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Next Month: What EU Enlargement Means for Europe

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Is the World Economy Getting What It Needs?

Easier financial conditions, led by a weaker dollar and stronger equity markets, mean prospects for the world economy look better. We hope dollar weakness will prompt more accommodative monetary policy and structural reforms outside the US

Since late 2000, we have repeatedly warned that world economic growth would be sluggish at best. We still expect the post-bubble adjustment—the undoing of a record current account deficit and record highs of private-sector indebtedness—to exert a persistent drag on the US economy. We entered 2003 predicting below-trend and below-consensus growth for the third straight year. Consensus has more recently moved closer to our view.

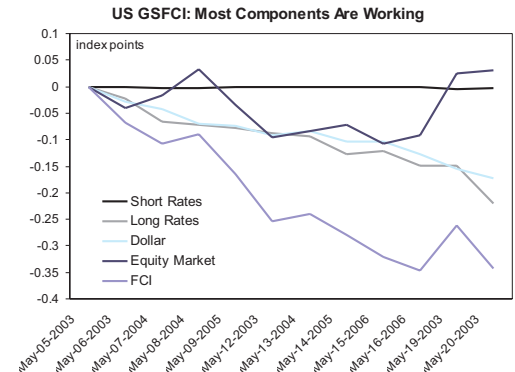
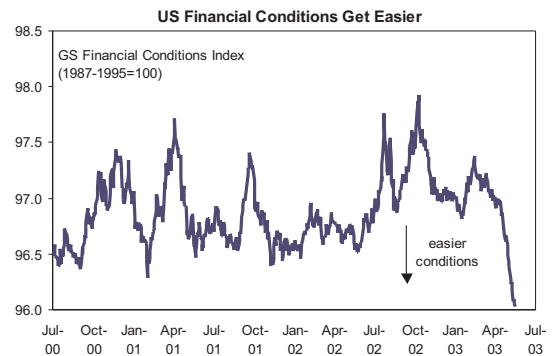
Although our long-term outlook has not changed, several recent developments suggest that the world economy might improve in the second half of the year and into early 2004. Oil prices have fallen some 30% from their pre-war peaks; financial conditions have eased; credit conditions have loosened; and corporate balance sheets are strengthening.

We are also starting to see encouraging signs of the important policy shifts we have flagged as the keys to a more positive view. Since the start of the year, we have called for more accommodative global financial conditions, which could be brought about by a sustained recovery in equity markets; a significant decline in the trade-weighted dollar; and more aggressive policy stimulus outside the US, particularly in Europe.

This shift now appears to be underway. US financial conditions have eased notably in recent weeks; the dollar has declined substantially against some trade partners and is likely to fall further; and the ECB has formally declared its fight against deflation. In addition, the Fed has signalled its intention not to raise rates for some time.

US Financial Conditions Are Easing

Despite aggressive Fed easing, US financial conditions remained tight for most of the period since early 2001, weighing down the economic recovery. Falling equity prices more than offset the drop in short term interest rates, while dollar appreciation throughout 2001 and sticky bond yields worked against stronger US growth. With the stock market reaching new lows in 2002,



financial conditions last October were actually tighter than before the Fed began its current easing cycle.

Financial conditions finally began to ease after the Fed's most recent rate cut last November. Credit spreads have narrowed, and the dollar has fallen substantially against some trading partners, particularly Europe. The equity market is also up more than 15% since its pre-war lows, without much backup in bond yields. Overall, our financial conditions index (GSFCI) is almost 150 basis points easier than in October and is now at the lowest (easiest) level since early 2001.

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Is the World Economy Getting What It Needs?

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Easier financial conditions improve the fundamentals for stronger US growth and reduce the probability the US will slip back into recession this year. It is too early to turn more bullish on the US economy, particularly since it is not clear whether these easier conditions will last. It may, however, be time to have some confidence that the downside risks to our forecasts are limited. Our equity strategists expect further stock-market gains, which is an important component of the GSFICI. We note, however, that the gains would have to be quite substantial if they are to have any serious chance of boosting consumer spending.

How Low Can the Dollar Go?

The dollar's fall over the past year has been most notable against the euro and the Canadian dollar; it has also fallen against the yen. But on a broad trade-weighted basis the dollar has fallen by much less—close to 10%. It has only recently fallen against some Latin American currencies, and it has not fallen against the developing Asian currencies that comprise 30% of the trade-weighted index.

In fact, the trade-weighted dollar cannot fall much further as long as the Chinese renminbi remains fixed at its current rate and as long as Japanese intervention holds back yen strength. Our revised exchange rate forecasts accordingly show a steeper dollar decline against the euro and the Canadian dollar. Our 12-month forecasts are 1.22 for the euro and 1.35 for the Canadian dollar. Further forecasts are in the table on page 6.

