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Lloyds TSB in talks to buy ailing HBOS

U.K. is pushing purchase to stabilize banking system

By Dana Cimilluca, Alistair MacDonald and Sarah Schaefer Muñoz

LONDON—U.K. bank **Lloyds TSB** is in talks to acquire mortgage lender **HBOS** PLC, in a government-brokered deal aimed at shoring up the British banking system amid a worsening global financial crunch.

A deal could be announced as soon as Thursday, said people familiar with the matter. The takeover would effectively be a rescue of HBOS, which has seen its share price fall roughly 50% in the past week as worries about banks' health have frozen the markets on which HBOS relied heavily to borrow cash. The combined bank would be by far the U.K.'s biggest mortgage lender, with more than £1 trillion ($1.783 trillion) in assets and nearly a third of the mortgage and retail deposit markets.

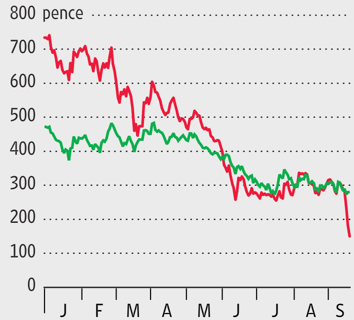
The talks are being spurred on by the U.K. government, which is eager to avoid an encore of the debacle surrounding mortgage lender Northern Rock PLC. Last year, Northern Rock became the target of the country's first bank run in more than a century, after the government balked at sponsoring a takeover by Lloyds.

An HBOS deal would be a large acquisition for Lloyd's, which, with £353 billion in assets, is about half the size of the Edinburgh-based lender. While it is unclear what

Please turn to page 30

British bankers

U.K. banks HBOS and Lloyds TSB Group are in advanced merger talks, the latest deal talks to result from the financial turmoil sweeping markets globally.



Assets, in billions of pounds

Bank	Assets
HBOS	681.4
LLOYDS TSB	367.8

Share of outstanding U.K. mortgages

Bank	Share
HBOS	20%
LLOYDS TSB	9%

Market value, in billions of pounds

	LLOYDS TSB	HBOS
LAST WEEK (Wednesday, 10 Sept.)	16.8	15.8
THIS WEEK (Wednesday, 17 Sept.)	15.9	7.8

Sources: Thomson Reuters Datastream (share price and market value); the companies interim financial reports (assets and mortgage share at June 30). Photo: Associated Press.

What's News—

Business & Finance

U.K. bank Lloyds TSB is in talks to acquire troubled mortgage lender HBOS in a government-brokered deal aimed at shoring up Britain's banking system. An agreement could be announced as soon as Thursday. Page 1

■ **The seizure of AIG** signaled the intensity of concerns about the wider dangers the firm's collapse could pose. Page 1

■ **Morgan Stanley plunged** as investors questioned whether the Wall Street bank could survive alone. Goldman Sachs shares also tumbled. Page 3

■ **Russia rolled out** a $70 billion emergency package to stop a free fall in the country's stock market. Page 1

■ **U.S. stocks declined** even as investors welcomed the Fed's $85 billion rescue of AIG. European shares dropped. Page 17

■ **The SEC issued** rules to curb a type of short selling that Wall Street has blamed for driving down financial stocks. Page 2

■ **Nortel cut** its revenue forecast and said it is putting a business up for sale. Page 32

■ **Alitalia teetered** on the brink of ruin as employees went on strike and an investor group threatened to withdraw its bid for the airline. Page 4

■ **BAA put Gatwick** up for sale, a move aimed at avoiding a breakup of the U.K. airports operator by regulators. Page 5

Markets 4 p.m. ET

MARKET	CLOSE	NET CHG	PCT CHG
DJIA	10609.66	-449.36	-4.06
Nasdaq	2098.85	-109.05	-4.94
DJ Stoxx 600	258.04	-5.50	-2.09
FTSE 100	4912.4	-113.2	-2.25
DAX	5860.98	-104.19	-1.75
CAC 40	4000.11	-87.29	-2.14
Euro	$1.4204	+0.0079	+0.56
Nymex crude	$97.16	+6.01	+6.59

Money & Investing > Page 17

World-Wide

Militants attacked the U.S. Embassy in Yemen, exploding a car bomb and launching attacks that failed to penetrate the compound, killing six guards and four civilians. Six attackers died in the second assault this year on the embassy. Page 8

■ **Israeli Foreign Minister Livni** won a Kadima party vote to replace Prime Minister Olmert handily, according to exit polls.

