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A Brightening Picture for the World Economy

As we approach the final quarter of 2003, we are more cheerful about the world economy than at any time so far this decade

We have become progressively more optimistic about the world economy since July, and we now forecast world growth of 4.0% in 2004, with above-trend growth of 3.5% for the US, 2.6% for Euroland and 1.7% for Japan.

Most importantly, a recovery in domestic demand seems to be underway in all the major regions. This would be a key shift away from the trend in recent years—indeed the past decade—of reliance on US domestic spending as the engine for global growth. This lopsidedness has left the world economy and financial markets vulnerable to any signs of spluttering in US demand.

The mini-recovery in growth and asset markets in late 2001 and early 2002, for instance, was predicated almost entirely on a sharp recovery in US domestic demand growth. Over that period, domestic demand in Japan and the Eurozone decelerated, leaving improving net exports the one bright spot in those economies.

In contrast, the current recovery in domestic demand seems more broadly based. For the first time since the recession began, private domestic spending has clearly troughed and may now be accelerating, or poised to accelerate, in all the major economic areas. US growth is picking up further in response to the fiscal stimulus and should grow well above trend in the next few quarters. A bigger surprise has come in Japan, where a recovery in domestic private spending to over 2% growth rates has driven the first leg of the recovery.

In Europe, the recovery has so far been more muted, but the private spending cycle has clearly moved through its trough. We expect demand to reach

%yoy	2003-2004 Forecasts			
	GDP		CPI	
	2003	2004	2003	2004
US	2.7	3.5	2.3	1.2
Japan	2.7	1.7	-0.2	-0.1
Euroland	0.6	2.6	2.0	1.5
UK	1.8	2.9	2.9	2.4
Non-Japan Asia	6.5	7.2	1.7	2.0
China	8.1	8.4	0.9	1.5
Latin America	1.3	3.7	10.8	8.0
World	3.1	4.0	3.4	2.7

3.4% by the end of 2004, as the inventory cycle turns positive, business investment rebounds and consumer spending recovers.

In fact, the recovery in private demand across the G3 is taking place in the same sequence as the retrenchment did. Demand growth turned negative first in the US (in June 2001 on a year-on-year basis), then in Japan (December 2001) and finally in Euroland (March 2002). It is not surprising that the recovery is occurring in the same order.

We are also optimistic in non-Japan Asia, where we expect an autonomous increase in domestic spending in addition to an improving export cycle. China appears to be accelerating after its SARS-induced dip, and we have just upgraded our GDP forecasts to 8.1% this year and 8.4% next on the back of better-than-expected domestic demand as well as export growth. Elsewhere in the region, notably in Thailand and Taiwan, the domestic-demand recovery is taking hold.

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% yoy	Domestic Demand Forecasts							
	2003				2004			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US	2.5	2.9	3.1	3.5	4.2	4.1	3.5	2.8
Japan	2.4	2.6	1.9	1.8	1.5	1.0	1.0	1.3
Euroland	1.5	1.4	1.6	1.7	1.9	2.8	3.2	3.4
UK	2.6	4.0	2.9	1.7	2.8	2.1	3.0	2.9
Non-Japan Asia	3.8	0.9	3.3	3.7	4.6	5.2	4.5	4.7
Latin America	4.4	3.7	4.8	3.8	5.5	2.8	3.8	3.7
World	2.6	2.5	2.8	2.9	3.2	3.3	3.2	3.1

A Brightening Picture for the World Economy

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What Could Undermine Domestic Demand?

A synchronized improvement in domestic demand is a rare occurrence. The last decade has seen only one year (1994) when domestic demand growth accelerated in the US, Euroland and Asia simultaneously.

Within the G3, there have been three comparable periods: 1) a very brief time in 2000 when Japanese private spending accelerated sharply, before demand slowed elsewhere; 2) late 1995 to mid-1997, which ended with Japanese fiscal tightening; and 3) late 1985 to early 1990, which ended with the US recession of 1990-1991.

Each of those phases came to an end through either policy tightening (Japanese fiscal tightening in 1997; monetary tightening in the US in 1989-1990 and globally in 2000) or the unwinding of a major imbalance or a new shock. Examples include the Gulf oil shock of 1990, the Asian crisis in 1997-1998 and the bursting of the investment bubble and the global equity market correction that began in 2000.

For now, we think a shock is a greater risk than is policy tightening. In the US, we think the Fed will not raise rates until mid-2005 at the earliest. In Euroland, greater flexibility on the Stability and Growth Pact has removed the risk of a recovery choked off by fiscal tightening. Overall, policy is helpful: real interest rates are at their lowest levels in decades, and fiscal policy remains mildly supportive of growth.