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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Currencies in the Fed's Broad TWI			
	2003 Fed Weights	% chg since TWI peak*	weighted % change*
Euro area	17.4	-25.1	-4.4
Canada	17.0	-15.0	-2.5
Japan	12.1	-13.8	-1.7
UK	4.4	-12.8	-0.6
Asia ex-Japan	29.4		
China	9.0	0.0	0.0
Taiwan	3.3	-1.1	0.0
Korea	3.9	-9.3	-0.4
Singapore	2.3	-6.0	-0.1
Hong Kong	2.6	0.0	0.0
Malaysia	2.2	0.0	0.0
Thailand	1.5	-3.8	-0.1
Philippines	1.1	2.2	0.0
Australia	1.2	-20.8	-0.3
Indonesia	1.2	-16.9	-0.2
India	1.0	-3.4	0.0
Latin America	14.4		
Mexico	10.6	13.3	1.4
Brazil	1.9	24.9	0.5
Argentina	0.5	109.6	0.6
Venezuela	0.4	49.3	0.2
Chile	0.6	4.7	0.0
Colombia	0.4	21.7	0.1

*a negative number indicates that the Dollar has depreciated against that currency

Despite some concern in the market, we have long argued that a weaker dollar would, on balance, be good for the world economy. A weaker dollar would help ease US financial conditions, offering welcome relief for the US economy, at least over the medium term.

Perhaps more importantly, a weaker dollar should allow monetary policy in the rest of the world to become more accommodative, which could boost overall global demand. By shifting non-US growth prospects from export dependency to domestic demand, this might help to balance world growth and improve the chances for an orderly decline in the US current account.

A weaker dollar could also increase pressure for structural reforms that would further stimulate domestic demand, particularly in Euroland.

How far can the dollar decline? With markets focused on the US balance of payments, the risk that the US cannot attract enough quality capital to offset the

large current account deficit, and the need for an eventual improvement in the current account, there is no reason why the decline should stop here.

If the dollar were to reach the all-time low for \$/DM (1.345, seen in April 1995), it would be at EUR 1.45—more than 20% below today's spot price. Before dismissing this out of hand, consider the period in late 2000 when EUR/\$ touched 0.827. If the euro could be some 30% undervalued then, it could also reach 1.45—which is 'just' some 20% overvalued. A 30% overvaluation would take the euro to nearly 1.50. Our 12-month forecast is a more benign 1.22, which seems quite reasonable in this context.

In fact, it is difficult to see what might stop the dollar's decline against the euro at the moment. Given the US Treasury Secretary's relaxed attitude toward the currency, lingering tensions between the US and some European countries over Iraq and the European Central Bank's general aversion to foreign-exchange intervention, we do not think intervention is likely. Monetary policy could work, but the ECB would need to cut rates more than the 50bp that is already priced into the market.

ECB Recognizes Deflation Danger

As US financial conditions are easing, the euro's strength against the dollar means that Euroland's financial conditions are tightening. While on face value this is a negative for the region's already lackluster 2003 economic outlook, it could be a longer-term positive—if it forces Euroland to become less dependent on US consumer demand.

That shift may finally be underway. The ECB's president has clearly signalled that the euro's strength would allow easier monetary policy. A more accommodative policy would support our Euroland outlook for 2004, which expects easier monetary conditions to boost domestic spending.

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GS CEO Confidence Index: Still Waiting for an Upturn

Our quarterly survey of business confidence, conducted in April, indicates that the end of the war has done little to boost CEOs' optimism about the economic outlook. The global index fell to 45.0 from 51.5 in the first quarter. Responses from Asia, hard hit by SARS fears on the heels of the war, dragged down the global reading. The US, at 51.7, was slightly above the 'no change' threshold, while Europe, at 49.2, was just below it. Yet both the US and Europe fell from the first quarter, with the US posting the sharper fall, from 58.3.

Anecdotal comments suggest that, although the war's conclusion did help sentiment, the overall economic picture remains weak. Concerns about consumer debt burdens, housing prices and now SARS are taking their toll. 'Some people think the post-war rally will give way to disappointing earnings and thus depressed markets.'