■ **EU leaders increasingly doubt** that Ireland will ratify the Lisbon Treaty before next spring, potentially delaying the appointment of new EU commissioners. Page 8

■ **The U.S. military's chief said** the U.S. will respect Pakistan's territorial sovereignty. Islamabad said it was informed before U.S. drones fired missiles that killed five people Wednesday. Page 9

■ **Defense Secretary Gates** expressed "personal regret" for U.S. airstrikes that killed Afghan civilians. A roadside bomb killed four U.S. soldiers and an Afghan.

■ **China's Sanlu** and local officials tried to cover up the discovery that baby formula contained melamine, Fonterra said, amid a widening scandal. Page 9

■ **Thai lawmakers elected** ousted leader Thaksin's brother-in-law, Somchai Wongsawat, as the country's prime minister. Page 9

■ **At least 11 people were killed** and 26 others wounded in two separate bombings in Baghdad.

■ **Russia signed** friendship treaties with Georgia's two breakaway provinces of Abkhazia and South Ossetia, but Georgian officials said they were legally void.

Editorial & Opinion

The Putin discount

Investors do what Western capitals wouldn't: Punish Russia. Review & Outlook. Page 11

Russia acts to right falling market

Emergency injection of $70 billion undercuts prior claims of stability

By Gregory L. White

MOSCOW—Less than a week after Prime Minister Vladimir Putin touted Russia as a "quiet harbor" for investors amid the global storm, the government and central bank rolled out a $70 billion emergency package to stop a free fall in the country's stock market.

The Kremlin also was preparing a much larger move to shore up share prices, channeling tens of billions of dollars in government funds to buy up stocks through a state-controlled bank, according to a person close to the situation. "They will use overwhelming force to defend the market," this person said. Highlighting the severity of the crisis, President Dmitry Medvedev was closely involved in the rescue planning, people close to the talks said.

Though the economic impact of the stock-market drop has so far been limited, the latest plunge rocked Russia's fragile and underdeveloped financial system as lending between banks was paralyzed. That threatened to reduce the flow of investment capital to the economy, potentially undermining growth and living standards—vital foundations of the Kremlin's public support.

The crisis could be a blow to the image promoted by Messrs. Putin and Medvedev of Russia as a resurgent power—an image reinforced just last month when Russian troops occupied parts of Georgia and forced the West to accept the de facto separation from Georgia of two Moscow-leaning breakaway provinces.

Though the war initially appeared to be a success in Moscow, with Georgia's military annihilated, it spooked foreign investors already worried about Kremlin pressure on big business. The ruble, which for years had been gaining against the dollar, suddenly slipped, alarming ordinary Russians.

After fewer than two hours Wednesday, regulators indefinitely suspended trading on Russian stock exchanges amid waves of selling. So

Please turn to page 30

The sprawling financial crisis

Traders around the kiosk where AIG shares are being traded on the floor of the New York Stock Exchange.

Reuters

■ Chairman of AIG aircraft-leasing unit plans buyback 4

■ U.S. presidential hopefuls look to boost bank regulation 14

■ Commercial real-estate debt could face a surge of sales 20

Bailout of AIG fails to calm fears as Wall Street plunges

By Matthew Karnitschnig, Deborah Solomon, Liam Pleven and Jon E. Hilsenrath

The U.S. government's seizure of control of **American International Group** Inc.—one of the world's biggest insurers—in an $85 billion deal signaled the intensity of its concerns about the danger a collapse could pose to the financial system.