More worrisome is the risk that the resolution of economic imbalances in the US, particularly in the extended household sector and the current account deficit,

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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could undermine the recovery there. We are already forecasting growth to slow in the second half of 2004 as higher yields dampen consumer spending and these imbalances become more pronounced.

Stronger domestic spending in the rest of the world would of course help the US economy maintain reasonable growth even with some deceleration in domestic demand.

Inflation Still Low as Deflation Fears Ease

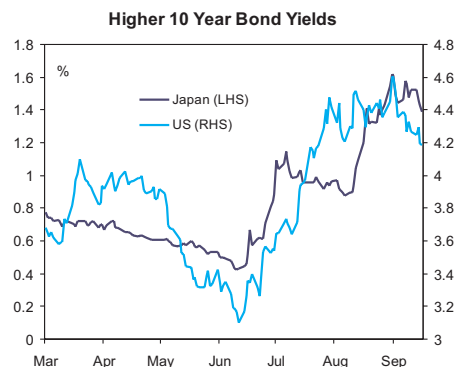
Whether interest rates will stay low will largely be determined by the performance of inflation; inflation expectations; and central banks' perceptions of inflation risks. Market fears of deflation eased significantly over the summer. The large rise in US, Japanese and global yields (recently somewhat unwound) and the evidence from inflation-linked bonds intensified market fears that short-term interest rates in the G7 will not stay at current low levels for long.

Yet the actual evidence on reported inflation suggests few grounds for such a large shift in expectations. Recent reported consumer price indicators and broader inflation indices in the G3 offer mixed signals, but the moves on the whole are modest.

The biggest risk seems to be in Asia, where money supply growth is accelerating rapidly in Japan and China. We do not think that the Bank of Japan will shift its policy over the next year, although the case for tightening is stronger in China.

In the US, we do not expect the Fed to raise rates before mid-2005 at the earliest. The economy has considerable potential to grow without triggering inflationary pressures. Given the low level of inflation, we think the Fed would like to see strong growth before it raises rates; even if the US were to grow at 5.0% next year (we forecast 3.5%), we do not think the Fed would be in a rush to tighten.

In Europe, we expect the ECB to stay on hold this year and raise rates by 100bp, to 3.0%, in the second half of 2004.

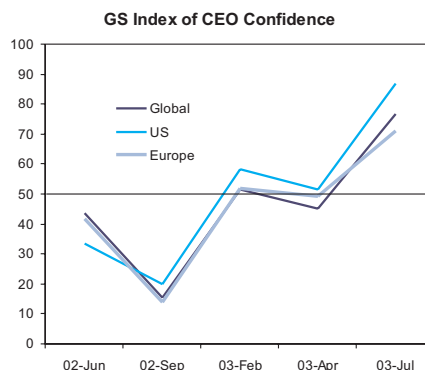


Risks to Our Views

Broadly, we see three risks to the upside and three to the downside:

The upside risks are: 1) Structural reforms could accelerate in Germany and Japan if policymakers see further improvements in business and consumer confidence or signs of accelerating domestic demand. This would boost US exports, which might allow a more optimistic trend in business fixed investment than we forecast. 2) If China surprised the world and revalued its exchange rate significantly, this could act as a catalyst to larger investment spending in 'old industries' within the G7 and OECD. We discuss this in greater detail on page 3. 3) Our July quarterly survey of CEO confidence showed a remarkable rise in global business confidence and the outlook for capital spending. If this mood persists in our October survey, it may be grounds for further optimism.

The major downside risks are: 1) A terrorist attack that damages consumer and business sentiment; 2) a rise in bond yields in the US; and 3) a failure of structural reform in Germany or Japan. ■



How China Can Help the World

By revaluing its currency, China could spark a global currency readjustment that would help US and global financial conditions, reduce deflationary risks and aid the improving prospects for a sustained global economic recovery

We estimate that the Chinese Yuan (CNY) is undervalued by 9.5%-15% on a trade-weighted basis, and we forecast that China will allow the CNY to move to more flexible trading bands within six months and that the currency will rise by 5% within 12 months.

Such a move on its own would have a limited impact on the world economy. We estimate that a 5% appreciation of the CNY against the US dollar would have a negligible impact on US growth (0.03%). Even a much larger revaluation, in isolation, would do little for global growth prospects.

Yet a stronger CNY could be much more important for the world economy if it were accompanied by significant currency shifts elsewhere. Asian governments that have steadfastly resisted any appreciation in their currencies against the dollar—including Japan, which has spent about \$76 billion to support the yen this year—might change their stance. Asian currencies account for some 40% of the trade-weighted dollar index, so a shift there could sharply reduce pressure on the euro and the Canadian dollar, which have thus far borne most of the burden of adjustment against the US dollar.

