THE WALL STREET JOURNAL.
WSJ.com
DOW JONES Newswires
EUROPE
DOW JONES A News Corporation Company
VOL. XXVI NO. 160
TUESDAY, SEPTEMBER 16, 2008

For information or to subscribe, visit www.services.wsje.com or call +32-2-741-1414 — Albania Lk 370.00 - Austria €3 - Belgium €2.90 - Croatia HRK 20 - Czech Republic Kc 110 - Denmark Dkr 22 - Finland €3.20 - France €2.90
Germany €3 - Greece €2.90 - Hungary Ft 530 - Ireland (Rep.) €2.90 - Italy €2.90 - Lebanon L£ 4000 - Luxembourg €2.90 - Morocco Dh 24 - Netherlands €2.90 - Norway Nkr 27 - Poland Zl 10.50 - Portugal €3 - Slovakia Sk 100/€3.32 - Spain €2.90
Sweden kr 27 - Switzerland SF 4.80 - Syria SE 150 - Turkey YTL 4.25 - U.S. Military (Eur) $2 - United Kingdom £1.40

Crisis sends banking back to its past

As securities firms disappear, branches make a comeback

By Carrick Mollenkamp

More than 200 years after it was born at the base of a buttonwood tree, Wall Street as we have known it is ceasing to exist.

The filing for bankruptcy protection by 158-year-old investment bank **Lehman Brothers Holdings** Inc. and the takeover of 94-year-old **Merrill Lynch** & Co., coming on the heels of the demise of Bear Stearns Cos., represent a milestone in the biggest restructuring of the banking industry since the Great Depression.

For decades, stand-alone securities firms such as Lehman, Merrill and Bear took big risks and made fat profits at the cost of occasional losses. As those firms are consumed in the wake of a disastrous foray into financial wizardry, the old business of chasing customer deposits and building branch networks is regaining prominence as the reliable way to make money. Institutions such as **Bank of America** Corp. and **Wells Fargo** & Co. in the U.S., as well as Germany's **Deutsche Bank** AG and Spain's **Banco Santander** SA, are moving to the top of the pecking order in a financial industry that is likely to be safer but a lot less lucrative for shareholders.

One hallmark of the new order is likely to be a turn away from the big risks—heavy borrowings, complex securities—that financiers embraced in recent years. Banks are heading "back to basics—to, if you like, the core purpose of the system with less bells and whistles," said Douglas Flint, finance chief at HSBC Holdings PLC and co-chairman of the Counterparty Risk Management Policy Group, a task force of bankers working on a framework to prevent systemic bank risk. "There is a recognition that when the dust settles...the construct of the industry will be different."

The shift reflects a broader reassessment of how best to do the core business of banking, which plays a central role in the economy by turn-

Please turn to page 31

Wall Street crisis

■ U.S. Federal Reserve is likely to hold the line on interest rates 3
■ Sovereign-wealth funds avoid the urge to hunt for bargains 11
■ Central banks pump cash into markets in bid to ease fears 19

AFP

The bankruptcy hit Lehman's London employees, above, particularly hard. Some bankers are being told **to end client relationships** and aren't sure they'll be paid.

What's News—

Business & Finance

The U.S. Fed asked Goldman Sachs and J.P. Morgan Chase to help prop up AIG. The news came as Lehman Brothers raced to sell off pieces before their value erodes. Meanwhile, Merrill Lynch's agreement to sell itself to Bank of America could reshape the U.S. banking landscape. **Pages 1, 2**

■ **U.S. stocks swooned** on the shock of Lehman Brothers' failure and fears for financials like AIG. The Dow industrials shed more than 500 points. **Page 20**

■ **Early dollar losses** were limited later in the day amid relative resilience in the face of the latest shock to the U.S. financial system. **Page 21**

■ **The Libor shows** that banks in the U.S. and Europe are reluctant to lend to one another, reflecting wariness for the industry's financial health. **Page 20**

■ **Central banks** around the world pumped cash into money markets, and investors raised expectations that interest rates would be cut soon. **Page 19**

■ **Crude oil settled** at $95.71 on the New York Mercantile Exchange—its first close below $100 since March 4. **Page 19**

■ **An Alitalia rescue plan** was partially revived as some labor unions signed a draft deal with the plan's key investors. **Page 6**

■ **Chemical giant BASF** launched a nearly $3 billion friendly offer to acquire struggling rival Ciba Holding. **Page 8**

Markets 4 p.m. ET

MARKET	CLOSE	NET CHG	PCT CHG
DJIA	10917.51	-504.48	-4.42
Nasdaq	2179.91	-81.36	-3.60
DJ Stoxx 600	270.68	-9.73	-3.47
FTSE 100	5204.2	-212.5	-3.92
DAX	6064.16	-170.73	-2.74
CAC 40	4168.97	-163.69	-3.78
Euro	$1.4197	+0.0019	+0.13
Nymex crude	$95.71	-5.47	-5.41

Money & Investing > **Page 19**

World-Wide

Zimbabwean President Mugabe agreed to cede some power for the first time, signing a deal that will make opposition leader Tsvangirai prime minister. But how much power the opposition will get remains to be seen. The decision on ministries each side will control wasn't resolved. **Page 9**

■ **The EU stepped up** its engagement in Georgia and launched an observer mission. NATO diplomats demanded immediate Russian withdrawal from Georgia.

■ **Pakistani security officials** said troops fired on U.S. helicopters, forcing them back to Afghanistan, but the U.S. military denied involvement. Elsewhere, Pakistani troops killed 24 militants.

■ **A suicide bomber attacked** a police gathering in Iraq's Diyala province, killing at least 22 people. Gates expects the U.S. combat role in Iraq to shrink.

■ **The IAEA said** U.N. efforts to investigate allegations that Iran tried to make nuclear arms have run into a dead end, with Tehran blocking any probe. **Page 11**

■ **South America's presidents** met in Chile for an emergency summit to find a peaceful solution to Bolivia's political crisis.

■ **Nigeria's main militant group** launched new attacks on energy infrastructure, killing a Shell crude-station guard. **Page 23**

■ **Chinese police arrested** two men on suspicion of contaminating baby-formula milk, as infants sickened rose to 1,253.

■ **Damien Hirst auctioned** off "The Golden Calf" for $18.6 million, among other works, at Sotheby's in London, showing the art market's resilience. **Page 29**

Editorial&Opinion

No rerun
That '70s show of entrenched inflation and low growth isn't coming back. **Page 15**

Merrill sale jars landscape for U.S. banks

By Matthew Karnitschnig, Carrick Mollenkamp And Dan Fitzpatrick

Merrill Lynch & Co.'s agreement to sell itself to **Bank of America** Corp. could instantly reshape the U.S. banking landscape, making the nation's prime behemoth even bigger. The deal shows how the credit crisis has created opportunities for financially sound buyers.

In a rushed bid to ride out the storm sweeping American finance, 94-year-old Merrill Lynch agreed late Sunday to sell itself to Bank of America for $50 billion. Early Monday, the two firms said the directors of both companies had agreed to the deal, which will be subject to shareholder and regulatory approvals.

Driven by Bank of America Chief Executive Ken Lewis, Bank of America has already made dozens of acquisitions large and small, including the purchase of ailing mortgage lender Countrywide Financial Corp. earlier this year. In adding Merrill Lynch, it would control the nation's largest force of stockbrokers as well as a well-regarded investment bank.

The combination, if approved by shareholders, would create a bank of vast reach, involved in nearly every nook and cranny of the financial system, from credit cards and auto loans to bond and stock underwriting, merger advice and wealth management.

"Acquiring one of the premier wealth management, capital markets, and advisory companies is a great opportunity for our shareholders," Mr. Lewis said. "Together, our companies are more valuable because of the synergies in our businesses."

At $50 billion, Merrill is being sold at about two-thirds of its value

Please turn to page 4

Lehman races to sell off units before value erodes

After filing for bankruptcy early Monday, **Lehman Brothers Holdings** Inc. raced to sell off pieces of the fallen investment bank before an exodus of employees and customers causes their value to erode.

The New York company, facing liquidation after filing for Chapter 11 protection in U.S. Bankruptcy Court for the Southern District of New York, continues to seek buyers for some assets, including its U.S. broker-dealer business and investment-management arm, according to people familiar with the situation.

By **Matthew Karnitschnig, Jeffrey McCracken, Susanne Craig, Carrick Mollenkamp, Jeanne Whalen** *and* **Carolyn Cui**

Lehman was trying to sell a substantial stake in the investment-management unit, including Neuberger Berman Holdings LLC, before the bankruptcy-court filing. The business was expected to fetch about $5 billion, and a number of private-equity firms have expressed interest in acquiring the operation.

After failing to engineer a deal to save the entire company over the weekend, Lehman executives now are trying to salvage what they can.

U.K.-based **Barclays** PLC, which held discussions about buying Lehman before the bankruptcy filing, remains interested in Lehman's U.S. broker-dealer unit, the core of the firm. Other buyers are circling, but it was unclear how much the business would be worth.

Other Wall Street firms are being deluged with résumés from Lehman's work force of about 25,000. Many of them are likely to lose their jobs, forc-

Please turn to page 4

BORN TO PERFORM.

NEW XEON® 7400 SETS PERFORMANCE RECORDS AT IBM.
Xeon offers best-in-class virtualization and leading performance with the first industry standard server delivering more than 1 million database transactions per minute. Learn more at intel.com/inside
GREAT COMPUTING STARTS WITH INTEL INSIDE.
©2008 Intel Corporation. All rights reserved. Intel, the Intel logo, Xeon and Xeon Inside are trademarks of Intel Corporation in the United States and other countries.

THE WALL STREET JOURNAL.

CRISIS ON WALL STREET

U.S. requests assistance for AIG

Fed asks Goldman, J.P. Morgan to make big loans available

By Matthew Karnitschnig And Liam Pleven

In an effort to prop up giant insurer **American International Group** Inc., the U.S. Federal Reserve on Monday asked **Goldman Sachs Group** Inc. and **J.P. Morgan Chase** to help make $70 billion to $75 billion in loans available to the company, according to people familiar with the situation. The move came as both state and federal officials scrambled Monday to help AIG find ways to come up with as much as $40 billion to help prevent a downgrade of its credit rating, an outcome that could ultimately prove fatal for the firm.

In New York, Gov. David Paterson announced that state officials are working with AIG on a plan that would allow the firm to, in effect, loan itself $20 billion, by borrowing against its assets. The state isn't loaning the company any money, rather it will allow the company to shift assets that are subject to tight regulation in order to give the company more liquidity in the short term.

Morgan Stanley is playing an advisory role for the Fed regarding AIG, whose problems have the potential to deepen the financial troubles that already plague Wall Street and the global economy. AIG has also sought a bridge loan from the Fed, though Fed officials aren't inclined to provide one, especially right after spurning Lehman Brothers. The Fed did host a meeting for AIG at its offices in New York on Monday, and the Morgan Stanley bankers were among those in attendance. The bankers are looking into the potential role of the government as well as systemic risk to the market of AIG's current situation.

Reuters

A security guard greets workers outside **AIG's headquarters** in New York's financial district on Monday.