Investors, meanwhile, despite their relief, questioned whether the bailout will effectively help stem the ripple effect that failing banks are having on world markets, sending U.S. stocks tumbling Wednesday. The Dow industrials fell 449.36 points, or 4.1%, to 10609.66, with the average's financial components sharply lower.

The bailout marked a dramatic turnabout for the U.S. government, which had been strongly resisting overtures from AIG for an emergency loan or some intervention that would prevent the New York-based insurer from falling into bankruptcy. Just last weekend, the government essentially pulled the plug

Please turn to page 31

THE WALL STREET JOURNAL.

THE FINANCIAL CRISIS

Europe often aids firms

Risks to economy, job protection fuel government rescues

While the $85 billion government bailout of **American International Group** Inc. is a highly unusual move in the U.S., European states have regularly come to the rescue of their distressed companies.

Despite the European Union's efforts to clamp down on protectionism, many European governments

By **David Gauthier-Villars** *and* **Stacy Meichtry** *in Paris*

believe intervention is necessary when national interests are at stake. The question is: How bad do things have to get before governments step in?

In recent decades, European governments have rescued large financial institutions when their potential collapse risked paralyzing the economy. Some nations go a step further, and also provide financial aid to protect jobs or maintain a national presence in key industries.

Italy's government is currently involved in the latest bailout of airline Alitalia SpA. Prime Minister Silvio Berlusconi has changed Italy's bankruptcy laws so the state can take on most of Alitalia's €1.2 billion ($1.69 billion) in debt, allowing the airline to transform itself into a healthier company.

Years of failed attempts to prop up the airline with state funds have cost taxpayers as much as €4.4 billion estimates Andrea Boitani, an economist at the Universita Cattolica of Milan.

"Unfortunately, the airline has the country's name in its logo," he said. "A failure of Alitalia would be seen as a failure of Italy."

France has a long tradition of intervening in the private economy, and the government often extends cash lifelines to companies in need. In 2004, when current President Nicolas Sarkozy was finance minister, the government spent €750 million to bail out engineering firm Alstom. The move was later seen as a success: The government not only saved the company from bankruptcy, but it later sold off its stake for a gain of €1.3 billion.

Germany has bailed out three banks since the summer of 2007, even though they posed little threat to the financial sector as a whole. IKB, WestLB and SachsenLB all lost money on U.S. mortgage-related securities. But their ownership by regional and federal governments meant they had sufficient political support to be bailed out with taxpayer money.

By contrast, the U.K. for decades stood back while much of its industrial and mining base failed or was bought up by foreign companies.

But the credit crunch has changed all that, as it puts Britain's overleveraged households and the economy's biggest growth machine—financial services—at risk. On Wednesday, the government was encouraging British lender **Lloyds TSB** to buy rival bank **HBOS** PLC, whose share price has fallen dramatically in recent days, and will amend its competition law to make it happen, a person familiar with the matter said.

The Bank of England, which at the start of the credit crunch was slower to pump money into markets than other central banks, also announced the extension of a liquidity plan, in which it swaps hard-to-sell debt for treasury bonds. Last fall, the U.K. government nationalized Northern Rock after the markets in which it had financed itself shut down.

Continental Europe, too, has a history of big bailouts to shore up its financial systems. In the 1980s, France spent an estimated €20 billion rescuing Crédit Lyonnais, then the country's largest bank, a move that economists credit for preventing a financial crisis.

A decade later, Scandinavia was hit by shockwaves that in some ways resemble those in the U.S. recently, when large parts of the banking systems of Sweden, Norway and Finland threatened to collapse. Financial deregulation, weak supervision by authorities, lax lending practices and low central-bank interest rates led to real-estate and other asset bubbles in the Nordic region. After interest rates rose and growth slowed, many banks faced big loan losses.

Norway nationalized the country's three biggest banks, Finland's government took over the savings-bank sector, and Sweden gave a blanket guarantee that banks would repay their debts. The rescue measures were expensive but are widely viewed as having prevented a financial meltdown.

—Marcus Walker in Berlin and Edward Taylor in Frankfurt contributed to this article.