Many arguments about why the CNY should not appreciate miss the mark. China is not primarily responsible for global deflationary pressures. China's import penetration into developed economies is too low and its product mix too different for currency shifts to have huge impact on trade flows. Its large bilateral trade deficit with the US is probably a function of the goods it produces and its status as the 'last stop' for products made elsewhere, not of the exchange rate. China will remain a competitive producer and a magnet for outsourcing even with a stronger exchange rate.

China should revalue, in our view, because it has become a barrier to a broader currency alignment. By revaluing, China could do much to help the world economy.

Weights in the US Dollar Trade-Weighted Index (%)			
Canada	17.4	Switzerland	1.4
Euroland	17.2	Australia	1.3
Mexico	11.6	South Africa	1.3
Japan	10.7	Philippines	1.2
China	9.8	Venezuela	1.1
UK	5.1	Israel	1.1
Korea	3.6	Indonesia	1.0
Taiwan	3.3	India	1.0
Malaysia	2.3	Sweden	1.0
Singapore	1.9	Russia	0.9
Brazil	1.7	Norway	0.7
Hong Kong	1.4	Colombia	0.5
Thailand	1.4		

Scenarios for a Currency Realignment

The key to our analysis is the notion of trade-weighted indices (TWIs) for the major currencies. The composition of a currency's trade-weighted index determines the impact of a shift in any single currency against it. The CNY holds a 9.8% share in the US dollar TWI. While this is a sizeable amount, it is not enough to have a meaningful impact on the dollar by itself.

To see what impact a broader currency realignment could have, we analyze three scenarios:

- Scenario I assumes a 15% rise in the CNY against the dollar, matched by similar moves in other Asian currencies and 10% rise in non-Asian currencies against the dollar. When we run this through our TWI model, the Asian currencies (including the CNY) experience TWI appreciation of around 5%, while the euro and other majors rise by a very modest amount.
- Scenario II assumes a 30% rise in the CNY, with 15%-20% rises in the yen and other Asian currencies against the dollar. The euro, the Canadian dollar and other currencies move in a way that keeps their own trade-weighted indices broadly unchanged. We find that, because the CNY rise outstrips the rest of Asia, China's TWI appreciates by

around 20%, taking more of the adjustment burden.

- Scenario III assumes a 10% rise in the CNY, 10% rises in other Asian currencies and a larger 20% rise in European currencies. In this case, the euro's TWI appreciates by nearly 10%, while Asian currencies are unchanged on a TWI basis.

Each scenario would lead to a 10%-15% decline in the US dollar TWI, while Scenarios I and III would have little impact on China itself.

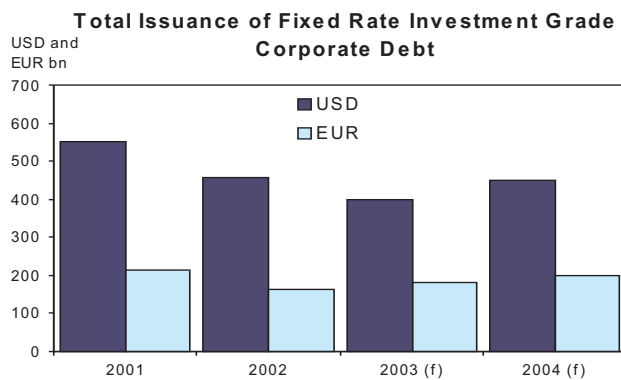
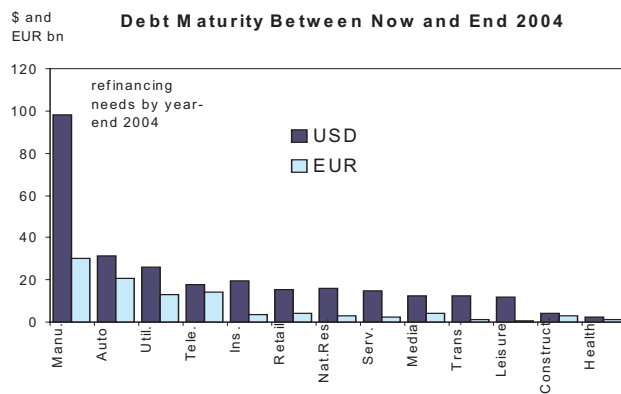
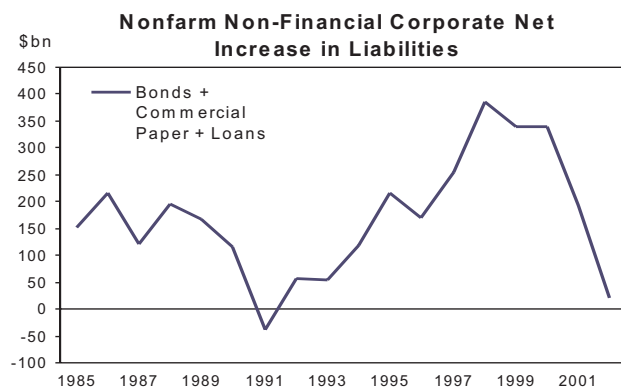
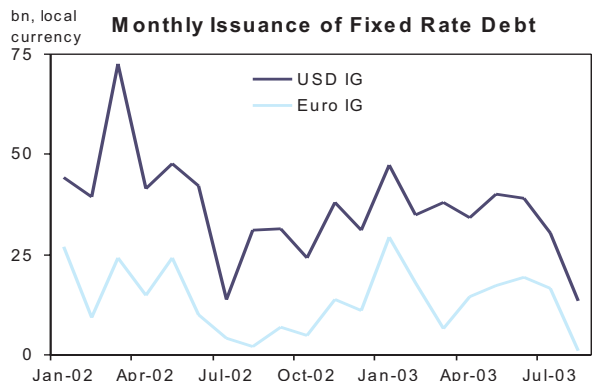
This 10%-15% dollar decline would be close to twice the depreciation in the dollar's TWI since it peaked in mid-2002. Such a fall could ease US financial conditions by 50-75bp, boosting US growth by 0.5ppt-0.75ppt within a year or so. Inflation could be expected to rise by around 0.5ppt. Ultimately the US trade balance would also improve.