Yet, at a midday news conference, Treasury Secretary Henry Paulson, when asked about a possible bridge loan to the firm, said the company's meetings with federal officials had "nothing to do with any bridge loan by the government" and rather was a private-sector effort that was important to the "financial system."

AIG itself made no public pronouncements about its plans, and nervous investors continued to hammer its share price. AIG's stock was down 59% at $5.01 in New York Stock Exchange trading just before the close Monday, and is down 91% for the year.

AIG has incurred a loss of $18 billion over the past three quarters, largely due to losses linked to subprime mortgages.

To raise money, AIG in recent days has explored selling off valuable units and getting an infusion from private-equity firms. The company, for instance, is looking into selling AIG Variable Annuity Life Insurance Company, which provides retirement services, according to a person familiar with the matter. An AIG spokesman declined to comment. While private-equity firms over the weekend such as **TPG** and **Kohlberg Kravis Roberts** & Co. had been talking with AIG about possible capital infusions, at this point private-equity firms would be more interested in buying specific AIG assets rather than contributing money to a capital infusion, according to people familiar with these firms' thinking.

During a weekend scramble to shore up its finances, AIG turned down a capital infusion from a group of private-equity firms led by **J.C. Flowers** & Co. because an option tied to the offer would have effectively given it control of the company, an 89-year-old giant that does business in nearly every corner of the world.

The proposed option would have allowed the firms to acquire AIG for $8 billion under certain conditions. That price is just one-fourth of AIG's market value.

J.C. Flowers didn't respond to messages seeking comment.

When AIG's board rejected the capital infusion, the company's recently appointed chairman and chief executive, Robert Willumstad, took the extraordinary step of reaching out to the Federal Reserve for help. Mr. Willumstad asked New York Federal Reserve President Timothy Geithner whether the Fed could backstop some asset sales.

Two other private-equity firms—KKR and TPG—offered to inject capital into AIG if the Fed agreed to provide the insurer with a bridge loan until its restructuring plan was completed.

AIG viewed the request to the Fed not as a bailout but rather as a temporary measure that would give the insurer some breathing room until it was able to dispose of the assets.

Eric Dinallo, the insurance superintendent in AIG's home state of New York, took a significant role in the talks over the weekend, according to a person familiar with the matter. One key issue, the person said, was the proposed shift of assets. Insurers typically face stringent regulations on how they use their assets, as regulators seek to make sure that they can meet their obligations to policyholders.

The turmoil in housing and credit markets has hammered AIG, largely because of contracts it sold protecting others against losses tied to subprime loans and other risky assets. AIG reported a second-quarter net loss of $5.36 billion last month after a first-quarter loss of $7.81 billion.

AIG had more than $1 trillion in assets at the end of the second quarter. Its shareholders equity—assets minus liabilities—stood at about $78 billion at that point.

—Aaron Lucchetti, Susanne Craig, Jon Hilsenrath and Peter Lattman contributed to this article.

Lehman clients assured accounts will be protected

By Kara Scannell

U.S. regulators assured brokerage customers of **Lehman Brothers Holdings** Inc. that their accounts will be protected and transferred to other brokerage firms.

On Monday, Lehman Brothers filed for Chapter 11 bankruptcy protection in New York, reporting $639 billion in assets and $613 billion in debts. The Securities and Exchange Commission said the Wall Street firm's brokerage business is expected to be unwound outside of Bankruptcy Court.

It isn't clear how the investment-management accounts will be sorted out. Monday, Lehman continued to seek buyers for some assets, including its investment-management arm, according to people familiar with the matter. A number of private-equity firms have expressed interest in acquiring the business.

The division includes private-client business, the Neuberger Berman mutual-fund group and some other asset-management activities. It had $282 billion in assets under management at the end of last year. Lehman said Monday that Neuberger customers could continue to trade normally and wouldn't be affected by the bankruptcy case of the parent.

Troubled firms in the past have tried to sell the business to raise money before liquidation. The Securities and Exchange Commission usually works closely with firms as they try to find buyers for the whole business or arrange for the customer accounts to be transferred to other firms.

When Drexel Burnham Lambert filed for bankruptcy in 1990, the SEC oversaw the transfer of customer accounts to rival firms. That may well be the process followed here.

—Diya Gullapalli and Matthew Karnitschnig contributed to this article.

CORRECTIONS & AMPLIFICATIONS

Steel Partners Japan Strategic Fund said Thursday that it had proposed a tender offer to buy heating-equipment maker **Noritz** Corp. A Corporate News page article in the Friday-Sunday edition incorrectly said Steel Partners made a tender offer.

INDEX TO BUSINESSES

This index of businesses mentioned in today's issue of The Wall Street Journal Europe is intended to include all significant references to companies. First reference to these companies appear in boldface type in all articles except those on page one and the editorial pages.

Advanced Micro Devices 8
Advent International...28
AIG 3
Air France-KLM 6
Air One 6
Alitalia 6
Alliance & Leicester ...31
Allianz SE 31
American International Group 2,3,17,19,20,21,24
Amgen 8
AMR 6
Aozora Bank 24
Apax Partners 28
Babcock & Brown 24
Banco Santander (Spain) 1,32
Bank of America 1,3,11,16,19,20,23,24,32
Barclays 3,11,16,20
BASF 8
BBVA 32
Bear Stearns....32
Best Buy Co. 8
Blackstone Group ..11,28
BNP Paribas 32
Burberry Group....29
CapitaLand 24
Carlyle Group 28
Carphone Warehouse Group 8
Cathay Financial Holding 24
Centro Properties Group 24
Cerberus Capital Management 24
China Development Bank....11
China Investment Corp. 11
Ciba Holding 8
Citic Securities 11
Citigroup 11
Commerzbank 31
Compagnia Aerea Italiana 6
Continental Airlines....6
Cosco....24
Crédit Agricole....8
Credit Mutuel 31
CVC Capital Partners .28
Dell....7,8
Delta Air Lines 6
Deutsche Bank 1,3,20
Deutsche Lufthansa AG .6
Deutsche Postbank 31
DLF....24
Electronic Arts 8
Eurohypo 8
Exxon Mobil 20
Fannie Mae 3,22,24
FerroChina....24
Forstaedernes Bank 22
Freddie Mac 3,22,24
GlaxoSmithKline 8
Goldman Sachs Group 2,4,8,23,31
Google 6
Government Investment Corp. of Singapore ..11
HBOS....3,20
Hewlett-Packard....8
IBM....8
Icici Bank 24
Inmobiliaria Colonial 8
Intel....8
J.C. Flowers 2
J.P. Morgan Chase 2,4,20,32
Judith Lieber 29
Keppel Land....24
Kohlberg Kravis Roberts 2
Korea Development Bank....11
Kuwait Investment Authority 11
Lehman Brothers 3,10,22
Lehman Brothers Holdings 1,2,3,10,11,16,19,20,21, 22,23,24,32
Lokalbanken i Nordsjaelland 22
Lufthansa 8
Macquarie Group 24
Merck & Co. 8
Merrill Lynch 1,3,10,11,16,19,20,21,23, 24,32
Mitsubishi UFJ Financial Group 24
Mizuho Financial Group 24
Morgan Stanley ..4,16,23
Napster 8
National Australia Bank 24
Newcrest Mining 24
Noritz 2
Northwest Airlines 6
Novartis 8
Nykredit 22
Permira 28
Phillips-Van Heusen ...29
Roche Holding 8
Roskilde Bank....22
Royal Bank of Scotland Group 8,20
Royal Dutch Shell ..23,28
Satyam Computer Services 24
Shin Kong Financial Holding....24
Shinsei Bank 24
Singapore Airlines 6
SN Airholding 8
Southwest Airlines 6
Steel Partners Japan Strategic Fund 2
Sumitomo Mitsui Financial Group 24
Sun Microsystems....8
Svenska Handelsbanken 22
Take-Two Interactive Software....8
Tata Consultancy Services 24
Temasek Holdings....11
Toyota Motor....29
TPG 2
TPG Capital....28
UAL 6
UBS 11,20
UniCredit....32
Unisys 8
United Overseas Bank 24
US Airways Group 6
Washington Mutual 20
Wells Fargo & Co. 1
Yahoo 6

FREE daily access to WSJ.com

If you bought today's paper from a retail outlet, simply register at: **wsj.com/reg/coupon** or renew at: **wsj.com**

Today's code is: **EUROPE-H-603**

THE WALL STREET JOURNAL EUROPE (ISSN 0921-99)
Boulevard Brand Whitlock 87, 1200 Brussels, Belgium
Telephone: 32 2 741 1211 FAX: Business: 32 2 732 1102
News: 32 2 741 1600 Editorial Page: 32 2 735 7562
SUBSCRIPTIONS, inquiries and address changes to:
Telephone: +32 2 741 1414
International freephone: 00 800 9753 2000
E-mail: subs.wsje@dowjones.com Website: www.services.wsje.com
Advertising Sales worldwide through Dow Jones
International. Frankfurt: 49 69 971428 0; London: 44 207 842 9600; Paris: 33 1 40 17 17 01
Printed in Belgium by Concentra Media N.V. Printed in Germany by Dogan Media Group / Hürriyet A.S. Branch Germany. Printed in Switzerland by Zehnder Print AG Wil. Printed in the United Kingdom by Newsfax International Ltd., London. Printed in Italy by Telestampa Centro Italia s.r.l. Printed in Spain by Bermont S.A. Printed in Ireland by Midland Web Printing Ltd. Printed in Israel by The Jerusalem Post Group. Printed in Turkey by GLOBUS Dünya Basınevi.
Registered as a newspaper at the Post Office.
Trademarks appearing herein are used under license from Dow Jones & Co. © 2008 Dow Jones & Company All rights reserved.
Editeur responsable: Daniel Hertzberg M-17936-2003

INDEX TO PEOPLE

This index lists the names of businesspeople and government regulators who receive significant mention in today's Journal.

For more people in the news, visit CareerJournal.com/WhosNews

Ai, Duo 22
Allison, Herb 24
Baker, Jamie 6
Bergantino, Gianmaria .20
Boman, Paer 22
Brady, Jason 21
Butcher, Craig 28
Church, Gregory 23
Clifford, Andrew 11
Colaninno, Roberto 6
Di Mattia, Lorenzo 3
El Khair, John 11
Flint, Douglas 1
Frink, David 7
Gargan, Jim 8
Gilligan, John 7
Gong, Frank 32
Greenspan, Alan 10
Hambrecht, Jürgen 8
Hampden-Turner, Michael 3
Hatzius, Jan 3
Hess, John 28
Hogan, Art 20
Horsnell, Paul 19
Kasman, Bruce 3
Kay, Roger 8
King, Matt 31
Kirby, Scott 6
Lacey, Colin 8
Lane, Roger 20
Lewis, Kenneth 1,32
Lomas, Tony 22
Lovett, Mark 20
Lowery, Elizabeth 29
Mack, John 16
Madsen, Aksel Tarras .. 22
Meyer, Armin 8
Meyer, Laurence 3
Moffett, David 24
Mudd, Daniel 24
Murry, Tom 29
Nordvig, Jens 21
Patel, Trush 22
Peper, Ed 29
Petrou, Karen 22
Pomerantz, Lenny 20
Rajendra, Ganesh 31
Rosén, Carl 28
Sajadi, Khash 22
Schmidt, David 24
Scott-Smith, Lisa 21
Shah, Priya 3
Sinche, Robert 21
Spiteri, James 24
Stevens, Sally 8
Sundstrom, Geoff 19
Syron, Richard 24
Thain, John 4
Van Egeraat, Chris 7
van Gisbergen, Jos 28
Vignola, Robert 29
Wagoner, Rick 29
Wang Qing 32
Whitney, Meredith 23
Zhao Xiao 32

Fed likely to hold the line

Some see possibility of a quick rate cut amid market turmoil

BY SUDEEP REDDY AND JON HILSENRATH

U.S. Federal Reserve officials aren't inclined to veer from plans to hold short-term interest rates steady at Tuesday's meeting, even though financial markets put rising odds on a quick rate cut following the weekend's drama on Wall Street.