Alitalia on the brink

An investor group threatened to drop its bid for Italian airline 4

SEC crafts tougher rules on short-selling delivery

By Kara Scannell

WASHINGTON—The U.S. Securities and Exchange Commission issued three new rules aimed particularly at curbing a certain type of short selling that Wall Street and others have blamed for driving down financial stocks.

The moves, which go into effect over several days, are intended to tighten existing rules and make it more difficult for traders to manipulate the market. In a short sale, a trader locates stock to borrow and then sell, hoping it will fall and can be repurchased later at a profit. The trader has to deliver the stock to the buyer within three business days.

Christopher Cox

Corporations and others have complained that loopholes have made it easier for traders to short sell stock without actually borrowing it and delivering it on time. They say the strategy has been used to put heavy selling pressure on stocks.

The SEC has said that most traders who missed the deadline have delivered shares within five to 10 business days and that the delays are often because of clerical errors or mistakes. Still, the SEC is eliminating the wiggle room and says that if a trader doesn't deliver shorted shares within three business days, he is prohibited from short selling the same stock unless the shares are actually borrowed ahead of the bear-ish bet.

The SEC is also tightening requirements on market makers for options and is making it illegal for a customer to mislead a broker about having located stock and then failing to deliver it.

The SEC's moves come after heavy short selling in the shares of investment banks and other financial companies in recent days. On Tuesday, U.S. Sen. Christopher Dodd (D., Conn.) criticized SEC Chairman Christopher Cox and said he was "disappointed" that Mr. Cox wasn't acting quicker to combat abusive short selling. The American Bankers Association also on Tuesday urged bank regulators to pressure the SEC to take steps against abusive short selling. The SEC declined to comment on Sen. Dodd's remarks.

On Wednesday, the president of the bankers association, Edward Yingling, said the SEC's move was a key component to restoring market stability but said the rules should have been in effect "yesterday."

Wall Street firms earlier this summer persuaded the SEC to temporarily restrict certain types of short sales for 19 financial companies. Observers say those short-sale restrictions helped limit downside in those stocks.

The move to renew those rules gained pace over the weekend as the crisis on Wall Street fanned out. Mr. Cox assured Wall Street chiefs that the SEC would institute protections as soon as possible.

Some traders and a number of academics say that the finger-pointing i s misplaced and that there is only so much short sellers can do to push stocks lower. "This problem is much bigger than short sellers," says Lou Brien, a strategist at DRW Trading in Chicago, pointing to the credit crunch and other systemic problems.

But with the market on edge amid the credit crunch and credit-rating firms citing weakness in stock and bond prices as a reason for negative ratings action, short sellers' muscle is greater than in the past.

Economy & Politics

Drill and grill

U.S. auditors question energy royalties derived from federal lands > **Page 10**

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.