We already forecast robust US growth over the next few quarters, although we expect it to slow later in 2004. The additional impact of a weaker dollar—spurred by the CNY—would go a long way toward allaying our fears of a slowing in growth beyond that, and would suggest scope to become more optimistic about the sustainability of the recovery.

Impact on Asset Markets

The prospect of stronger US and global growth would be a fresh positive for equities, particularly cyclicals, and for emerging-market assets. A more balanced and sustainable global recovery could also see equity volatilities and equity risk premia decline further.

Bond markets would presumably react negatively to the falling risk of deflation. Stronger growth and inflation forecasts could be worth an extra 30-40bp on US bond yields. But we think that, even if the US were to grow by close to 5% for all of next year (our forecast is 3.5%), the Fed would still not be in a hurry to raise rates. ■



Source: Thomson Financial Securities Data; Goldman Sachs.

A Look at the Investment Grade Debt Market

Credit Issuance Should Not Set Off Alarm Bells

Markets seem to be concerned about the potential of a large increase in bond supply over the next year. While we expect a rise in global investment grade issuance, we think that its effect will be benign and that it will not lead to significant upward pressure on spreads. This thinking supports our more positive investment view on euro spreads relative to US dollar spreads. We have a slight underweight position on global investment grade credit, but this is mainly motivated by weakening demand, rather than by concerns over supply.

Refinancing Needs

To get a sense of the amplitude of the refinancing needs of existing dollar- and euro-denominated debt, we have analyzed the amount of debt coming to maturity before the end of 2004 in both markets. Manufacturing companies account for about 34% of total refinancing needs of the non-financial sector, while automotives have a 16% share. The share of total refinancing needs of global industrials, global automotives and US dollar utilities is larger than their current weight in their respective investment grade benchmark indexes. This could create a negative technical for these sectors, and makes them more vulnerable to potential deterioration of financing conditions. The increased issuance from these sectors, which are generally rated BBB, is likely to contribute to a further deterioration of the overall rating of the investment grade market.

US Dollar Market Will Remain Much More Active than the Euro Market

Over the past two years, issuance of fixed rate US dollar investment grade bonds has been about double that of euro issuance. We believe this ratio will remain largely unchanged.

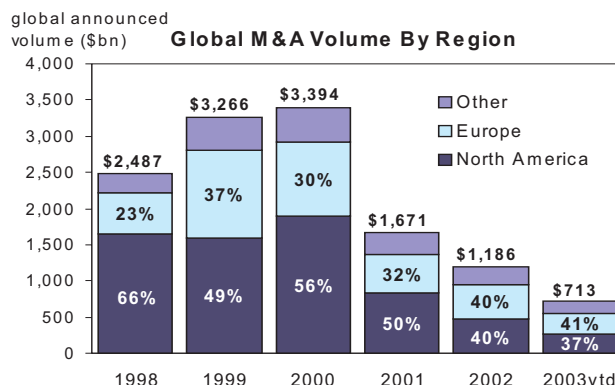
First, funding in the US dollar market is currently cheap relative to financing in euros, and may provide a short-term boost to US dollar issuance. The spread to LIBOR for debt with similar ratings and similar maturities is almost identical in US dollars and in euros, while usually there is a 10-20bp spread pickup for access to the deeper and more liquid US dollar market.