Consolidation looks slightly less likely than in the first quarter, with the global reading at 59.2 against 68.5 last quarter, with optimism in Latin America supporting the global reading. Vertical consolidation seems off the table everywhere but in Europe. As one banker notes, 'management teams are not getting paid to take unnecessary risk'; another says 'no leaps of faith.' Horizontal M&A is generally preferred to vertical, although the readings on this score are still lower than last quarter. Yet several European respondents note an increased appreciation of M&A as a defensive measure: 'some clients appreciate that absolute size can help withstand downturns, and that in such markets investors prefer liquid stocks. Getting smaller or focusing is not as high on the agenda as it used to be.'

Hopes of an upturn in capital spending receive some support from this survey. Investments in existing assets is clearly preferred ('lots of focus on organic growth'). After several years of underinvestment, 'at some point companies must reinvest, or they risk the future.' The strongest reading for international capex comes from Japan; the overall reading, however, is at its lowest point since our survey began. ■

CEO Confidence Index																					
index	General Business Outlook			Overall Consolidation			Vertical Consolidation			Horizontal Consolidation			Capital Investment in Domestic M&A			Capital Investment in International M&A			Capital Investment in Existing Assets		
	Global	US	Europe	Global	US	Europe	Global	US	Europe	Global	US	Europe	Global	US	Europe	Global	US	Europe	Global	US	Europe
Apr-03	45.0	51.7	49.2	59.2	54.2	51.7	32.5	37.5	49.2	74.2	64.2	54.2	32.5	42.5	44.2	12.5	29.2	37.5	57.5	54.2	52.5
Feb-03	51.5	58.3	51.9	68.5	72.2	72.2	35.4	33.3	40.7	83.1	86.7	77.8	38.5	43.3	29.6	20.0	16.7	25.9	51.5	43.3	56.7
Sep-02	15.4	20.0	13.9	36.5	40.0	33.3	34.6	46.7	27.8	63.5	60.0	63.9	21.2	13.3	22.2	13.5	20.0	11.1	40.4	33.3	41.7
Jun-02	43.5	33.3	41.7	61.0	55.6	66.7	--	--	--	--	--	--	39.1	33.3	33.3	26.1	22.2	33.3	39.1	22.2	41.7

Is the World Economy Getting What It Needs?

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The ECB has also unveiled a helpful review of its monetary policy strategy. While the review is unlikely to lead to major changes to the conduct of monetary policy, it does acknowledge that the ECB has been much more tolerant of inflation above 2%. To guard against the risk of deflation, the ECB has added the proviso that it will 'aim to keep inflation at close to 2% over the medium-term.'

The ECB now clearly does not want to see inflation falling well below 2%. Given this, the weak economic activity and the disinflationary effects of the strong euro, we expect the ECB to cut rates a further 50bp, to 2.0%, by late summer.

A New Take on US Monetary Policy

Recent days have also seen an important shift in US monetary policy. This was not in our January list of desired policy measures, but we see it as a welcome development. In fact our US economists

think the Federal Reserve should go even further, as we discuss below.

Over the past decade, the Fed had followed a policy of 'opportunistic deflation'—tightening monetary policy pre-emptively whenever growth climbed sufficiently to put pressure on resources. At its May meeting, however, the Fed shifted to a reactive policy, in which above-trend growth is sought until the inflation rate moves higher.

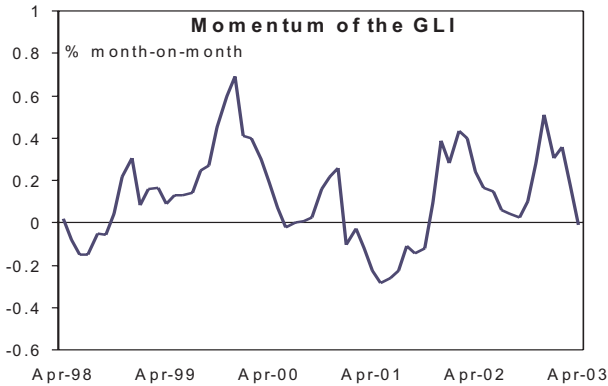
With inflation below the Fed's implicit target (of 1.5% on the core PCE deflator and 2% for the core CPI), a policy of opportunistic deflation no longer makes sense. Fed officials will now tend to be very tolerant of growth until inflation rises. After all, with inflation below target, higher inflation is now an explicit goal of monetary policy. This is one reason, along with a slightly below-trend US growth forecast, why we do not foresee any monetary policy tightening until 2005 at the earliest.

Our US economists think the Fed should go further and commit explicitly to keeping the federal funds rate low until the core PCE deflator hits 2% on a year-over-year basis. This would anchor inflation expectations in positive territory and increase the likelihood of a sustainable economic recovery.

Is the World Outlook Improving?