But concern about deteriorating markets and financial institutions could quickly prompt a change of heart among Fed officials or lead them to use their end-of-meeting statement to open the door to more rate cuts.

The case for a quick rate cut: The market turmoil could add significantly to the risk of weaker economic growth ahead. The Fed has taken pre-emptive action repeatedly over the past year, cutting interest rates as protection against a deeper economic downturn. The failure of **Lehman Brothers Holdings** Inc., the rapid takeover of **Merrill Lynch** & Co. by **Bank of America** Corp. and continuing concerns about insurance giant **American International Group** Inc. added to those risks.

The decision depends largely on whether the market fallout worsens on Tuesday. Fed officials expect some stress in markets. They are hoping it will remain manageable and not put too much pressure on credit conditions and the overall economic outlook. But they also recognize that markets haven't faced the failure of a major investment bank with the financial system as interconnected as it is today.

Reuters

The U.S. Federal Reserve **now has to gauge** to what extent turmoil in the markets will hurt broader economic growth.

Futures markets on Monday put better than even odds on the Fed cutting the 2% federal-funds rate, at which banks lend to each other overnight, by a quarter percentage point on Tuesday. Before the weekend, traders put the likelihood at just 10%.

The risk for policy makers: Cutting rates immediately could remove some of their flexibility in case the financial crisis worsens. The Fed cut rates after the market crash in 1987—a 25% drop in stocks—and after the Sept. 11, 2001, terrorist attacks. But in both cases the potential turmoil was much clearer.

They are likely to be resistant to taking action after less than two days of trading, when the longer-term impact on credit costs and credit availability will be unclear. The Fed previously has inserted language in its post-meeting statement to signal a willingness to take action between meetings if necessary. Those words could re-emerge on Tuesday.

At the very least, Fed officials are likely to suggest "increased uncertainty and increased downside risks as a result of the turmoil and the likely associated restriction of credit," UBS economists said in a note to clients.

Fed officials will likely point to other action they have taken to calm financial markets. Policy makers over the past year have sought to distinguish between interest-rate policy, targeted to address economic conditions, and the Fed's lending programs designed to ease short-term funding problems.

The Fed expanded its lending facilities substantially on Sunday night, accepting equities as collateral for its loans.

Global stock markets tumble

BY NEIL SHAH

LONDON—Global stock markets tumbled Monday as news of **Lehman Brothers Holdings** Inc.'s bankruptcy filing prompted a wave of selling. But the fallout for stock and credit markets was less severe than anticipated even as traders scrambled to assess the potential damage.

In Europe, the pan-European Dow Jones Stoxx 600 Index fell 3.5% to 270.68, its third-worst drop this year. Shares of some major banks in the region plummeted by double-digit percentages, and credit markets slumped on worries about more pain at other financial institutions.

In the U.S., the Dow Jones Industrial Average was down 504.48 points, or 4.4%, to 10917.51 in late afternoon trade. Treasury yields tumbled as investors sought the relative safety of government debt. Many of Asia's largest markets, including in Toyko and Hong Kong, were closed, but financials fell sharply in those markets that were open.

Some traders sought insurance in the derivatives market to protect against potential problems at European banks and companies or to cover Lehman-related positions, pushing the cost of such protection significantly higher.

As a result, the cost of insuring against default on €10 million ($14.2 million) of European company debt for five years rose about 27% to €130,000 annually, compared with €102,650 on Friday, according to the Markit iTraxx index. Trading was sparse, however, as many banks sought to figure out how they are exposed. That process could take several days. The reaction was milder than in the wake of the Bear Stearns bailout in March. On March 17, the cost reached a record €167,000.

"The reaction [Monday] is a little bit more moderate than I would have expected," said Michael Hampden-Turner, credit strategist at Citigroup in London.

Analysts and traders have long worried about how the $62 trillion credit-derivatives market would be affected by the collapse of one of its major bank players, though Mr. Hampden-Turner said Lehman's involvement in this market may be smaller than many think. "Repo is my biggest concern at this point," Mr. Hampden-Turner said, referring to the repurchase market, where banks and other players borrow cash for the short term by putting up various assets as collateral.

Financial institutions that lent Lehman cash may be stuck with collateral they don't want. In a typical so-called "repo" deal, a borrower will turn over securities in exchange for a temporary loan. A bank now holding those securities may have the right to sell. Any major selling could put significant pressure on the market, Mr. Hampden-Turner said.

The pall over Europe's major financial institutions took a toll on their shares and standing with credit-market investors.

The cost of protecting **Barclays** PLC's debt against default jumped to about €157,500 annually Monday from €134,000 Friday, while similar costs for **Deutsche Bank** AG stood at €112,500, from €85,000 Friday, according to Markit.

An index that measures the cost of insuring the debt of 25 European financial firms jumped to about €117,500, compared with €96,000 on Friday, according to a trader.

In European stock markets, the U.K.'s FTSE 100 index skidded 3.9% to 5204.20, its largest one-day decline since March 17. Lender **HBOS** PLC plunged 18%, and Barclays, which had negotiated over Lehman Brothers during the weekend, lost 9.9%. The German DAX index fell 2.7% to 6064.16, its lowest close since Oct. 4, 2006, and the French CAC-40 index lost 3.8% to 4168.97, its steepest decline since Feb. 5.

Russian shares, already battered by the global turmoil and investor flight after last month's war in Georgia, dropped again Monday, with the dollar-denominated RTS index down 4.8%.

—Gregory L. White in Moscow and Rob Curran in New York contributed to this article

CAPITAL ▪ DAVID WESSEL

Extent of damage by crisis turns on availability, price of credit

BY DAVID WESSEL

After one of the most tumultuous weekends Wall Street has ever seen, how much bleaker is the outlook for the U.S. economy, the parts where most Americans work, live, borrow and save?

"The simple answer is: We don't know," J.P. Morgan Chase economist Bruce Kasman said Monday, discarding the usual confidence that forecasters usually demonstrate in predicting the economy's growth rate to the nearest tenth of a percentage point.

The economy's direction turns on something hard to predict: Do the events of the weekend make lenders and investors even more cautious and reluctant to take risks, thus choking off credit to consumers and companies and strangling the U.S. economy? Or does Black Sunday mark a catharsis in the prolonged financial crisis, the moment when bankers faced reality, took their losses and restructured their industry?

Early signs were mixed. When markets opened Monday, the nightmare didn't arrive. Stock markets around the world fell, but the declines were modest next to headlines that **Lehman Brothers** was filing for bankruptcy, **Merrill Lynch** was selling itself to **Bank of America** and insurer **AIG** was still seeking a rescuer with deep pockets. Financial markets seemed to function reasonably smoothly, to everyone's relief.

But the already wide gap—the "spread" in market lingo—between yields investors demand on investment-grade securities and those on safe U.S. Treasury securities widened to March levels, a reflection of deteriorating confidence among investors and a measure of the extent to which financial conditions are constraining the economy. A lot turns on how much wider those spreads get.

"How much does the price and availability of credit change? Where are we going to be three weeks from now in terms credit spreads, the actual rates consumers and corporate pay?" Mr. Kasman asked. Mortgage rates have fallen since the government seized control of mortgage giants **Fannie Mae** and **Freddie Mac**, he noted, wondering how much of that might be reversed in coming days.

Among the uncertainties confronting the economy, the willingness and ability of banks and financial firms to lend is among the most important. With big and unanticipated losses eroding capital cushions, the firms have to raise new capital or contract lending to levels commensurate with reduced capital. Raising capital is tough, as AIG, Freddie Mac and Lehman show. Contracting lending may be prudent for every individual firm, but devastating to a modern economy that relies on credit to fuel growth.

All of this comes as the U.S. economy is in what former Federal Reserve governor Laurence Meyer describes as a "danger zone," close to if not in recession. Employers have reduced payrolls every month this year, eliminating 605,000 jobs in all. The unemployment rate has climbed to 6.1% from 5% since December. And the Federal Reserve said Monday that output by American factories fell a sharp 1.1% in August, mostly but not entirely because of auto-industry cutbacks. Factory output outside autos has fallen or been flat for five months now, and factory output is now running 1.9% below year-earlier levels.

Still, the biggest financial shock since the Great Depression hasn't—at least so far—been accompanied by the usual symptoms of deep recession. The economy, for instance, shed more jobs in the first eight months of 2001, after the stock market bubble burst, than it has so far this year. And the government says the economy contracted in the last quarter of 2007 but grew in the first and second quarters—and forecasters say it appears to be growing in the soon-to-end-third quarter.

Why isn't it worse?

"It's a great question," said Mr. Meyer, now a private forecaster. "The economy was really strong going into the housing correction in 2006. It had the strength to withstand the housing shock. Then you get the credit shock. The Fed eased—by past perspective—incredibly aggressively. That significantly offset the deteriorating financial conditions which, with rising oil prices, were enough to stagger the economy, bringing it close to recession. But you've got to appreciate the resiliency."

Even before the weekend's events, 14 of the 51 economists responding to a Wall Street Journal survey this month had predicted the U.S. economy will contract in the fourth quarter as the adrenaline of fiscal stimulus checks and earlier rate cuts wane. The average of the 51 forecasts was fourth-quarter growth at a meager 0.7% rate, a pace likely to produce rising unemployment. Lower oil prices are welcome and better for the economy than higher oil prices, but Monday's drop is best seen as a symptom of waning global demand than a source of strength.

The continuing decline in house prices is eroding homeowners' wealth and discouraging new construction, but the economic ill-effects are greatly magnified as house prices erode the value of securities held by major financial firms. "Mortgage credit losses deplete the equity capital of leveraged financial institutions and persuade them to reduce their financial leverage," Goldman Sachs economist Jan Hatzius said in an analysis presented at the Brookings Institution last week. "This reduces the supply of credit to households and nonfinancial businesses."

Mr. Wessel responds to reader comments at WSJ.com/CapitalExchange. Or email him at capital@wsj.com.

Lehman scrambles to sell units

Continued from first page

ing them to look for work amid already painful downsizing in the financial-services industry.

Filing for Chapter 11 protection at the holding-company level, instead of seeking Chapter 7 liquidation or putting the entire company into bankruptcy, gives Lehman a little more time and control of what happens to its various assets. The company can now continue to shop around subsidiaries such as its broker-dealer operations, investment-management division, real-estate holdings, book of loans and its private-equity portfolio.

In the coming days and weeks, Lehman will likely put some of its subsidiaries into bankruptcy, either to speed a sale of the assets or to give those businesses the protection of an automatic stay, which usually prevents creditors from taking actions against a bankrupt entity.