Second, US-based firms are likely to issue more debt than European corporates, and naturally tend to do much of that in dollars. Total debt of non-financial corporates as a percentage of that sector's nominal GDP was slightly higher in Euroland than in the US. However, in Euroland much of that debt is in the form of bank loans, while US firms go more quickly to the capital markets, which helps explain why the dollar credit market is so much more developed. As the privileged relationship with the house bank remains in Europe, we think new issue activity will remain significantly lower in euros than in dollars.

There are a series of reasons to expect a rise in issuance, but the increase in activity in the primary market should remain limited. Total issuance for 2003 should be around \$400 billion and EUR 180 billion for the US and Euroland, respectively. For 2004, we expect some 10% growth above this year's figure; issuance should remain well below the 2001 peak level. The analysis above also supports our somewhat more positive view on euro spreads relative to dollar spreads. While motivated by technicals, our recent move to a slight underweight position on investment grade credit concerns the demand side, not the supply side. ■

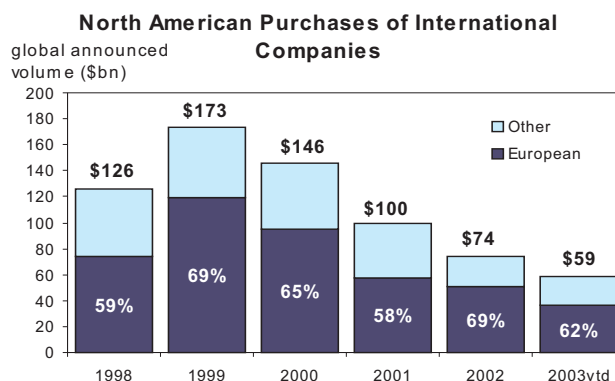
M&A Volumes Continue Their Downward Trend

- At \$713 billion, 2003 year-to-date merger volume is down 12% from the same period in 2002.
- European M&A currently accounts for 41% of year-to-date announced volume, while four of the ten largest M&A deals announced this year involve European targets. North American M&A has declined to only 37% of total volume in 2003 year-to-date, significantly below the 52% five-year average. Interestingly, two of the ten largest transactions this year involve target companies based in Asia.



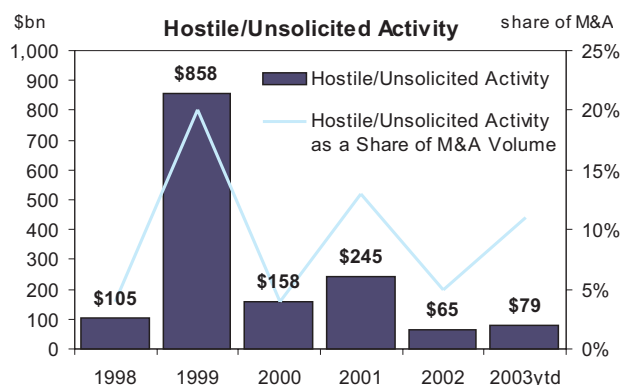
North American Firms Are Buying in Europe

- Announced cross-border volume in 2003 year-to-date is \$200 billion, or 28% of total merger volume. Inter-regional cross-border volume by North American companies has been more prevalent this year than have European purchases of non-European companies.
- Recent notable cross-border transactions include Procter & Gamble's \$7 billion acquisition of Wella, which is one of the ten largest purchases ever of a European company by a US acquiror.



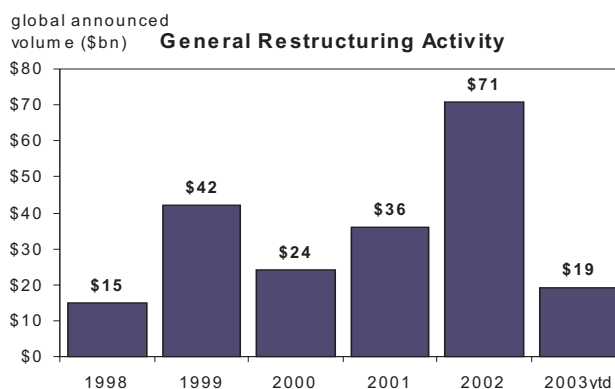
Hostile Activity Picks Up Significantly

- We have seen a recent pickup in hostile and unsolicited activity, with six of the ten largest situations year-to-date announced since May. At \$79 billion, 2003 year-to-date hostile and unsolicited activity already exceeds the full-year 2002 volume by 22%.
- While much of last year's unsolicited activity was focused on minority squeeze-outs, 2003 has seen something of a resurgence in traditional M&A activity, much of which has been geared toward European target firms.