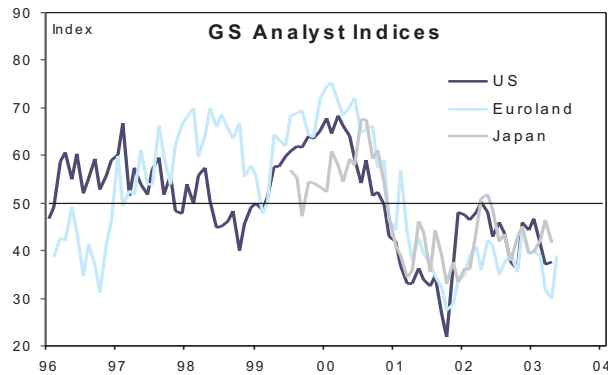
Possibly. Certainly the outlook had been grim: growth in the advanced economies was probably close to zero through April. This weakness was largely related to the war, and we do expect to see some post-war bounce in the data over the next few weeks.

Although we remain concerned about the persistent post-bubble excesses, we are heartened by the dollar's fall and moves toward easier policy outside the US. This provides some grounds for optimism about the longer-term outlook. ■



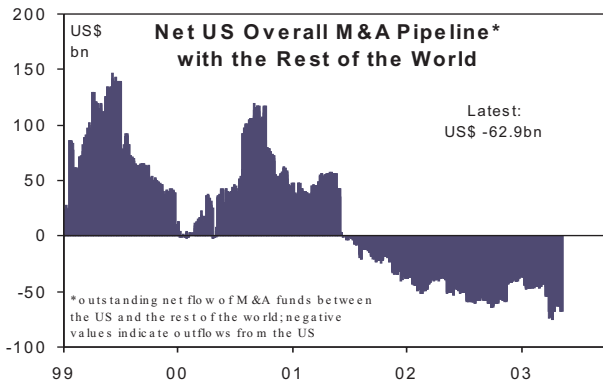
GLI: No Sign of Better Global Economic Conditions

- On a month-on-month basis, momentum in our Global Leading Indicator has declined further, at 0% (flat) in April against 0.2% in March. Weak business confidence and a sharp decline in industrial metals overshadow recent gains in consumer confidence. Taiwan exports fell dramatically as inventory restocking fades further.
- Consistent with the tone of most economic recent data, the GLI shows that the industrial cycle has stalled, despite hopes that the end of the war in Iraq would lift the uncertainty clouding the global economic outlook.



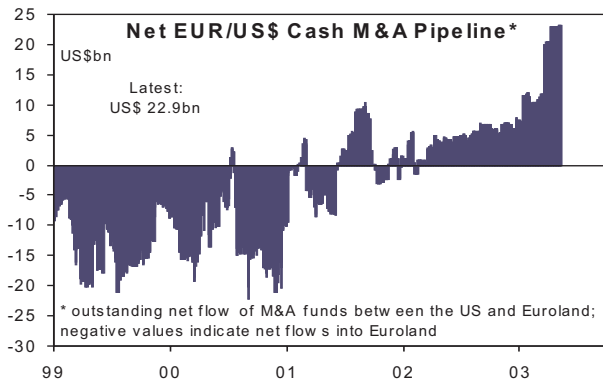
GS Analyst Indices: Edging Up, But Still Weak

- With military operations in Iraq winding down, the US GS Analyst Index edged up to 37.7% in April from 37.1% in March. The small headline rise understates the extent of the improvement, as the composite index was held down by a big drop in materials prices.
- The Euroland index rose to 39.1 in May from 29.8 in April. The May figure suggests that the war disrupted economic activity only temporarily. It also argues against other data suggesting that economic activity was deteriorating badly regardless of the war.



M&A Pipeline Suggests US Investments Abroad

- Our M&A pipeline measures the total amount of pending cross-border M&A deals. The pipeline between the US and the rest of the world shows a pending outflow from the US of \$63 billion.
- At \$333 billion, 2003 year-to-date merger volume is down 8% versus the same period in 2002. Because M&A transactions do not appear in the balance of payments until they are effective, the official FDI numbers do not overlap with the pending deals in our M&A pipeline. Our pipeline suggests that further US investments abroad may be likely.