The sales process of Lehman assets will likely play out in the next few weeks, people familiar with the matter said. In the case of some of the troubled real-estate holdings, the sales process could take months or years.

The fallout from Lehman's bankruptcy filing was especially swift and harsh at the firm's operations outside the U.S.

Dazed and grim employees of Lehman Brothers' London offices came to work Monday morning expecting to be out of a job soon. Many made calls to headhunters, while others headed to the local pub early in the afternoon.

Duo Ai, who works in fixed-income research, said many of his colleagues were reeling. "We really didn't see this coming. We thought some bank would buy Lehman," he said.

Jerry Shi, senior vice president and Lehman's global head of equity valuation, held a meeting early Monday morning with the six New York-based people in Lehman's midtown office. "I told them that I have probably pushed them too hard, because I really wanted them to learn more," he said. "Jerry, you should have pushed up harder," a staffer responded, Mr. Shi said.

Though operations have ceased in Mr. Shi's office, everybody showed up Monday morning. People were packing up their belongings, exchanging personal contact information, taking calls from friends and family, but mostly just sitting around waiting to hear more about their fate.

"We're all speechless. It's hard to believe what has happened," Mr. Shi said, "When we got home Friday, we thought we would be acquired by another bank." Now, "we will all be out looking for jobs."

Employees are grumbling about Chief Executive Richard Fuld's handling of the crisis and regulators' balking at bailing out Lehman, according to two people who work at the company. Their colleagues, they say, are considering looking for opportunities in other sectors, given the problems in the financial industry.

In an effort to address employees' concerns, the management sent out an email Monday morning with a list of frequently asked questions. As to whether they should still come to work and whether they will get paid, the company said "the firm is working to ensure continuing operations" and "to plan and effectuate an orderly liquidation and sell assets," and that the company is working to "ensure payment of payroll."

A big challenge for Lehman will be to quickly find buyers for its many businesses where the most valuable assets are the people who work there. Many of those top people have or will soon be pursued by rival investment banks and other financial-services firms.

"All over Wall Street right now people are hiring headhunters to target some of the professionals that Lehman has assembled. They are putting together lists of names or divisions or certain needs," said Jeff Werbalowsky, co-CEO of investment-banking firm Houlihan Lokey Howard & Zukin, which represented creditors in some of the largest bankruptcies, such as Enron and WorldCom.

"The challenge for Lehman is to maximize the value of those elevator assets," he said.

Customers of Lehman Brothers, including customers of its wholly owned subsidiary, Neuberger Berman, may continue to trade or take other actions with respect to their accounts, Lehman said.

The New York law firm of **Weil Gotshal & Manges** is representing Lehman Brothers. The case has been assigned to U.S. Bankruptcy Judge James Peck. No hearings were held on Lehman on Monday.

Lehman was forced to file for bankruptcy after its restructuring plan "did little to quell the rumors in the market" about its viability, Lehman Chief Financial Officer Ian T. Lowitt said Monday.

The resulting uncertainty, particularly among the banks through which Lehman clears securities trades, "ultimately made it impossible for the company to continue to operate its business," Mr. Lowitt said in a bankruptcy affidavit.

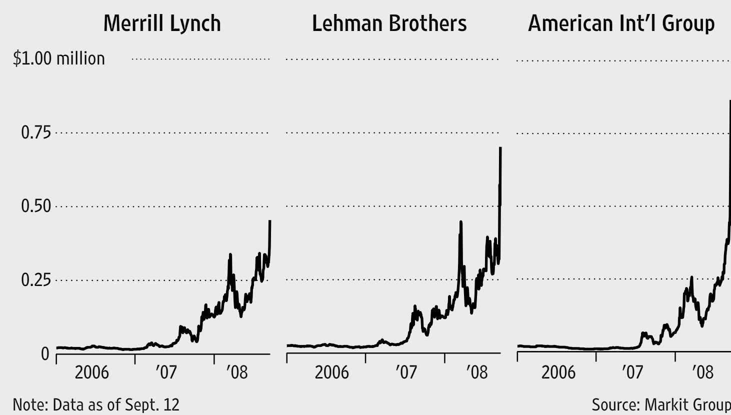
In the affidavit, Mr. Lowitt said Lehman's problems began with the recent unfavorable business environment including a lack of liquidity in the credit markets, slow trading in equity markets and declining values of assets.

Employees at the Lehman units that filed for insolvency in the U.K. may not be paid, said Tony Lomas, a partner at PricewaterhouseCoopers assigned to help manage the proceedings for four Lehman companies in the U.K.

—Michael Rapoport contributed to this article.

Credit check

The amount an investor must pay annually for protection against a default on $10 million in debt over five years.



Note: Data as of Sept. 12

Source: Markit Group

A summary of credit default swaps and how they play into Lehman's woes

What they are: Credit default swaps are contracts between two parties that act like insurance against debt defaults. They are also used by hedge funds, investment banks and others to bet on a company's fortunes.

How they work: CDS buyers make regular payments to sellers, who in turn promise to make big payouts if a company's bonds default or it files for bankruptcy. Buyers and sellers don't need to hold the underlying debt when they enter into the contracts, which can be for periods such as one year or five years.

Size of the market: CDS have been written on over $62 trillion worth of bonds and loans

How they trade: CDS trade 'over the counter,' or directly between buyers and sellers.

The problem with Lehman: Lehman is a large buyer and seller of CDS and entered into many contracts with different firms. In addition, other banks and investors have bought CDS tied to Lehman's own debt. A bankruptcy filing could trigger large payouts from institutions that have sold swaps on Lehman debt. Lehman's own counterparties, meanwhile, may have to re-hedge their positions with other firms.

Merrill deal could instantly reshape the U.S. banking landscape

Continued from first page

of one year ago and half its all-time peak value of early 2007.

"Why would Bank of America do this?" said analyst Nancy Bush at NAB Research LLC in Annandale, N.J. "Ken Lewis always likes to buy the biggest thing he can. So why not this? You are master of the universe, basically."

Merrill could give Bank of America strength around the world, including emerging markets such as India. And Merrill is also strong in underwriting, an area Bank of America identified last week at an investors' conference where it would like to be more aggressive.

The deal is all the more dramatic because Merrill, upon the arrival of John Thain as CEO, did more than many U.S. financial giants to insulate itself from the financial crisis that began last year. It raised large amounts of capital, purged itself of toxic assets and sold big equity stakes, such as its holding in financial-information giant Bloomberg LP. That Merrill has opted to sell itself thus underscores the severity of the crisis.

Absorbing Merrill comes with huge risks. Merrill had the highest ratio of "problem assets" subject to write-downs to capital of the top three independent securities firms, according to Fox-Pitt, Kelton. Analysts were already betting it would have to write down an additional $3 billion or more in the third quarter beyond what it had announced in July.

Mr. Lewis said on Monday that he felt "no pressure" from federal government regulators to sign the deal.

Messrs. Lewis and Thain nonetheless worked quickly, the two men acknowledged at a news conference at Bank of America's New York offices. Mr. Thain said he began to look for an acquisition partner for Merrill after exploring "the implications for a Lehman bankruptcy."

Associated Press

Merrill Lynch CEO **John Thain**, left, and Bank of America CEO **Ken Lewis**, right, at a news conference Monday after Bank of America's $50 billion deal with Merrill.

Through the weekend, federal officials, including Federal Reserve Bank of New York head Timothy Geithner, made it clear they strongly encouraged a deal to sell Merrill. They worried the firm could be the next to approach the brink of failure after Lehman, said people familiar with the matter.

The all-stock deal came together quickly. With Merrill stock dropping sharply last week, Merrill President Gregory Fleming, a former financial-institutions adviser, urged Mr. Thain to contact Mr. Lewis to see if he would be interested in a sale. The two banks had preliminary discussions in the past, so the interest was there, according to a person familiar with the matter.

On Saturday afternoon, Mr. Thain called Mr. Lewis, who responded favorably. Bank of America, which by then had been considering a bid for Lehman as well, decided that Merrill was the better deal and felt more comfortable with Merrill since the two had engaged in prior discussions. Mr. Thain then went to the Federal Reserve Bank of New York. He quickly saw that a deal for Lehman was unlikely, according to a person close to him, which strengthened his resolve to pursue a deal with Bank of America.

Bank of America said it would exchange 0.8595 share of its common stock for each Merrill Lynch common share, valuing Merrill at $29 a share. Merrill's shares changed hands at $17.05 each on Friday, after falling sharply in the wake of Lehman's looming demise. The transaction is expected to close in the first quarter of 2009. Bank of America said it expects to achieve $7 billion in pretax cost savings,

"I think John Thain at Merrill is the ultimate realist," said Ms. Bush, the NAB Research analyst, who expected federal regulators to bless the deal. "He knows if Lehman goes under he is not far behind. He wants to cut the best deal he can."

In the past 15 months, Merrill and Lehman have both had tens of billions of dollars of risky, hard-to-sell assets carried on balance sheets that were piled high with debt. When the credit crunch hit in mid-2007, the assets kept deteriorating in value and couldn't easily be sold, eating into both firms' capital cushions. Recently, Lehman's balance sheet topped $600 billion and Merrill's $900 billion.

Merrill's previous chief, Stan O'Neal, was ousted in October 2007. His successor, Mr. Thain, tried to repair the firm's balance sheet by arranging an infusion of more than $6 billion in capital starting last December, tapping investors led by Temasek Holdings, a Singapore government investment fund.

But the losses kept coming this year. Mr. Thain was forced in July to sell a huge slug of more than $30 billion in collateralized debt obligations, or securities backed by pools of mortgages or other assets, at a price of just 22 cents on the dollar. That step required the firm to raise still more capital, under painful terms that repriced some of the December stock sales at about half the original price.

During the flurry of historic deal making this weekend, Merrill also put out feelers to **Morgan Stanley** about a possible deal, which would have united two of Wall Street's oldest brands, according to a person familiar with the talks. But the talks didn't go anywhere because there wasn't enough time for Morgan Stanley to review the idea and Merrill wanted to do a deal quickly, this person said. Merrill was also stepping up talks with commercial banks both in Europe and the U.S.

Mr. Thain would collect an exit package valued at about $9.7 million if Bank of America completes its takeover, according to David M. Schmidt, a pay consultant for James F. Reda and Associates LLC in New York.

That figure represents accelerated vesting of restricted stock units that Mr. Thain got when he took command last December. Only two thirds of those 500,000 units would become shares that he could sell.

The future of both Morgan Stanley and **Goldman Sachs** was front and center Monday morning, as Wall Street woke up to a world where the independent broker-dealers are increasingly few in number. They would be the last of the big five independent firms, with Merrill and Bear Stearns Cos. having been sold and Lehman likely to close down.

—Randall Smith, Susanne Craig and Aaron Lucchetti contributed to this article.

The Siemens answer: The world's first pocket ultrasound system.
For instant insight.

With our highly efficient and innovative imaging systems, we provide what modern medicine needs. And we offer it when and where it's needed most. The ACUSON P10™ ultrasound system provides visual information at the first point of patient contact – reducing delays, when time can be a matter of life and death. **www.siemens.com/answers**

Answers for life.