AIG 19
Air China 32
Air One 4
Alfa Group 6
Alitalia 4
Allied Security Trust ...29
Altria Group 7
American International Group 1,2,4,15,17,18,21,30
ArcelorMittal 6
Ashford Hospitality Trust 20
Banco Santander (Spain) 3
Bank of America 3,19,20
Bank of China 19,21
Barclays 17,18,22
BHP Billiton 6,7
Blackstone Group 20
BMW 5
BNP Paribas 3
Boeing 4
Bristol-Myers Squibb ...9
Charles River Ventures 29
Chevron 18
China Merchants Bank 19,21
Cisco Systems 27,32
Citic International Financial Holdings ...22
Citigroup 17
Comcast Corp 27
Compagnia Aerea Italiana 4
Companhia Vale do Rio Doce 6
Daimler 5
Deutsche Bahn 26
eBay 27
Eni 18
European Aeronautic Defence & Space 4
Fannie Mae 17
Farimex Products 6
Fonterra Co-operative Group 9
Ford Motor 5
France Télécom 26
Fraport 5
Freddie Mac 17
General Motors 5
Goff Capital Partners .20
Goldman Sachs Group 15,17,18,20,22
Google 27
Groupe Danone 9
Grupo Ferrovial 5
HBOS 1,2,17,18,19,32
Hewlett-Packard 4
Hochtief 5
HSBC Holdings 3
Hyundai Motor 5
IBM 27
ICICI Bank 21
Inditex 5
Industrial & Commercial Bank Of China 19,21
Intel 27
Intellectual Ventures .27
International Liquidity Fund 20
Kleiner Perkins Caufield & Byers 29
Kyivstar 6
Lehman Brothers Holdings 17,18,19,20,21,22
Lightstone Group 20
Lloyds TSB Group 1,2,17,18,19,32
L.M. Ericsson 29
Manchester Airport Group 5
Merrill Lynch 3,19
Micro Focus 26
Mitsubishi Motors 5
Mitsubishi UFJ Financial Group 21
Monsanto 7
Morgan Stanley 3,17,18,20,22
Motorola 29,32
Nestlé 9
Nissan Motor 5
Nokia 6,27
Nordea Bank 26
Nortel Networks 32
Northern Rock 19
NTP 29
Nvidia 27
Olympic Airlines 7
Petro-Canada 17
Philip Morris International 7
Plug Power 19
Porsche Automobil Holding 5
Primary Fund Class Institutional 20
Qinetiq Group 26
Ranbaxy Laboratories ..6
Research In Motion 29
Reserve Management 20
Reserve Primary Fund 18,20
Rio Tinto 6
Rothmans 7
Royal Bank of Scotland PLC 26
Royal Dutch Shell 18
RPX 29
Samsung Electronics 6,18
SanDisk 6,18
SAP 27
Sherborne Partners 26
Shijiazhuang Sanlu Group 9
Simpson Thacher & Bartlett 27
Sony 27
Spirent Communications 26
Standard & Poor's 4
Starr International 30
Tata Motors 4
Telenor 6
Teliasonera 26
Texas Instruments 27
ThinkFire USA 29
Thomson Reuters 30
ThyssenKrupp 6
Tommy Hilfiger Handbags & Small Leather Goods 7
Total 17
Toyota Motor 5
U.S. Steel 6
UBS 17,18,19,22,26
Verizon Communications 27
Vimpel Communications 6
Virgin Atlantic 5
Volkswagen 5
Wachovia 20
Washington Mutual 17,18
Woolworths 7

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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

Agarwal, Nitin 6
Amster, John 29
Anton, John 6
Baranov, Gennady 5
Bernanke, Ben 31
Bodner, Martin S. 7
Bonchev, Ivan 5
Bradford, Charles 6
Brien, Lou 2
Brunne, Tim 17
Carpinello, Greg 19
Chu, Charlene 19
Crews, Terry 7
Critchlow, Anne 5
de Margerie, Christophe 17
Demirali, Peter 18
Diggle, Steve 22
Ellison, David 3
Ferrier, Andrew 9
Fineberg, David 17,18
Fishwick, Eric 21
Garfield, Spencer 20
Geithner, Timothy 31
Godbold, Gene 20
Goh, Puay Yeong 22
Goncalves, George 17
Gottestein, Thomas 26
Greenberg, Maurice R. .. 30
Günthardt, Peter 26
Gutman, Henry 27
Hampden-Turner, Michael 17,18
Holbourn, Oliver 26
Jen, Stephen 22
Jester, Dan 15
Johnson, Steve 7
Kant, Ravi 4
Kelleher, Colm 3
Kong Dong 32
Kuroki, Tatsuo 21
Kvalheim, Pal 6
Liddy, Edward 31
Mack, John 3
Matthews, Colin 5
McCurdy, Dan 29
Menchel, Matthew 7
Mishlyatesev, Sergei 5
Mittal, Aditya 6
Myhrvold, Nathan 27
North, Richard 7
Olsson, Sten 6
Onnink, Ludo 7
Paulson, Henry 31
Phillips, Don 18,20
Putman, Donald 3
Ramteke, A.B. 6
Ray, Debasis 4
Root, Stanley 5
Runte, Douglas 4
Sants, Hector 26
Schorr, Glenn 3
See Chin Teik 4
Shafran, Steve 15
Sharpe, Gary L. 19
Spector, Jeffrey 20
Thomas, David 5
Thomas, Gareth 30
Tsang, Dale 21
Udvar-Hazy, Steven 4
Viniar, David 20
Welham, Adam 26
Wenig, Devin 30
Willumstad, Robert 30,31
Yingling, Edward 2
Zafirovski, Mike 32