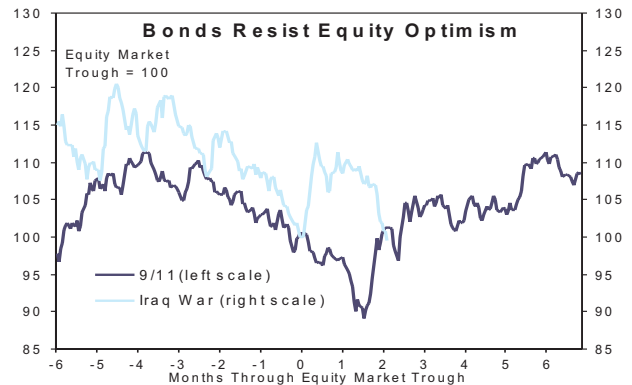
Europe Captures Center Stage in the M&A Market

- Total US acquisitions of foreign firms lagged foreign purchases of US firms in 2002, but US companies announced more new cross-border deals, a point not captured in the balance of payments. The net euro/dollar cash pipeline shows potential M&A-related cash inflows into Euroland worth \$23 billion.
- European M&A currently accounts for 45% of year-to-date announced volume. Five of the ten largest M&A deals announced this year involve European targets. North American M&A has declined to only one-third of the total volume this year.

Source: Thomson Financial Securities Data; Goldman Sachs.

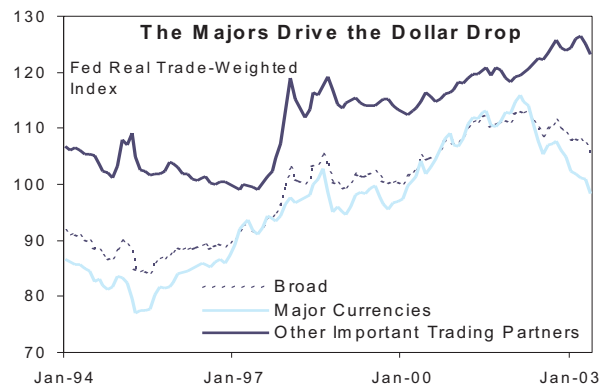
Bonds Resist Equity Optimism

- Asset market correlations have demonstrated some important shifts in recent weeks. Since early 2001, improved equities, a stronger dollar and higher yields have tended to move hand in hand, and the positive impact of equity rallies on financial conditions has been undercut by rising bond yields and a strengthening dollar.
- Recently, despite the rally in equity markets, bond yields have not risen significantly, and the dollar has failed to strengthen. The shift in correlations has allowed an easing in financial conditions that has not been possible before.



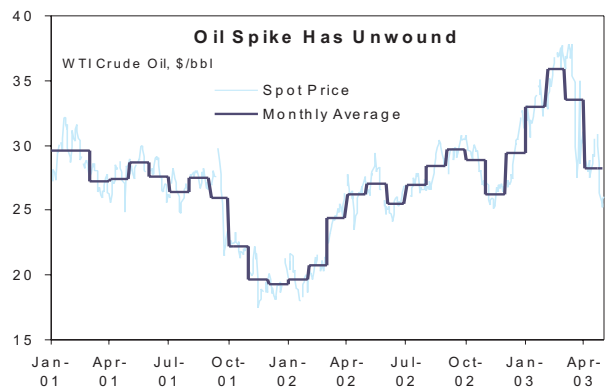
The Majors Drive the Dollar Drop

- The dollar has fallen substantially against Europe and Canada, but it has held up against other trading partners, including Latin American and developing Asian currencies, since 2002.
- With Asian and Latin American currencies comprising much of the trade-weighted basket, it is hard to engineer the large dollar depreciation that appears necessary. We think the euro, the Canadian dollar and ultimately the yen may bear much of the burden of adjustment.



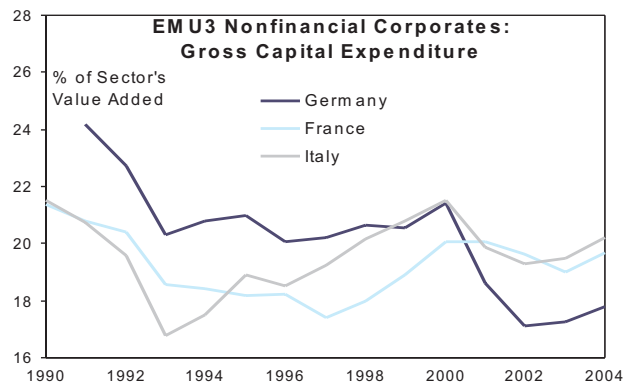
Oil Spike Has Unwound

- April's fall in oil prices partly reflected weakness in Asian demand as a result of SARS-related disruptions to transportation demand. The impact of those demand reductions on oil prices may provide a positive impulse for non-Asian consumers.
- Yet our underlying view of the oil market over the next six months remains cautious, and a tight near-term supply situation continues to suggest higher prices this summer, particularly before Iraqi oil returns to the market.