SIEMENS

CORPORATE NEWS

AEROSPACE

Airbus will sell wing unit to GKN for $244 million

BRITISH automotive- and aerospace-parts maker **GKN** PLC said it agreed to buy a wing-component-manufacturing business from European plane maker Airbus for £136 million ($244 million).

The business, based in Filton in southwest England, employs 1,500 workers making metallic wing components and assemblies for a broad range of Airbus aircraft. GKN was selected by Airbus—a unit of **European Aeronautic Defence & Space** Co.—as the preferred bidder for the Filton plant in December. The deal is part of Airbus's efforts to attract outside investment to its plants to help share development costs.

—Michael Carolan

MARITIME SERVICES

Smit rejects buyout offer from Boskalis as too low

SMIT INTERNATIONAL NV rejected a €1.11 billion ($1.58 billion) takeover offer from rival maritime-services company **Boskalis** NV, saying the proposal "undervalues Smit on a standalone basis, failing to recognize the value of Smit's strategy." Boskalis said its intended bid of €62.50 a share represents a premium of about 30% to Smit's closing price Friday. Both companies are based close to the port of Rotterdam, the Netherlands. Boskalis's main activities include the construction and maintenance of ports and waterways, land reclamation, coastal defense and riverbank protection.

—Roberta B. Cowan

INTERNET

Newspaper group opposes Yahoo-Google agreement

THE WORLD Association of Newspapers said it opposes a pending deal on advertising between **Yahoo** Inc. and **Google** Inc. and wants European Union and U.S. regulators to block it on antitrust grounds. The U.S. Justice Department is already investigating the deal.

The Paris-based newspaper group said the agreement would reduce the cost of paid search advertising and lower revenues for newspapers' and others' Web sites, which receive payment from the online giants. Yahoo and Google have said the deal affects only North America, but the newspaper group said European spapers would be affected.

—Associated Press

U.S. airlines are moving to a la carte model

Fuel crisis speeds up industrywide push to charge by services

By Scott McCartney

DELTA AIR LINES Inc. slapped a "fuel surcharge" on frequent-flier reward tickets when oil was at $140 a barrel. American, United and US Airways began charging to check a single bag when oil was over $130 a barrel, each blaming fuel costs.

And now that the price of a barrel of oil—the biggest expense in operating an airline flight—has fallen below $100 a barrel, will airline passengers see any fee relief?

THE MIDDLE SEAT

Not likely. In fact on Monday, **UAL** Corp.'s United Airlines boldly doubled its fee to check a second bag to $50 one-way.

While some airlines have reduced the fuel surcharges they place on cargo shipments, passengers have yet to see any relief. Airlines say fuel prices remain volatile and significantly higher than just a year ago.

But a bigger change is at work in the airline industry. Airlines have long hoped they could find ways to extract more revenue out of customers than just fares, and this year's fuel crisis prompted them to ratchet up the push toward charging for different services a la carte.

So far, baggage fees and other charges are significantly improving the usually dismal finances of the industry. Passengers are paying them, if begrudgingly, and aren't shifting in large numbers to the few airlines that don't charge fees like **Southwest Airlines** Co. So **Continental Airlines** Inc. joined the fee fray last week with a $15 charge to check a first piece of luggage, and United was emboldened this week to raise its fees rather than lower them as oil prices fall.

"The concept of charging for what people use or don't use is something that will probably continue," said a spokesman for **AMR** Corp.'s American Airlines when asked about fees and surcharges. Says a spokesman for **US Airways Group** Inc.: "We have no plans to change any of these."

Just as free hot meals in coach will likely never fly again on most U.S. airlines, free baggage may indeed be a relic of a bygone era. J.P. Morgan estimates that the new fee structure and other charges airlines have imposed, from selling pillows and bottled water to charging for "free" frequent-flier awards, will add $3 billion a year to U.S. industry revenue. That's a lot for an industry that has never earned more than $5.3 billion in a year.

"It was only the reality of $140 oil that gave the U.S. industry the courage to pursue a strategy they wanted to pursue," said JP Morgan airline analyst Jamie Baker. "You hold onto it as long as you can until competitive pressures force you to back off."

US Airways says the pay-for-what-you-use change amounts to a "business-model transformation." Instead of spreading the cost of baggage handling over all passengers, including those who don't check bags, the airline thinks it's fairer to charge bag-checkers for the service. Similarly, US Airways charges $2 for coffee, soda or bottled water, $50 to "process" a frequent-flier travel award to Hawaii and $35 just to buy a ticket in person at the airport.

No matter the price of fuel, President Scott Kirby sees the change as permanent. "The industry is evolving to a more a la carte model," he said. "Airlines can't continue to operate as they did."

Among its new service fees, **US Airways** now charges $2 for coffee, soda or bottled water and $35 to buy a ticket in person at the airport.

To be sure, airlines might have to roll back fees if a couple of competitors have a change of heart. But so far, Southwest has been a lone holdout. Last week, Continental began charging a $15 fee to check a first bag, despite the lower oil prices. Continental said it will generate $100 million annually from that fee alone. United said all of its add-on fees could total $700 million next year.

The fees remain a major source of frustration for travelers. "I think it's stupid," said Issa Isaac of Ypsilanti, Mich., who had to pay $50 last week in Dallas to check a second bag with Delta even though he is a platinum-level frequent flier with Delta's merger partner **Northwest Airlines** Corp.

Linda Hartzell of Grants Pass, Ore., flew to Dallas to join hurricane relief efforts for the American Red Cross and got hit with $40 in fees to check two bags of Red Cross equipment.

"It's confusing with all the different fees," she said. "But I think it's going to be a forever thing. What has to be has to be."

Air France, a unit of **Air France-KLM** SA, and **Singapore Airlines** Ltd. have both cut fuel surcharges on international tickets, and Northwest and **Deutsche Lufthansa AG**, among others, have reduced the fuel surcharge they place on cargo shipments.

With international air fares, fuel surcharges are added on to base fares much like taxes and security fees. Since they are broken out—allowing travelers to see exactly how much the fee is costing them—airlines may face more pressure to reduce them if fuel prices continue to drop. But, domestic U.S. fares, by government rule, don't have separate fuel surcharges—it's all baked into the basic fare. So for domestic fares, there may be less pressure to drop prices because of fuel.

Like other airlines, Delta says it can't talk about future pricing moves. "Delta's fares and fees will continue to remain competitive with the rest of the industry," a spokeswoman said.

Most airlines will still report big losses this year, and the industry is still paying fuel costs more than 50% higher than last year. Fuel makes up about 40% of the cost of flying for commercial airlines.

"The airlines are still behind the curve," says Standard & Poor's credit analyst Philip Baggaley. He notes that the slowing economies around the world—a major reason oil prices have fallen—are bad for airlines since international business travel, which has been a bright spot for airlines in the past, could decline.

Alitalia rescue revived but key unions object

By Stacy Meichtry

A plan to rescue **Alitalia** SpA was partially revived as some labor unions signed a draft deal with a group of Italian investors who plan to take over the insolvent state-controlled airline.

In order to guarantee that Alitalia will continue flying, however, a deal needs to be reached with another set of unions who represent the airline's pilots and flight crews.

Alitalia flights were operating according to schedule Monday, despite warnings from a top government official that the carrier could begin canceling flights this week if a deal is not reached. Italy's civil aviation authority has also warned that Alitalia's operating license could be pulled.

The preliminary deal announced early Monday lays out the maximum number of staff that could be employed by **Compagnia Aerea Italiana**, or CAI, a new company that plans to buy Alitalia's viable assets and merge them with smaller rival **Air One** SpA. Under the terms of the agreement, the merged airline will have a total of 12,500 employees—compared with 20,000 people currently employed by Alitalia and Air One.

The two unions, which represent Alitalia's pilots and flight crews, issued a joint statement Monday denouncing the draft deal as an "irresponsibile act." The unions also blasted the agreement for limiting reductions in job cuts to Alitalia's ground crew.

CAI, which is headed by Italian entrepreneur Roberto Colaninno, had previously agreed to retain 11,500 employees from the two airlines, so the deal represents a first concession to unions who represent Alitalia's ground staff.

Now, the deal would need to be approved by unions representing Alitalia's strike-prone pilots and flight crews—which have so far rejected all of CAI's proposals. CAI essentially wants pilots and flight crews to fly more and serve more routes.

Dell's plan to sell plants leaves Irish jittery

Facility in Limerick, formerly 'stab city,' gave region a boost

By Justin Scheck And Joellen Perry

Dell Inc.'s plan to sell its assembly plants could pose problems for cities that count the tech giant as a major employer. Nowhere have worries been greater than in Limerick, Ireland, where a Dell facility with about 3,000 workers helped revitalize the economy.

"It would be dreadful news if something were to happen to Dell," said John Gilligan, who earlier this year became the 812th mayor of Limerick, a city of almost 91,000.

Mr. Gilligan, whose son-in-law works at the Dell plant, said the city hasn't received any recent word from Dell on the plant's future.

There's reason for concern: Dell has approached contract computer manufacturers with offers to sell its plants, according to people familiar with the matter. One person briefed on the strategy, which was reported in the Sept. 5 Wall Street Journal, said some factories Dell doesn't sell could be closed.

As for Limerick, Dell executives have privately discussed closing the plant for two years, said two people with knowledge of those discussions. One of those people said Dell executives early last year decided to close the factory, though they didn't establish a firm timeline.

This person said the goal is to move production capacity from Ireland to Poland, where Dell opened a factory early last year—though the company is moving cautiously to limit any disruption of manufacturing and defections of sales and operations staff Dell wants to retain. In addition to factory workers, Dell has more than 1,000 office workers who will likely remain in Ireland, that person said.

A Dell spokesman declined to comment on the future of the Ireland plant. "It's clear from our regulatory filings that we're continuing to evaluate and optimize our global manufacturing and distribution network," said spokesman David Frink.

Dell, of Round Rock, Texas, is trying to cut manufacturing costs because of growing pressure to improve its profitability. While Dell's factories in India, China, Brazil and Malaysia should be relatively easy to sell, these people said Dell may close facilities in the U.S. and Ireland, where high labor costs make them less desirable. Dell closed a Texas plant earlier this year.

Dell opened its Ireland plant in 1991, joining a wave of U.S. tech companies that needed a base in Europe to avoid import tariffs and control costs for transporting finished goods. Many chose Ireland because of a low corporate tax rate—estimated by the country's Industrial Development agency at 12.5% compared with 30% in Germany and 39.5% in the U.S. The Irish government also gave Dell grants totaling €55 million ($78.2 million), according to a spokeswoman for the development agency.

Limerick saw the benefits. In addition to factory jobs, companies supplying components to Dell have provided several thousand more jobs, said Mr. Gilligan. Limerick—once known as "stab city" for its high crime rates—has begun redeveloping its decrepit public housing, and the city recently approved a €350 million downtown redevelopment project, he added.

Local uncertainty has grown in recent years, though, as rising labor costs have diminished Ireland's attractiveness as a manufacturing hub. Dell, meanwhile, ran into its own problems as a company that grew around sales of commercial desktop computers shifted to consumer laptops.

Dell

Dell opened its **Limerick, Ireland, plant** in 1991, but rising labor costs have lessened Ireland's appeal as a manufacturing hub.

