq war to the virtual exclusion of all else. We think markets can continue to rise on the unwinding of war risk and incrementally better economic data. But the longer-term outlook is poor

Global asset markets have ignored or discounted recent economic data. That is fortunate, since the data generally present an ugly picture. We think the immediate post-war period will see further pricing out of war risk. The lessons of September 11 suggest that current market trends could persist for a few months, even if our cautious view of the longer-term global economic outlook is correct.

Fundamentals Point Toward Recession

The advanced economies have been stuck in neutral gear for the last six months. In the US, job losses continue, and ISM indices have fallen to their lowest levels since just after September 11; they are consistent with an economic contraction. Our GS Surprise Index, which measures the 'average' surprise in US data, is at its lowest level in its (short) history and also at levels consistent with stagnation. European business surveys point to an economy teetering on the brink of recession and consumers unwilling to loosen their purse strings. Japan's industrial sector has recently contracted.

In fact, the G3 may already be technically in recession. Weakness in the US data is probably too short-lived and too shallow at this point to qualify as recession, but it will come close if current trends are not quickly reversed. Our forecasts imply that Germany basically slipped into recession in the first quarter, and Japan will do so in the second quarter. Whether formal definitions are met or not, the second quarter is almost certain to be the OECD's weakest since the end of 2001.

Will This Gloomy Picture Swamp the Markets?

Probably not, at least in the short term. The question of whether we are currently in recession may be largely academic. For the markets, recent data is already history; recent price action is clearly based on expectations for the next few months. The tendency to discount weakness as 'war-related' is likely to persist until there is sufficient data to prove otherwise.

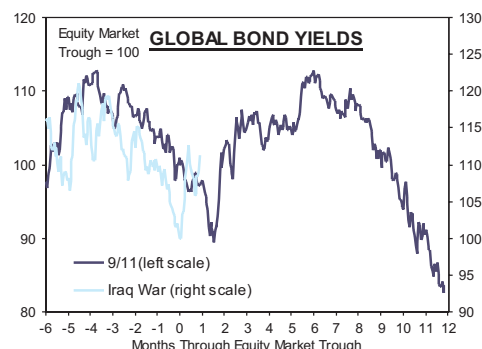
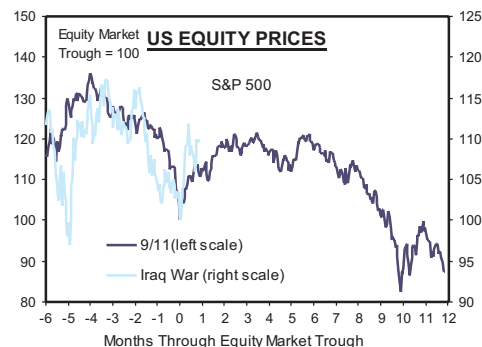
How long can this continue? The experience after September 11 provides interesting clues, perhaps more interesting than those from the first Gulf War. The terrorist attacks had a smaller effect on underlying trends than most people (ourselves included) expected, but they had a profound impact on short-term data, confidence and perceptions of market risk.

As now, the attacks occurred in a soft and weakening economic environment. Although the impact of the attacks was more sudden and concentrated than the war, there may be some parallels in the aftermath. After September 11, equity markets declined sharply as risk perceptions rose, bond yields fell and the dollar came under pressure. Business and consumer confidence plummeted, and economic data deteriorated sharply.

But soon thereafter, the combination of declining risk perceptions and (briefly) improving data created an optimism that persisted for a considerable time. Even though our view that the fundamental trends would prove decisive was ultimately correct, it was some time before it was possible to distinguish this from the short-term turn for the better.

The recovery took place in three phases:

- From late September through October 2001, risk perceptions began to subside, as the markets' worst fears did not materialize. World equities rallied up 15%; the dollar bounced back; and bond yields (affected in part by news of the termination of the US 30-year note) rose in early November. Technical momentum boosted the initial trends.
- From about November to February 2002, the data began to improve. Confidence jumped sharply, reversing its previous declines. The economic impact of the attacks also faded quickly. While both the third and fourth quarters of 2001 showed very weak global GDP growth, by late 2001 short-term prospects were improving rapidly. The sharp swing in US inventories, itself in part a function of excessive pessimism



about demand, helped drive very strong growth in the first quarter of 2002. With better data, optimism about a self-sustaining recovery resurfaced, and markets held their gains.

- Fundamental pressures then reasserted themselves. Yet it was not until April 2002—more than six months after the attacks—that market movements began to reverse, with world equity prices falling about 15% through the third quarter. A bit later, the data clearly confirmed that the recovery was fading.

Trends in the major asset markets were closely correlated across these phases, with much of the 'juice' occurring early. The best part of the equity market rally and the rise in bond yields was over by mid-December, and the dollar peaked in late January. In the first quarter of 2002, markets range-traded as improving data validated the initial moves. All three markets peaked by early April; the reversal was underway in earnest by mid-May.

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