Morgan Stanley, Goldman shares tumble

Investors question brokerages' ability to stay independent

By Aaron Lucchetti, Randall Smith And Jenny Strasburg

Morgan Stanley fought for its life Wednesday, as a seventh straight decline in the company's share price sent the stock to a 10-year low.

Morgan Stanley shares, after a harrowing day, were down $8.67, or 30%, to $20.03 near the close on the New York Stock Exchange. **Goldman Sachs Group** Inc. shares fell $27.15, or 20%, to $110.22.

It may be able to survive the storm, but the weather has gotten rougher. Through midday Wednesday, the company had lost about 10% of the assets in its prime-brokerage business since the start of the week, up from 3% through Tuesday, according to a person familiar with the firm.

Morgan Stanley said it was doing everything it could to shore up a rapidly sinking stock price. "The smartest people at this firm are focused on solutions," a spokeswoman said. When pressed about potential merger discussions, she declined to comment.

The firm has said it believes it can stay independent because it doesn't need immediate funding, but it has also recognized that confidence in an investment bank is a commodity that can wither quickly and must be preserved at any cost.

Morgan Stanley CEO John Mack called Treasury Secretary Henry Paulson and Securities and Exchange Commission Chairman Christopher Cox on Wednesday, as well as Goldman Sachs CEO Lloyd Blankfein, to discuss how to stop the rapid decline in the two firms' share price. They didn't discuss a merger, but mainly how to stop short-sellers betting on a decline in Goldman and Morgan shares, a person familiar with the matter said.

Unlike Lehman Brothers's share-price decline, Morgan Stanley's doesn't coincide with an effort to raise capital by selling equity in the company.

Morgan Stanley Chief Financial Officer Colm Kelleher said Tuesday that the firm doesn't need to issue debt or new stock to raise capital until 2009. But the share-price decline has unnerved some hedge-fund clients, which could erode the franchise and send the company looking to sell to a bigger bank.

Mr. Mack, a onetime bond trader, has been a deal maker through his career. Bankers and investors debated Tuesday whether he would try to do another one for the firm where he started in the 1980s.

In 1997, he pulled off a giant deal when he merged the white-shoe investment bank with brokerage giant Dean Witter. Seven years later, as an executive at Credit Suisse Group, Mr. Mack left after clashing with fellow executives about pursuing a major merger. Mr. Mack thought it was a good idea; others at Credit Suisse didn't.

In a memo to employees in the middle of trading Wednesday, Mr. Mack asked: "What's happening out there? It's very clear to me—we're in the midst of a market controlled by fear and rumors, and short-sellers are driving our stock down."

Donald Putman, a managing partner at investment-banking boutique Grail Partners, said he didn't expect Mr. Mack to fight for independence. Drawing a parallel to **Merrill Lynch** & Co. CEO John Thain, who agreed to sell the firm to **Bank of America** Corp. earlier this week, he said Mr. Mack "doesn't have theological objections to a transaction" with a global commercial bank.

DAILY SHARE PRICE

Morgan Stanley

Wednesday midafternoon: **$20.67**

Year-to-date change: **down 61%**

Source: WSJ Market Data Group

Traders at the post on the New York Stock Exchange floor that handles Morgan Stanley and Wells Fargo, Wednesday.

Wednesday morning, a Morgan Stanley spokeswoman said the investment bank wasn't in merger talks. Nonetheless, potential partners being bandied about among Morgan Stanley employees included **HSBC Holdings** PLC of the U.K., Spain's **Banco Santander** SA and France's **BNP Paribas** SA.