Executives decided the company should sell as many of its plants as possible, said people briefed on those plans. But that process could take years, they said. So in the meantime, Dell has considered shorter-term solutions.

Closing or scaling back the Ireland plant could help, those people said, because the factory in Lodz, Poland, is large enough to absorb much of the laptop production being done in Ireland—and PCs can be built in Poland less expensively.

Chris Van Egeraat, a researcher at the National University of Ireland who studies the PC industry, said Poland also has a low corporate tax rate and easy shipping routes to much of Europe, but its labor costs are much lower following recent rises in Ireland. "Ireland is not the same economy it was when these plants arrived," he said.

BEING THE EUROPEAN LEADER IN ENERGY SERVICES MEANS WE CAN OFFER YOUR CITY INNOVATIVE ENERGY SOLUTIONS.

Just like Amsterdam, many cities can now build on our experience to minimize their energy consumption. Solutions such as installation audits, green energy and energy performance contracts help reduce energy consumption and cut CO_2 emissions. Let's rediscover energy. Energy that's more reliable, more respectful and better consumed. **www.gdfsuez.com**

GDF SUEZ

REDISCOVERING ENERGY

OOA C.V. (joint venture Bouwfonds MAB & Meyer Bergman) - SAATCHI & SAATCHI

THE WALL STREET JOURNAL. EUROPE

Executive Travel Program

Guests and clients of 320 leading hotels and car rental agencies receive The Wall Street Journal Europe daily, courtesy of

addictlab.com
global creative think tank

CORPORATE NEWS

BASF makes friendly bid for Ciba

Specialty chemicals are focus of offer; nearly $3 billion deal

By Mike Esterl

FRANKFURT—**BASF** SE, the world's largest chemicals company by revenue, stuck to the sidelines the past two years as high prices and new competition propelled others toward industry consolidation. It is now joining the fray.

The German heavyweight joined the rising merger-and-acquisition wave Monday by launching a friendly offer worth almost $3 billion to acquire struggling Swiss rival **Ciba Holding** AG, a specialty chemicals manufacturer with about $5.8 billion in annual sales.

Jürgen Hambrecht

BASF's takeover bid also reflects a shift into specialty chemicals by the big industry players. Specialty chemicals serve as high-value building blocks for products ranging from semiconductors to paint. Profit margins for more basic, commodity-like chemicals are shrinking because of rising competition from low-cost producers in the Middle East and elsewhere.

"Chemicals consolidation will accelerate in the near future," said Jürgen Hambrecht, BASF's chief executive, in a conference call Monday with investors. BASF, he added, "has to play a pro-active role."

The chemicals sector is fragmented, with the 10 largest companies having a combined global market share of about 20%. BASF, which booked €58 billion ($82.45 billion) in revenue last year, said the acquisition of Ciba would catapult it into the leading positions in plastic additives and paper chemicals from No. 4 currently. It also would allow BASF to become a bigger supplier to the water-treatment industry.

Ciba represents the first major acquisition by BASF since 2006, when it spent roughly €7 billion to buy three specialty-chemicals companies, including New Jersey-based catalyst maker Engelhard Corp. Several rivals have pulled the trigger on multibillion-dollar deals since then, including Dow Chemical Co., which agreed in July to acquire specialty-chemical company Rohm & Haas Co. for $15 billion.

BASF said in late July it expected "rockier" times amid volatile prices for raw materials but still reported a 27% surge in second-quarter net profit on the back of its large oil-and-gas unit, which is helping offset rising manufacturing costs.

Chemistry experiment

Germany's BASF is launching a friendly $3 billion tender offer to buy Swiss rival Ciba. Selected key data in 2007

	BASF	Ciba
Sites	~100 major sites	~60
Employees	~95,000	~13,000
Sales	€57.9 billion	€4.0 billion
EBIT before special items	€7.61 billion	€336 million
EBITDA* margin	18.2%†	13.9%†

*Earnings before interest, taxes, depreciation and amortization †Before special items

Source: BASF

The Ciba deal also comes as private-equity firms scale back their ambitions in the chemicals sector, including Apollo Management LP, which is trying to back out of a 2007 accord to buy Huntsman Corp. for $6.5 billion. Ciba said last month it was weighing the sale of some of its businesses after reporting a quarterly net loss of 606 million Swiss francs ($535.8 million), including a goodwill impairment of 595 million francs in its water and paper-treatment unit.

"We are in between the big raw material suppliers and the big customers," said Ciba Chairman Armin Meyer in Monday's conference call. "This sandwich position, if you like, is getting worse and worse."

Some analysts cautioned BASF risks overpaying by offering 50 francs a share, which is 32% above Ciba's closing price on Friday and 60% higher than the 30-day trading average. WestLB wrote in a research note that the deal implies a multiple of 8.6 times enterprise value to operating profit, compared with current multiples of 5 to 6 in the chemicals sector.

BASF's shares fell almost 4.2% to €36.24 in Frankfurt on Monday.

Mr. Hambrecht predicted Ciba will bolster innovation and boost BASF's profits in the second year after the acquisition.

BASF's chief executive also wouldn't rule out further acquisitions but noted his management team has its "hands full now" with the proposed Ciba takeover.

BASF said it will launch the tender offer on Oct. 1 and expects to wrap up the acquisition by the first quarter of 2009 at the latest.

Intel six-brain chip may upend competition

By Don Clark

Intel Corp.'s new six-brain chip is getting strong reviews from computer makers and prompting a debate over the potential threat to high-end offerings from Intel and other vendors.

The addition to Intel's Xeon line, code-named Dunnington, is designed to plug into existing server systems with minimal modifications—replacing chips that now have four calculating engines. Several computer makers are reporting test results of machines using the chip that they are calling a milestone for x86 technology, which was originally developed for use in personal computers.

"It's pretty bone-crushing performance," said Jim Gargan, a vice president in **International Business Machines** Corp.'s x86 server unit.

Intel, which announced the new Xeon on Monday in San Francisco, and rival **Advanced Micro Devices** Inc. have been steadily increasing the capability of low-end server systems that are used for chores such as running Web sites. Their latest offerings are expected to help consolidate computing jobs on a smaller number of more-powerful servers, saving on electrical power and floor space in computer rooms.

Companies such as **Dell** Inc., **Hewlett-Packard** Co. and **Sun Microsystems** Inc. initially plan to use the six-processor Xeons in servers that use as many as four chips—boosting the total number of processors from 16 to 24. IBM is offering servers with as many as eight of the new Intel chips, starting at $10,389; **Unisys** Corp. will offer a system with as many as 16 chips, or 96 processors in all, priced at as much as $135,000.

Such capacity levels could encroach on the turf of more specialized technology, some industry executives say. Potential targets include machines powered by Intel's high-end Itanium chips, as well those that use Sun's Sparc chips and IBM Power chips—both known by the designation designation RISC, for reduced instruction-set computing.

Dell, whose servers with two of the new Xeons start at $5,300, estimates the new Intel chip boosts the performance of some server models by 30% to 40%, but costs about 75% less than a comparable system using Sun's Sparc chip. "You are really reaching RISC-class performance at a fraction of the cost," said Sally Stevens, a Dell director of platform marketing.

Roger Kay, an analyst at Endpoint Technologies Associates, thinks the new Xeon could particularly take sales from systems that use Itanium; H-P jointly developed the chip and is its biggest user.

Unisys plans to convert its mainframe software to use x86 chips, said Colin Lacey, a Unisys vice president of systems and storage. Other industry executives say there is a danger of making apples-and-oranges comparisons. Mainframe computers and servers based on RISC chips have features that x86 servers don't, they say, such as the ability to handle millions of transactions per minute with high reliability. That helps with jobs such as managing airline-reservation systems or bank cash machines.

Sun, for example, said its commitment to its Sparc technology isn't diminished by the addition of servers based on the new Xeon chip. "We have learned from years of customer feedback that most companies are strongly tied to either Sparc or x86," a Sun spokeswoman said.

Amgen puts hopes on drug for bone strengthening

By Ron Winslow

For nearly two decades, **Amgen** Inc.'s fortunes have been linked largely to drugs that bolster the blood. This week, the biotechnology company will showcase data on a new medicine that strengthens bone—and, Amgen hopes, its own growth prospects.

At a meeting of the American Society for Bone Mineral Research in Montreal, Amgen researchers are presenting 25 different reports on denosumab, which helps fend off osteoporosis. The bone-weakening disease affects some 10 million Americans.

In a series of announcements over the past year, the Thousand Oaks, Calif., company has said major clinical trials indicate denosumab is effective not only in improving bone-mineral density, an important measure of bone strength, but in reducing hip, spinal and other fractures that plague people with osteoporosis. Researchers will provide critical details on those studies, giving doctors and investors clues to whether the drug is likely to be a niche product or a dominant player in what is now a crowded $7 billion global osteoporosis market.

For Amgen, much is at stake. Sales of its flagship anemia drugs Epogen and Aranesp have nosedived in recent quarters amid safety and regulatory concerns and tightened Medicare and insurer-reimbursement policies. Denosumab is the first significant drug candidate to emerge from a research-and-development overhaul Amgen initiated at the beginning of the decade to recharge a scientific enterprise that had faltered, after its early success with blood-building Epogen and Neupogen put Amgen on the map in the late 1980s.

Growing enthusiasm about denosumab's prospects have helped restore luster to Amgen's shares, which currently trade at more than $60 after sinking to less than $40 early this year in response to problems with the anemia medicines. Current osteoporosis treatments—notably a class of drugs called bisphosphonates that include **Merck & Co.**'s Fosamax (now available in generic form), Reclast from **Novartis** AG and Boniva from **Roche Holding** AG and **GlaxoSmithKline** PLC—are difficult for many patients to take, providing an opening for denosumab, which is given as a twice-yearly injection.

But even after the data are digested this week, questions will remain. Little is known about denosumab's long-term safety, a potential stumbling block for approval. Doctors and analysts wonder how Amgen will price the drug and whether patients will prefer twice-yearly shots to current drugs taken once weekly or once monthly, or an annual infusion.

Amgen plans to file its application to the Food and Drug Administration by the end of the year, with hopes that denosumab will be approved by late next year.

GLOBAL BUSINESS BRIEFS

Inmobiliaria Colonial SA

Shares decline following debt-restructuring accord

Spanish real-estate company **Inmobiliaria Colonial** SA said it finalized a long-awaited debt-restructuring agreement, but its shares fell after key shareholders signaled they might not hang on to their stakes. Colonial said it restructured €7 billion ($9.95 billion) of its €9 billion debt load by signing a five-year, €6.5 billion loan with a syndicate of banks that held the bulk of its debt. The syndicate is led by **Goldman Sachs Group** Inc., **Royal Bank of Scotland Group** PLC, **Crédit Agricole** SA's Calyon and **Eurohypo** AG. Colonial will sell some assets and use the proceeds to amortize the new loan. It will also issue €1.4 billion in convertible bonds. Colonial shares closed down 13% in Madrid.