Restructuring Is an Increasingly Important Share of M&A

- Corporate restructuring activity peaked at \$70 billion in 2002 as companies pursued a variety of ways to raise cash. 2003 has seen \$19 billion of restructuring activity year-to-date.
- Companies continue to sell assets that are no longer part of their strategic focus, influencing divestiture volume. Year-to-date divestiture activity accounts for 36% of announced volume. Overall, divestitures have historically accounted for approximately 25% of announced merger activity.



Year-to-date figures are through 31 August 2003.
Source: Thomson Financial Securities Data; Goldman Sachs.

THE WORLD IN A NUTSHELL

	Outlook	Key Issues
United States	The economy is growing fast, but not fast enough to generate employment gains. On the demand side, the situation is rosy, but data continue to disappoint on the labor side. The absence of job creation may begin to weigh more heavily on confidence this fall. We anticipate strong growth for the next few quarters but think this will fade in the second half of 2004. We estimate the ten-year cumulative budget deficit to be about \$5.5trn.	We think the Fed will not tighten monetary policy until mid-2005 at the earliest. Economic momentum will slow once the fiscal stimulus wears off and the impact of the drop in mortgage financing curbs consumer spending. Inflation should continue to decline as long as the economy has excess labor and capital. The Fed will also be patient because it wants inflation to climb. The output gap needs to be used up first.
Japan	A corporate profit recovery is underway, driven in part through sales but largely through the effects of restructuring, which is most pronounced in the manufacturing sector. A declining savings rate is helping sales to remain firm by offsetting the impact of restructuring on incomes. In August, our GS Analyst Index hit its highest level since October 2000, boosted by a revival in sales and new orders.	Economic data shows growing momentum in the recovery, and we think growth looks sustainable to at least mid-2004. Capex (surprisingly and strongly) and exports are the twin engines of growth; machinery orders, a leading indicator for capex, should remain firm. Companies continue to rely on internal funds for now. Large companies have ample free cash flow.
Europe	Given the weaker euro, sticky inflation and a better growth outlook, the ECB should see monetary policy as appropriate for some time. Tightening is likely to begin in mid-2004, with rates reaching 3% by yearend 2004. We remain optimistic about the euro and expect appreciation to accompany signs of improving economic activity. Growth should rise markedly, to 2.6% in 2004 from 0.6% this year.	Sweden's No vote to EMU membership is clearly a negative for the euro that highlights the importance of successful reform and stronger longer-term growth within the Eurozone. The EU could help restore confidence by developing more vigorous reform and a clear path for the Stability Pact. A UK referendum on the euro is unlikely in this parliament, and Denmark may delay its vote beyond 2005-2006.
Non-Japan Asia	With continuing demand from China and Europe and signs of a cyclical recovery in the US, Asia's economic outlook is improving. Terms of trade have improved substantially since May and domestic demand is picking up, notably in Taiwan and Thailand. The outlook is improving in Hong Kong, where unemployment seems to have peaked, and in Singapore, where the impact of SARS has faded.	We have raised our China GDP forecasts to 8.1% in 2003 and 8.4% in 2004 to reflect greater-than-expected strength in domestic demand and exports. Cyclical momentum has not peaked, and the likelihood of a policy-triggered hard landing is small. Any policy tightening should be directed at cyclical industries. We continue to expect modest renminbi appreciation (5%) within 12 months.
Latin America	Argentina's recovery has lost momentum, and fiscal and banking-sector reforms are required. Brazil's new economic team is maintaining sensible policies and making good progress on structural reforms. Mexican growth should rebound in Q4 along with a recovery in US industrial output. Venezuela's real sector is experiencing a sharp contraction due to crippling FX, capital and price controls.	We have upgraded our forecasts for regional growth, now anticipating 1.3% this year and 3.7% in 2004, but much work still needs to be done on structural reform. Argentina needs to restore fiscal solvency and pursue reforms in the fiscal and banking sectors, while Brazil needs to reduce regulatory uncertainty and improve its microeconomic policies to attract FDI.
Central and Eastern Europe, Middle East and Africa	Russian GDP is growing strongly, led by double-digit production and export increases in the oil sector and by solid domestic demand. Despite lower commodity prices, we expect growth to be 6.1% this year and 4.4% next. Reforms in the electricity, gas and housing sectors and in the state bureaucracy have slowed ahead of parliamentary and presidential elections in late 2003 and early 2004.	EU expansion in May 2004 will allow further growth and investment opportunities in the 10 accession countries, but governance of a 25-member EU will be complicated. All of the Central Europeans are struggling with unduly large fiscal deficits and inadequate fiscal transparency. The EU's final assessment report on the accession countries' readiness will be issued in November.