Euroland Corporates Cut into Capex

- Like their US and UK counterparts, German, French and Italian corporates have largely reduced their recourse to external sources of finance. German firms stand out as having cut deeper into capex than have their French and Italian counterparts.
- Although high leverage remains a focal point, the growth of the stock of debt has stabilized. Our fixed income strategists continue to recommend a moderately overweight stance on European credit products, particularly at the lower end of the credit spectrum.



Source: Goldman Sachs.

THE WORLD IN A NUTSHELL

	Outlook	Key Issues
United States	We have been bearish on capital spending for the last 2½ years. The near-term outlook is improving; real capital spending growth could accelerate to more than 5% by late 2003. But sustained strength remains unlikely. Capacity utilization and the return on capital are still below historical averages and are unlikely to move up sharply anytime soon. We see a renewed capital spending slowdown to a below-trend pace in 2004.	By altering the 'balance of the risks' statement, the Fed signaled a shift in monetary policy. Inflation is now too low, rather than too high. We think Fed officials should go further and precommit to keeping the fed funds rate low until the core PCE deflator rises to 2% year-on-year. This would require some sacrifice of policy flexibility, but the benefits would include a stronger anchor for keeping inflation expectations in positive territory and an even flatter yield curve.
Japan	Although the impact of a strong yen on the real economy has diminished in recent years, a strong yen will still have a considerable effect. A 10% yen rise lowers production by 2.5pp and corporate earnings by 2.0pp. The Goldman Sachs Financial Conditions Index has been declining in step with the decline in long-term interest rates, but should begin rising again as a result of yen appreciation.	Public funds are moving away from a strategy aimed at portfolio diversification and are concentrating once again on safer asset management, in the form of domestic bonds. The scaling down in public funds' investments will have a negative impact on Japanese equity supply and demand balance. Conversely, public funds will add momentum to the JGB market, chiefly in the long-term sector.
Europe	We expect Euroland GDP growth to rise to an above-trend rate of 2.7% in 2004; the consensus is 2.0%. Many of the negatives that have held back economic activity in the past are beginning to fade. Meanwhile, the ECB has eased monetary policy aggressively. Real interest rates are unusually low. With the usual lags, easy financing conditions will provide a significant boost to economic activity.	Germany may not lead Euroland's recovery, but it should be a willing participant. The adjustment to the private sector's financial position clears the way for stronger domestic demand growth. The catalyst for this is likely to come from a recovery elsewhere in Euroland that boosts demand for German exports. Germany has been gradually improving its competitive position relative to other Euroland countries.
Non-Japan Asia	Our forecast for Korea's 2003 GDP growth remains broadly unchanged at 4.3%. Against consensus, we now expect a temporary rebound in growth in the second quarter. This rebound will give way to renewed weakness in the second half. We see cyclical bottoming in late 2003 or early 2004, and we have adjusted our 2004 forecast to 5.3% from 6.5%.	Asian exports have bucked the OECD manufacturing slump, largely thanks to China's economic strength. While China has punched above its weight in terms of pulling in imports from Asia, this has not translated into meaningful enhancement in the pricing power of Asian exporters. The sequential momentum of Asian exports to China is already past its peak, and we expect more moderation ahead.
Latin America	In Mexico, the central bank's preemptive and persistent tightening of monetary policy is reducing both actual and expected inflation. At the same time, real GDP growth has not rebounded. Risks for growth are skewed to the downside. The central bank may have completed its tightening cycle, but the beginning of an easing cycle depends on a stronger drop in actual and expected inflation.	Brazil's new administration has stabilized the economy and continues to gain credibility, largely through tighter financial policies and the delivery of social security and tax reforms to Congress. Brazil could see modest growth in the second half, followed by an expansion of 3.0% in 2004. We think bolstering growth will require stronger policies, including an increase in domestic savings.
Central and Eastern Europe	EU enlargement in 2004 remains on track. We see little risk to the ratification process for the first ten accession countries. While they have all committed to proceed into EMU at a later date, widely indicated for some to be by 2007, the last few weeks have seen a number of statements from two prominent candidates—Poland and Hungary—suggesting that they might be in no hurry.	Spreads on Bulgarian and Romanian Eurobonds have rallied recently and are back to the lows seen in February. The current level of spreads is justified only in an optimistic scenario with continued political stability and steady progress towards EU membership. The risks of political changes (particularly in Bulgaria) and slippages on reform programs (particularly in Romania) are substantial.