Deutsche Lufthansa AG

Deutsche Lufthansa AG, Germany's flagship airline, said it will pay €65 million ($92.4 million) to buy a 45% stake in **SN Airholding** SA, the parent of Brussels Airlines. Lufthansa has the option to buy the remaining 55% beginning in 2011. The price will be linked to the performance of Brussels Airlines, with a cap of €250 million for the entire company, Lufthansa added. The airline said last month it was in talks with SN Airholding to buy an initial 45% stake. Brussels Airlines was created in 2002 from the remains of former Belgian flagship carrier Sabena. It then merged with low-cost carrier Virgin Express Holdings PLC. It mainly operates flights throughout Europe from its main hub in Brussels, with another focus on flights to Africa.

Best Buy Inc.

Best Buy Inc. has agreed to buy **Napster** Inc. for $121 million, saying it hopes to use the digital-music company to reach new customers. The acquisition includes Napster's 700,000 digital-entertainment subscribers, Web-based customer-service platform and mobile capabilities. Best Buy has been expanding its wireless products and services, rolling out cellphone departments to all of its U.S. stores. In May, the consumer-electronics retailer paid $2.1 billion to form a joint venture with U.K.-based **Carphone Warehouse Group** PLC. In May, Napster began selling songs in the unrestricted MP3 format, hoping it would bolster its position against Apple Inc.'s iTunes and Amazon.com Inc.'s online store.

Electronic Arts Inc.

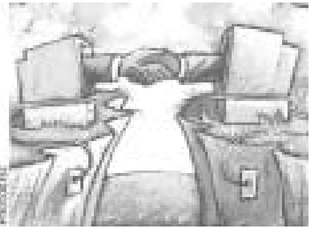
Nearly seven months after announcing an unsolicited offer to acquire **Take-Two Interactive Software** Inc. for $2 billion, **Electronic Arts** Inc. Sunday dropped the bid for its videogame rival. The offer by EA, launched in February, would have united two of the largest publishers of videogames, with hits such as EA's Madden football and Take-Two's Grand Theft Auto series. EA had long said it needed to integrate Take-Two's games into its portfolio by the holiday season for its offer of $25.74 a share to make sense. Take-Two's management consistently rejected that offer as too low.

—Compiled from staff and wire service reports.

ECONOMY & POLITICS

EUROPEAN UNION

Bloc may eliminate taxes on new high-tech goods



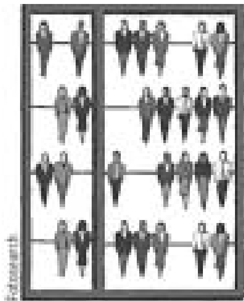
UNDER pressure from the U.S. and Asia, the European Union proposed eliminating taxes on imports of newly developed high-tech goods in the hope of avoiding a lengthy and costly World Trade Organization dispute.

Brussels said it wants to "update and expand" a 1996 WTO agreement that ended tariffs on information-technology equipment by granting the special treatment to new products that have entered the market since the accord went into effect.

The U.S. says these new products are already covered by the deal and charges the 27-nation bloc with breaking the rules. *—Associated Press*

LABOR COSTS

Wage growth slows down in 15-country euro zone



WAGES in the 15 countries that use the euro grew at a slower pace in the year ending in June than in the 12 months ending in March.

The slowdown should be welcomed by the European Central Bank, which fears workers will demand higher wages to compensate for higher prices. The annual inflation rate surged to a 16-year high of 4% in July, and it will take time before the ECB believes wages won't rise sharply in response.

Eurostat said total labor costs in the euro zone during the three months from April to June rose 2.7% from the second quarter of 2007, slower than a 3.5% rise in the first quarter. *—Paul Hannon*

U.S.

Industrial output posts biggest drop in three years

INDUSTRIAL production in the U.S. fell 1.1% in August, the biggest decrease in three years. The drop reflected lower car production and utilities output.

The August fall followed a revised rise of 0.1% in July, the Federal Reserve said Monday. Capacity utilization decreased to 78.7% in August from 79.7% the month before.

Output of motor vehicles and parts fell 11.9% last month and was down 20.7% from the year before.

The drop in utilities output reflected unseasonably mild temperatures. In addition, Hurricane Gustav affected energy production, the Fed said. *—Jeff Bater*

Mugabe acts to ease grip

Zimbabwe president to grant Tsvangirai prime-minister post

By Sarah Childress And Farai Mutsaka

ZIMBABWE PRESIDENT Robert Mugabe agreed to cede some power for the first time in his 28-year reign, signing a deal that will make opposition leader Morgan Tsvangirai the country's prime minister.

But with Mr. Mugabe still the head of state, how much power the opposition will get remains to be seen.

The decision of which ministries each side will control was left unresolved Monday. The parties haggled until just before the signing ceremony that same day, and South African President Thabo Mbeki, who brokered the negotiations, said they would return to the table to hammer out the cabinet portfolios.

Mr. Tsvangirai is angling for control of the economic ministries, which would give him the power to help rebuild Zimbabwe's devastated economy, the opposition said. Mr. Tsvangirai also wants control of the security ministries, which would lessen Mr. Mugabe's hold on the police and intelligence organization that he uses to uphold his rule.

Already suffering from hyperinflation, Zimbabwe is also struggling under heavy sanctions from the European Union and the U.S. The EU said Monday it would lift sanctions only if the power-sharing deal allows Mr. Tsvangirai a role in ruling the country rather than a ceremonial post, and if Mr. Mugabe showed willingness to reinstate democratic rule in the country.

The country has been at a political impasse since Mr. Tsvangirai won the March presidential elections but didn't gain the majority needed to avoid a second round of voting. As the two parties prepared for a June runoff, ruling-party supporters launched a wave of violent attacks against opposition supporters.

Mr. Tsvangirai pulled out of the runoff, citing fears for his supporters' safety. Mr. Mugabe claimed victory in the one-man vote, a result this new deal effectively ratifies.

Robert Mugabe, second from left, shakes hands with Zimbabwean politician Arthur Mutambara, left, at the signing of Monday's power-sharing deal.

Russell Brooks, a spokesman for the U.S. State Department, said Washington was "cautiously optimistic" about the deal, but would wait to see how it would be implemented before considering softening its stance.

In the deal, Mr. Mugabe will be chairman of a cabinet with 31 seats: 16 will be assigned to the opposition Movement for Democratic Change, with three from a breakaway faction that aligned with Mr. Tsvangirai during the March elections, but it is possible the group could also be persuaded to side with Mr. Mugabe. Mr. Mugabe's ruling party will hold 15 seats. Mr. Tsvangirai's party also holds the majority in Parliament.

The allotment represents the first time the president has presided over a cabinet in which his party, ZANU-PF, is in the minority. But if Mr. Mugabe retains the loyalties of the security forces that have long underpinned his regime, Zimbabwe's power structure won't likely change appreciably.

In remarks at the signing, Mr. Mugabe seemed to struggle to acknowledge Mr. Tsvangirai's new role in the government. He called his rival "that member of the MDC," or simply, "he."

Mr. Mugabe has ruled Zimbabwe since he helped liberate the country from white rule in 1980. Once revered as a hero, he has largely become reviled by many Zimbabweans as he consolidated his rule with a system characterized by graft and patronage. In his 28 years of leadership, one of Africa's most promising nations, rich in gold, platinum and bountiful farms, was driven into economic ruin.

The MDC said it was expecting the complete power-sharing deal to be finished soon. "We are still negotiating [the cabinet posts], but we don't have any reason to believe that it is a process that can undo what we have done here today," MDC spokesman Nelson Chamisa said.

Some of Mr. Tsvangirai's supporters had insisted he hold out for a presidential post. Mr. Tsvangirai defended his decision in an address to the crowd of Zimbabweans assembled to witness the signing. "I have signed this agreement because I believe it represents the best opportunity to build a peaceful and prosperous future for the nation of Zimbabwe," he said in a speech punctuated by cheering from supporters.

He also said progress wouldn't be possible without "public acknowledgment of past wrongs," a reference in part to the campaign of violence waged against opposition supporters in recent months by ruling-party members and supporters. Details of the accord released Monday didn't address the question of whether officials implicated in the violence would be held accountable.

Israeli minister has edge in race to succeed Olmert

By Cam Simpson

JERUSALEM—Israel's government hangs in the balance this week as the top political party in the nation's ruling coalition prepares to elect a leader to succeed embattled Prime Minister Ehud Olmert.

It will be up to the winner to try to maintain Israel's fragile and fractious coalition government, build a new one or lead the centrist Kadima party into general elections next year.

Independent polls here show Foreign Minister Tzipi Livni with a large lead heading into the primary. But she may not have enough support to win the four-candidate race outright on Wednesday. That would force a runoff next week.

Tzipi Livni

Her main rival, Shaul Mofaz, Israel's transportation minister, is promising to buck the polls. The former head of the Israeli Defense Forces is touting the strength of his grass-roots political machine, including strong support from trade unions.

A Dahaf poll of 850 registered Kadima voters published Friday in Israel's Yediot Ahronot newspaper showed Ms. Livni leading all contenders, with 47%. Mr. Mofaz placed second, with 32%. The other two candidates are Interior Minister Meir Shitrit and Public Security Minister Avi Dichter.

The new leader of Kadima will need to keep together its wobbly ruling coalition or form a new one. If the party leadership fails to do that—and analysts are increasingly skeptical—it will necessitate a nationwide general election, likely to take place in March. Underscoring the pessimism even within the Kadima ranks, Ms. Livni is campaigning in part on the theme that she is best-suited to lead the centrist party into a general election.

The uncertainty has heightened the sense of diplomatic paralysis in Jerusalem. Mr. Olmert has launched a flurry of initiatives aimed at making peace along Israel's borders, including overtures to Syria, Lebanon and the Palestinian group Hamas, which controls the Gaza Strip. Most initiatives now appear stalled.

Some analysts see even bigger stakes, saying the increasingly bitter tenor of the Kadima campaign threatens to unravel the centrist movement that has come to dominate Israeli politics since its formation in 2005. Any splintering of Kadima, which is Hebrew for "Forward," could have far-reaching implications, likely sending Israeli politics shifting to the right. The party was established by then-Prime Minister Ariel Sharon around the policy of withdrawing from Palestinian territory and maintaining Israel as a Jewish state.

"Many wounds have been opened in this campaign," says Uriel Reichman, an academic who founded Kadima with Mr. Sharon. He said he believes it will be difficult for the movement to survive, especially if Ms. Livni loses. Of the two leading contenders, Ms. Livni may be the more likely to bolt the party and jeopardize its future if she suffers defeat.

Mr. Reichman, president of Israel's Interdisciplinary Center, a private college in the city of Herzliya, says it is unclear whether Ms. Livni or Mr. Mofaz has the ability to rebuild the current coalition or cast a new one. Right now, the coalition maintains power with just 67 seats in the 120-member Knesset.

The key swing votes belong to the tiny Shas party, which has 12 seats and represents primarily ultraorthodox Jews originating from Arab countries. The party's leader said this week that he wouldn't form a coalition with any party that put the future of Jerusalem on the negotiating table with the Palestinian Authority.

In the past year, Israel has been involved in peace talks with the Palestinian Authority. Negotiating borders in Jerusalem is seen as a fundamental issue, because both sides see the historic city as their capital.

In July, Mr. Olmert announced plans to retire in the face of a series of criminal corruption probes. Mr. Olmert has maintained his innocence.