KEY ECONOMIC AND MARKET FORECASTS					
	GDP (%)	Consumer Prices (%)	3M Rate Forecasts* (%)	Bond Yields** (%)	Exchange Rate Forecasts
US	2003: 2.7 2004: 3.5	2003: 2.3 2004: 1.2	3m: 1.2 12m: 1.2	Current: 4.2 12m: 3.6	-- --
Japan	2003: 2.7 2004: 1.7	2003: (0.2) 2004: (0.1)	3m: 0.1 12m: 0.1	Current: 1.4 12m: 1.5	3m \$/JPY: 111 12m \$/JPY: 108
Euroland	2003: 0.6 2004: 2.6	2003: 2.0 2004: 1.5	3m: 2.2 12m: 3.0	Current: 4.2 12m: 4.6	3m EUR/\$: 1.14 12m EUR/\$: 1.26
UK	2003: 1.8 2004: 2.9	2003: 2.9 2004: 2.4	3m: 3.6 12m: 4.4	Current: 4.6 12m: 4.7	3m GBP/\$: 1.61 12m GBP/\$: 1.70
Non-Japan Asia	2003: 6.5 2004: 7.2	2003: 1.7 2004: 2.0	3m: 4.0 12m: 3.5	Current: 7.3	3m \$/KRW: 1110 12m \$/KRW: 1050
Latin America	2003: 1.3 2004: 3.7	2003: 10.8 2004: 8.0	3m: 5.0 12m: 5.2	Current: 8.7 12m: 10.1	3m \$/MXN: 10.30 12m \$/MXN: 10.75
Central and Eastern Europe	2003: 3.3 2004: 3.9	2003: 3.6 2004: 4.7	3m: 5.0 12m: 5.0	Current: 5.5 12m: 6.0	3m EUR/PLN: 4.45 12m EUR/PLN: 4.40

* 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.

EU Enlargement: Growth Impetus or Governance Nightmare?

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All these factors will increase potential output and thus the potential for non-inflationary growth throughout Europe.

Economic Risks to the Accession Countries

- Central European budget deficits, which are already clearly too high, will increase further as public investment rises to foster the growth necessary to catch up with the rest of Europe. Vague medium-term projections envisage fiscal adjustments to bring the deficits toward 3% of GDP. While possible, this will be difficult; failure would carry the risk that foreign-held domestic securities (up to 25% of some markets) would be sold and the funds repatriated, putting considerable pressure on regional currencies.
- Central European growth will largely depend on the ability to spread imported technology and know-how from the FDI inflows into other sectors. We see a risk that better capitalized, better organized and more experienced medium-sized firms in the EU will out-compete local competitors in sectors not dominated by

FDI. If not contained, this could bring a repeat of the pain associated with German reunification, but without the massive financial inflows.

Governance Will Be a Challenge

Most of the estimated benefits of enlargement are dependent on better implementation of existing legislation (most noticeably the Single Market), as well as an acceleration of reforms in both the existing member states (labor market rigidities and health and pension reforms) and in the accession countries (fiscal reform and institution building).

The EU needs to streamline its own governance set-up, both to legislate and enforce more effectively as well as to support national reform processes. Lack of fiscal coordination remains a huge issue, with the Stability and Growth Pact under severe strain. Labor mobility, while liberalized in principle, is almost non-existent in practice. And of course the euro remains contentious, not least after Sweden's recent No vote.

Institutional reforms to ease these governance problems are now centered on a draft EU constitution. The draft redefines

the relative powers of the EU and the member states and streamlines many decision-making processes within the EU institutions.

The draft also recognizes that even majority voting among 25 members may be insufficient for its grand vision of Europe. Accordingly, it allows options (termed 'enhanced cooperation') for subsets of countries to act in smaller combinations on various issues.

If practice falls short of the necessary creativity, this 'enhanced cooperation' may be the route for further political integration among a subset of the 25 EU members. Over time, this might change the EU from the union of the past to an increasingly loose constellation of concentric circles of countries enjoying varying degrees of economic and political cooperation. This would make the economic benefits of enlargement more difficult to obtain. ■

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EU Enlargement: Growth Impetus or Governance Nightmare?

May 2004 will see the European Union expand from 15 to 25 member states. Enlargement could lift Europe's long-run potential growth rate, partly by providing an impetus for wide-reaching reforms. But we see a substantial risk that the EU could descend into an increasingly ungovernable group of countries rather than a closer union

A large part of the positive economic impact of EU enlargement has already been felt throughout Europe, because of the wide-ranging trade and investment integration between west and east over the past ten years. Nonetheless, actual expansion should provide a further boost to growth in Europe.