KEY ECONOMIC AND MARKET FORECASTS					
	GDP (%)	Consumer Prices (%)	3M Rate Forecasts* (%)	Bond Yields** (%)	Exchange Rate Forecasts
US	2003: 2.1 2004: 2.5	2003: 2.2 2004: 1.2	3m: 1.0 12m: 1.0	Current: 3.4 12m: 4.0	-- --
Japan	2003: 1.3 2004: 0.2	2003: (0.2) 2004: (0.1)	3m: 0.1 12m: 0.1	Current: 0.6 12m: 0.8	3m \$/JPY: 115 12m \$/JPY: 111
Euroland	2003: 0.8 2004: 2.7	2003: 2.0 2004: 1.5	3m: 2.2 12m: 2.7	Current: 3.8 12m: 4.9	3m EUR/\$: 1.12 12m EUR/\$: 1.22
UK	2003: 2.1 2004: 2.7	2003: 2.9 2004: 2.4	3m: 3.8 12m: 4.1	Current: 4.0 12m: 4.9	3m GBP/\$: 1.60 12m GBP/\$: 1.65
Non-Japan Asia	2003: 5.9 2004: 6.8	2003: 1.1 2004: 1.4	3m: 5.0 12m: 4.5	Current: 7.1	3m \$/KRW: 1325 12m \$/KRW: 1200
Latin America	2003: 0.9 2004: 3.2	2003: 11.3 2004: 11.2	3m: 8.5 12m: 9.1	Current: 9.0 12m: 10.1	3m \$/MXN: 10.30 12m \$/MXN: 10.75
Central and Eastern Europe	2003: 3.7 2004: 4.5	2003: 4.5 2004: 2.9	3m: 5.2 12m: 4.9	Current: 4.8 12m: 5.0	3m EUR/PLN: 4.10 12m EUR/PLN: 4.10

* 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.

Can Euroland Accelerate Without US Fuel?

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The model predicts a recovery for two reasons: Euroland will follow the rebound from the trough that occurred in the US in 2002, with the usual lags; and falling real interest rates in late 2002 and early 2003 will boost growth significantly only by late 2003, given the long lags with which policy operates.

Stranger Things Have Happened

In addition, several countries whose growth has traditionally been much more closely correlated with the US have managed to decouple as a result of the unusual current US circumstances. If decoupling can occur in economies with much closer historic relationships with the US, it is hard to argue that it is impossible in Euroland.

The first example is Australia, where correlations with US GDP growth have been over 60% (although we think this has its roots more in common shocks than in causation). Australia has avoided many of the imbalances that the US has built up, allowing the two economies to decouple recently. Correlations between Australian and US growth since 1998 have been less than 20%, and Australia managed to grow by more than 4% through 2001 despite the US recession.

The second is Canada. Like Euroland, Canada had not had a recovery in the last two decades where GDP growth had moved above trend without a US above-trend recovery. The last year has shown that it can. Unlike Australia, simple growth correlations between the US and Canada have remained high, but the Canadian economy has generated a strong domestic recovery. Canada's case is particularly interesting since the direct linkages with the US are the strongest of any major economy and its growth cycle is more closely correlated with the US than is any other country's.

With Australia and Canada generally avoiding many of the imbalances built up in the US, policy easing has resulted in much stronger performance than past relationships with the US would have predicted. In both cases, the factors behind the decoupling are similar to what we foresee for Euroland.

Two Big Risks

There is no general reason why Euroland cannot move above trend if the US does not. To say that it can do so, of course, is not to say that it will. If Euroland is to recover, it will be important that restraints on domestic spending do not prevent monetary stimulus from working as it normally does.

We see two major risks to our view. The first is a large global shock that hits both Euroland and the US. Tumbling global equity markets or spiking oil prices would make it much harder to envisage strong outperformance, as common drags would easily swamp local advantages.

The second is a shock that hurts Euroland but not the US. The most obvious concern is a continued sharp appreciation of the euro. Without an offsetting policy response, euro appreciation could tighten financial conditions in Euroland significantly, while loosening them in the US. We find that a 10% rise in the currency would roughly take 0.9 percentage points off growth within six quarters. While significant euro appreciation is already built into our forecasts, it is important that the European Central Bank cuts interest rates forcefully enough to offset its effects, if Euroland's recovery is to proceed as we expect.

The clearest market implications of our views are for short-term interest rates. In part based on the experience in Australia and Canada, we expect tightening to begin earlier in Euroland and short-term spreads to widen. The implications for longer-dated bond and equity markets, which are traditionally more highly correlated across regions, are more complex. The general presumption must be that a growth surprise in Euroland's favor would lead to relative equity market outperformance and relative bond market underperformance. ■

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Can Euroland Accelerate Without US Fuel?