Bank crisis stirs U.S. race

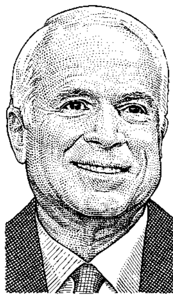
McCain, Obama spar over solutions and where blame lies

By Nick Timiraos
And Elizabeth Holmes

GRAND JUNCTION, Colo.—The U.S. banking crisis threatens to shake up the U.S. presidential race as well as the next president's agenda, forcing both candidates to confront a financial calamity and not just a weak economy.

John McCain and Barack Obama, trying to seize an advantage on the crisis, sought to wrap the market instability into broader campaign themes, but both found themselves wrestling on unfamiliar territory. Republican candidate Sen. McCain pointed to his credentials in cleaning up Washington's excesses while Democratic candidate Sen. Obama blamed the crisis on Washington's focus on deregulation for the past three decades.

At a rally in Orlando, Fla., Sen. McCain promised to replace an "outdated patchwork quilt of regulatory oversight" designed more than a half-century ago. He told workers they weren't responsible for the crisis and that they shouldn't be held responsible for the fix. "The time has come and gone where the taxpayers should be viewed as the solution to the problems that are not of their making," he said.


John McCain

But Sen. Obama seized on Sen. McCain's comment that he was confident in the economy's fundamentals, which he called "strong" even as he acknowledged the seriousness of the crisis. "Sen. McCain, what economy are you talking about?" Sen. Obama said at a rally here, where he continued to portray his Republican rival as out of touch on the economy. "What's more fundamental than the ability to find a job that pays the bills and that can raise a family?"

Sen. McCain later clarified the remark: "The American worker and their innovation, their entrepreneurship, the small business, those are the fundamentals of America and I think they're strong."

Sen. Obama, meanwhile, singled out the Bush administration's deregulatory push for what he described as "the most serious financial crisis since the Great Depression." While Sen. McCain wasn't at fault, he said, "I do fault the economic philosophy he subscribes to...one that says we should give more and more to those with the most and hope that prosperity trickles down."

Both candidates focused heavily on the financial crisis in remarks throughout the day, and both supported the government's refusal to step in with a rescue deal for **Lehman Brothers Holdings** Inc. over the weekend. But each offered few specifics about what they would do. "We are going to have a lot of rebuilding to do," Sen. Obama said at a rally in Colorado.

The McCain campaign introduced a new ad Monday to capture the mantle of reform by promising tough changes to "protect your life savings." "Our economy is in crisis. Only proven reformers John McCain and Sarah Palin can fix it," an announcer says. Sen. McCain on Monday blamed special interests for Americans' loss of trust and confidence in government.

While the candidates have each called for reforms, they disagree over the intended targets. The McCain campaign has pointed to government meddling as a reason for economic difficulties. "Government has got to get out of the way, in some respects, of the private sector," vice presidential nominee Sarah Palin said in an interview with ABC News last week.

Both candidates rushed to address the need for regulatory overhaul in March after the collapse of Bear Stearns Cos., but until the government was forced to backstop mortgage-finance giants Fannie Mae and Freddie Mac last week, the financial crisis was viewed as a distant problem, one that concerned Wall Street bankers but not rank-and-file workers.

Barack Obama

Instead, middle-class concerns such as taxes and health care have had far greater resonance with voters. That could change as the events of the past two weeks underscore how the housing market's problems have spread, further fueling economic anxieties. Consumers could face higher interest rates on everything from their mortgages to credit cards, further pressuring home prices. Businesses, already shedding jobs, could see higher costs from tightened lending standards.

At the same time, the crisis further constrains the next president, sapping time and money from ambitious proposals on health care and tax relief. The government rescue of Fannie and Freddie carries a price tag that could be modest or could reach as high as $300 billion. Former Federal Reserve Chairman Alan Greenspan said in an interview with Bloomberg Television recently that the government couldn't afford to pay for $3.3 trillion in tax cuts proposed by Sen. McCain without making similar spending cuts.

Sen. Obama said he spoke about the market turmoil Monday morning with his economic team, including former Fed Chairman Paul Volcker and former Treasury Secretary Lawrence Summers. Sen. McCain said he had conferred with Treasury Secretary Henry Paulson.

Palin sought $453 million in funds

By Laura Meckler
And John R. Wilke

Last week, Republican presidential candidate Sen. John McCain said his running mate, Alaska Gov. Sarah Palin, hadn't sought earmarks or special-interest spending from Congress, presenting her as a fiscal conservative. But state records show Gov. Palin has asked U.S. taxpayers to fund $453 million in specific Alaska projects during the past two years.

These projects include more than $130 million in federal funds that would benefit Alaska's fishing industry and an additional $9 million to help Alaska oil companies. She also has sought $4.5 million to upgrade an airport on a Bering Sea island that has a year-round population of less than 100.

Sen. McCain has made the battle against earmarks and wasteful spending a centerpiece of his campaign. He has never sought earmarks for his state of Arizona and vows to veto pork-barrel spending bills that come to his desk as president, saying these projects should go through normal budget review. And he derides the argument that states often make: that they're funding important projects.

"If they're worthy projects they can be authorized and appropriated in a New York minute," he explained on his campaign bus earlier this year, before Gov. Palin joined the ticket. "If they're worthy projects I know they'd be funded."

During an appearance Friday on ABC's "The View," Sen. McCain said Gov. Palin shared his views, and hasn't sought congressional earmarks. "Not as governor she hasn't," he said.

In fact, in the current fiscal year, she is seeking $197 million for 31 projects, the records show. In the prior year, her first year in office, she sought $256 million for dozens more projects ranging from research on rockfish and harbor-seal genetics to rural sanitation and obesity prevention. By comparison, her predecessor, Gov. Frank Murkowski, sought more than $350 million in his last year in office.

The McCain campaign said Sunday that Gov. Palin's overall record is one of fiscal discipline. "Her record is cutting the number of earmark requests from the previous administration sizably," said McCain spokesman Tucker Bounds, and she has vetoed wasteful state spending.

As for Sen. McCain's televised comments on Friday, Mr. Bounds added, "If he gave viewers a mistaken impression, it certainly wasn't intentional."

In an interview with ABC News on Friday, Gov. Palin herself suggested she no longer seeks earmarks for her state. "The abuse of earmarks, it's un-American, it's undemocratic, and it's not going to be accepted in a McCain-Palin administration. Earmark abuse will stop."

When pressed about her record as governor, she said: "We have drastically, drastically reduced our earmark request since I came into office. This is what I've been telling Alaskans for these years that I've been in office, is no more."

The state's earmark requests stand out in part because its state government is among the wealthiest in the U.S. Flush with oil and gas royalties, it doesn't impose income or sales taxes. In fact, money flows the other way: Every man, woman and child this year got a check for $3,200.

CAPITAL JOURNAL ▪ Gerald F. Seib

Wall Street's turmoil presents both campaigns with problems

IN HIS REACTION to the Wall Street meltdown, look for Sen. John McCain to play the part of Teddy Roosevelt, man of the people: Don't use taxpayer money to bail out financial titans, he'll say, and don't be afraid to regulate Wall Street.

And look for Sen. Barack Obama to play the part of, well, Barack Obama, man of change: This mess proves what I've been telling you, he'll say—that the team that's in charge has to get off the playing field. Oh, and I saw this coming, and they didn't.

That's the picture that emerges from the campaigns' initial reactions, and from conversations with some key advisers, in the wake of Wall Street's weekend walk on the dark side.

The common thread within the two campaigns' reactions is the recognition that when household names such as **Lehman Brothers** and **Merrill Lynch** are going down the drain, the problems on Wall Street can't be ignored on the campaign trail. In fact, they now figure to be a fixture in the race's last 50 days.

And that makes the problem a tricky one for both campaigns, for in political terms the Wall Street mess is an equal-opportunity one. It poses significant problems for both presidential candidates and doesn't especially play to the strengths of either.

The problems are worse for the Republican, Sen. McCain, for one simple reason. His party controls the White House and, by default, automatically suffers some damage from any bad economic news that breaks on its watch. That's the way it goes in national politics: Your party occupies the White House, you take some of the hit when bad things happen, particularly when it appears they have been taking shape for years.

In addition, Sen. McCain is at a disadvantage because he is more a national-security and character candidate than an economics candidate. He has never been particularly comfortable talking about economic policy—and now he will have to do more of exactly that.

He also has picked a running mate, Gov. Sarah Palin, who, despite all her political appeal elsewhere, is decidedly short on experience in markets and finance. Mitt Romney, had he been the running mate, could look comfortable doing a television interview talking about a crisis of confidence in the markets; that's a lot less likely with Gov. Palin.

BUT SEN. OBAMA and the Democrats have some problems of their own. Sen. Obama has his own inexperience questions to deal with, which become a bit more acute at a moment that feels a bit like a national crisis. Can he be a reassuring figure on a subject as far-reaching as an earthquake in the markets?

Moreover, Sen. Obama's own running mate, Sen. Joe Biden, was chosen far more for his national-security experience than for his background in finance and markets. To the extent that he brought a feel for economics to the ticket, it was a feel for the Main Street variety, not the Wall Street kind.

For both campaigns, faced with such unpleasant realities, simply ignoring Wall Street's problems was a viable option last week. That has all changed. The question now isn't whether to address the problem, but how to do so.

So now, the campaigns will do what comes naturally: Frame a response that at least tries to reinforce their core messages.

For the McCain campaign, that means looking like a different kind of Republican, certainly different from the incumbent Republican administration on whose watch the market problems developed. Toward that end, the McCain team instantly released a TV ad that talked in decidedly un-Republican terms about the need for regulation of the markets: "Tougher rules on Wall Street to protect your life savings," the TV ad declares.

SEN. MCCAIN was even more pointed in his own remarks at a campaign rally Monday: "This is a failure....We will reform the regulatory bodies of government."

The McCain response also tries to play to the populist streak of a candidate so eager to associate himself with Teddy Roosevelt that he played a Roosevelt video biography at the party's convention. Sen. McCain has appeared distinctly uncomfortable in recent weeks over the Bush administration's decisions to bail out first Bear Stearns and then Fannie Mae and Freddie Mac, effectively helping the investment class, with which the party is identified in popular stereotype, to unwind from its messes.

When the Bush administration decided over the weekend to do the opposite with Lehman Brothers and let it sink into bankruptcy, there was almost a sense of relief when Sen. McCain issued a statement declaring: "I am glad to see that the Federal Reserve and the Treasury Department have said no to using taxpayer money to bail out Lehman Brothers...."

It's easier for Team Obama to take the offensive. "This is a pretty compelling argument for the failures of economic policy in the last eight years," one senior adviser said simply. In his own written reaction, put out before dawn Monday, Sen. Obama was almost as pointed in trying to tie blame to Sen. McCain and the Bush team in one stroke: "I certainly don't fault Sen. McCain for these problems, but I do fault the economic philosophy he subscribes to...."

Look for lots of reminders that Sen. Obama sponsored legislation to curb abuses by subprime lenders and that he wrote the Treasury Department and the Federal Reserve in March 2007 urging them to act on problems in credit markets.

Above all, though, if you run a campaign in which every sign and every backdrop screams out, "Change," you simply point to every unpleasant event to underscore that theme. Wall Street provided another over the weekend.