Various studies indicate that the cumulative increase in GDP could be about 0.7% for the existing members during this decade and by up to 19% for the accession countries. The precise numbers will largely depend on policy measures within the EU, but, to the extent that enlargement accelerates reforms—as we think it will—the growth impetus should be considerably stronger.

Big Benefits Already . . .

Foreign direct investment (FDI) has driven Central European growth and provided a lifeline for EU companies. Spurred by assurances of ultimate integration, along with wage costs about 25% of the EU level for a highly educated workforce that delivered about 50% of EU productivity levels, EU-based firms began investing heavily in the region in the mid-1990s.

In all, they have now allocated more than EUR100 billion in FDI to the accession countries, of which more than 90% has gone to Poland, the Czech and Slovak Republics and Hungary. American and Asian firms have provided a further

EUR35 billion in FDI, while another EUR30 billion was transferred in equity and debt portfolio investment.

Largely because of this, Central Europe's investment-to-GDP ratio is a relatively high 26%, compared to the EU's 19.3%. FDI has also brought technical know-how and managerial skills. As a result, Central European per capita income (measured in euros) has increased about three times faster than in the EU since the mid-1990s.

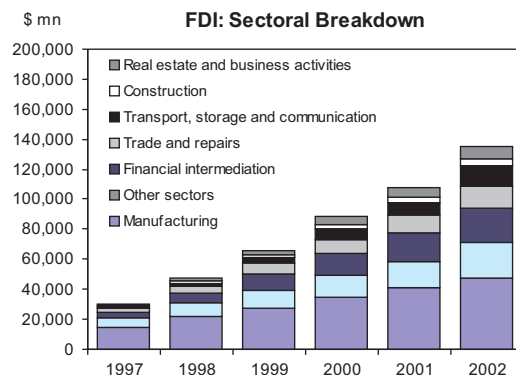
While this inward investment has tapped into EU savings, its drainage on EU growth has been limited. Trade between the regions has doubled. The flow of investment and stronger growth into Central Europe has also helped to foster a more proactive reformist stance among EU policymakers and businesses.

. . . With More to Come

While impressive FDI inflows are likely to continue and may well accelerate, the single most beneficial part of integration will be the implementation of the **Single Market**, which will liberalize remaining trade restrictions (mostly in agriculture) between the two regions.

EU exporters will find the 75 million people in the accession countries easier to access with uniform standards and procedures. Domestic markets in the existing EU will also benefit from efficiency gains stemming from increased competitive pressures from Central European-based producers.

The spread of the Single Market is likely to have the greatest impact for the existing EU members, particularly for Germany, Austria, the Netherlands and Sweden. In fact, existing members will reap some 80%-90% of the total benefits of the Single Market's expansion. More stringent compliance with the Single Market by existing members would further boost this potential gain.



Source: National Statistics and GS Estimates
* Cumulative FDI series for Hungary and Czech Republic do not include pre-1996 flows.

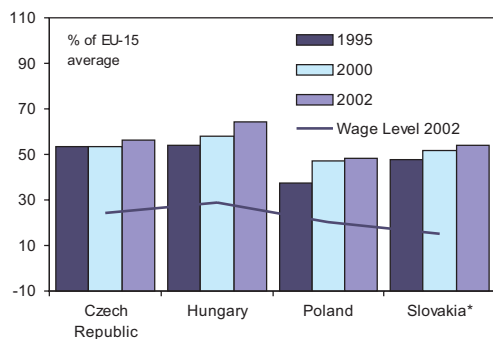
Official transfers are also estimated to have a strong positive impact on growth on the accession countries, and only a marginally negative impact on the existing members. If these estimates prove to be true, the EU is looking at an amazing bargain. On a net basis, the 10 new states stand to receive up to EUR25 billion during 2004-2006; institutional constraints mean the figure is likely to be closer to EUR20 billion.

This is less than 0.1% of pan-EU GDP. In comparison, East Germany received about 4% of pan-German GDP in transfers during the early years of German reunification. Each of the ten accession countries may receive about 1% of their GDP in net contributions, one-half to one-third what the Southern Europeans and Ireland received as a share of their (much higher) GDP when they joined.

Labor mobility has played a major political role in the enlargement debate, but the short-term economic impact is likely to be quite limited. Surveys show that very few Central Europeans will move west in the early years of EU membership. Family ties, language barriers and improving living standards are thought to outweigh the prospect of a more immediate jump in material living standards for many people.

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Central European Productivity vs. the EU



* Slovak data are based on national definition
Source: Eurostat and GS calculations