Our forecast that Euroland will outperform the US next year has been greeted with some skepticism. Yet historical evidence suggests that it can, and Europe is less hindered by post-bubble excesses than is the US. The biggest risk is continued euro appreciation without an offsetting monetary policy response

We expect Euroland to return to above-trend GDP growth of 2.7%, while the US remains below trend at 2.5%. The idea that Euroland will accelerate when the US does not has been greeted with some skepticism. There is a widely held view that Euroland is now so reliant on the US economy to provide its growth stimulus that only a vigorous US rebound will drag it out of its current doldrums.

Key to our Euroland forecast is the expectation that domestic demand will recover next year. This in turn is predicated on several ideas: 1) real interest rates will remain unusually low (outside Germany); 2) fiscal policy will not act as a constraint, despite the Growth and Stability Pact; 3) the stronger euro will boost real incomes and help domestic consumption; 4) capital spending will post a cyclical recovery, with total fixed investment growing 3.5%; and 5) stronger confidence will boost inventories.

Are Our Forecasts Asking Too Much of Europe?

Although the US and Euroland economies have often moved together, the relationship has been much less close than the common view holds. The correlation of GDP growth between the US and Europe since 1980 is just less than 30%.

Although the perception that the US drives Euroland's cycle is strong, a much more plausible explanation is that the two regions have been hit by common shocks and have reacted in similar ways. The closest relationships appear around the oil price spikes of 1973-74 and 1979-80 and the global monetary tightening of the early 1980s.

Where global influences have been smaller and local influences relatively more

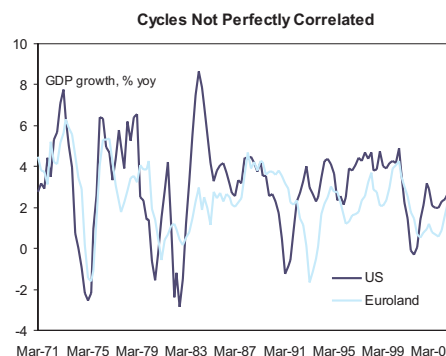
important, cycles have diverged. The most obvious example is the German unification of 1990-94. Others include the 'Volcker tightening' in the early 1980s, which led to a double-dip recession in the US that had no clear counterpart in Europe; and the 1998 Asian and Russian financial crises, from which Euroland suffered more and recovered more sharply.

If common shocks are responsible for the links, why does Euroland often lag the US? One answer is that activity and policy adjust more slowly in Europe. Because European firms view labor more as a fixed cost than a variable one, they may adjust production more slowly to temporary drops in demand. Euroland monetary policy is less aggressively pre-emptive, and the channels through which it operates are probably slower. As a result, a global disturbance is likely to have a more rapid impact on the US than on Euroland.

US Restraints Do Not Weigh on Euroland

In 2004 we think common shocks will become less important and local differences more so. The recent cycle has already been a mix of global and local influences. The downturn in 2001 had its roots in two major global shocks. The first was the collapse in global IT spending and the related equity and investment bust. The second was the sharp rise in oil prices. These large shocks affected both regions, resulting in large and correlated investment downturns.

But consumer spending growth has diverged notably. Buoyed by rate and tax cuts, US consumers have remained remarkably resistant to the broader economic slowdown, while Euroland



consumers have cut back spending in line with slowing incomes and growth.

The US suffers restraints on its recovery that Euroland does not. The US private sector deficit remains excessive, and the attempt to reduce it will weigh on US spending. In Euroland, households have less need to increase saving, and excess capacity is a less serious impediment to investment. These differences should be more obvious in consumer behaviour than in the investment cycle. While we expect consumer spending to accelerate in Europe as incomes pick up, we expect growth to remain flat in the US. And we expect a modest recovery in investment spending in both regions, with a later, stronger recovery in Euroland.

The timing of policy responses has also been different. Real interest rates fell faster and earlier in the US, and the main impact of that policy stimulus is likely to fade soon. Euroland's policy stimulus has come later, and the impact of monetary policy on domestic spending may not have its full impact until later this year.

As a check, we have devised a simple model that predicts Euroland GDP growth as a function of US GDP growth, European real interest rates and the real euro exchange rate. This model forecasts a similar acceleration in Euroland GDP growth, even if US growth remains below trend.

US and Euroland Forecast Paths									
% year-on-year	GDP			Investment			Consumer Spending		
	2002	2003	2004	2002	2003	2004	2002	2003	2004
US	2.4	2.4	2.5	(3.1)	(0.3)	2.1	3.1	2.1	2.5
Euroland	0.8	0.8	2.7	(2.7)	1.0	3.3	0.7	1.1	2.7

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