Mr. Mack entertained the idea of a lock-up with Merrill Lynch last weekend as banking executives met at the Federal Reserve Bank of New York to discuss the future of Lehman Brothers Holdings Inc., but Merrill wanted to move too quickly for Mr. Mack, according to people familiar with the matter.

Mr. Mack and his fellow executives held out hope that their stock price would react better to the company's earnings announcement this week. The company's profit and net revenue topped even Goldman Sachs, the largest investment bank by market value that has generally avoided big problems amid the credit crunch.

But after the earnings announcement Wednesday afternoon caused initial enthusiasm among investors, Morgan Stanley shares resumed their downward march Wednesday. They continued lower even after the SEC announced that new restrictions would be placed on investors who bet on declines in share prices.

One money manager, David Ellison of FBR Capital Markets Corp., traced Morgan Stanley's market woes to the extent of its debt financing of a big balance sheet. Morgan Stanley, he said, has "a trillion dollars in assets"—the same, he said, as American International Group Inc., the giant insurer that was propped up on Tuesday with a government support package.

"How do you know what you've got with a trillion dollars—that's a million millions. That's a big number. What kind of army of people do they have looking at those assets?" The problem, Mr. Ellison said, is "how they were financed—with other people's money."

Mr. Putnam predicted that Mr. Mack would do a deal, but that he might not need to act right away if the SEC rules give Morgan Stanley shares some support this week. Mr. Mack would rather pursue a deal in an environment "where there's time to do what's smart rather than doing what's urgent," he said.

Whether he will have a choice is an open question. UBS banking analyst Glenn Schorr complained that investors have been buying credit-default protection on Morgan Stanley while selling shares in anticipation of buying them back at a lower price, a one-two punch that hurts sentiment and scares away other buyers.

Indeed, Mr. Schorr approved of Morgan Stanley's strategy of reducing risk and said it is in a better position than fallen peers, but he still gives the stock a "neutral" rating. "It's an issue of confidence," he said.

But the door isn't completely shut, especially if Morgan Stanley stock continues to slide. "We have to be adaptable," Morgan Stanley Chief Financial Officer Colm Kelleher said in an interview Tuesday night. "If the market fully decides that you need deposits, then it's decided."

Mr. Kelleher said Tuesday night that "we need these markets to normalize. Frankly, I believe this nonsense will end."

The company could do something less dramatic. It believes, for instance, it could raise more equity, if it needed to, a person familiar with the matter said. On Wednesday, the SEC beefed up its on-site presence at both Morgan Stanley and Goldman Sachs.

Lehman's London workers face late checks, uncertainty

By Carrick Mollenkamp, Jeanne Whalen And Dana Cimilluca

LONDON—Ending days of uncertainty for **Lehman Brothers Holding** Inc. employees here, the firm's insolvency administrator said Wednesday they will be paid for the month of September, though their checks will be late.

The question mark over pay highlights a widening divide at the firm: Employees at headquarters in New York face a clearer future than those overseas. Lehman on Tuesday agreed to sell the bulk of its U.S. operations to Britain's **Barclays** PLC, but in London, Lehman's European base, it is in the process of winding down.

On Wednesday, the bank's local insolvency administrator, PricewaterhouseCoopers LLC, held a series of town-hall-style meetings at Lehman's office tower in the Canary Wharf business district for employees. Some attendees found the sessions frustrating, people who were present said, because they couldn't get an answer to a question many have been asking lately: Did Lehman transfer money from the U.K. to New York just before filing for bankruptcy protection, leaving London strapped for funds?

PricewaterhouseCoopers representatives told attendees that it will be looking into all transactions between the entities around the time of the company's Chapter 11 bankruptcy-court filing, said a Lehman trader who attended.

PricewaterhouseCoopers partner Tony Lomas, on a Webcast for reporters Wednesday, said Lehman didn't have bank accounts in the U.K. and that it relied on its U.S. parent for funding. "When we arrived [Monday morning], there were no funds here," Mr. Lomas said. On Monday, as Lehman announced its bankruptcy filing, Mr. Lomas had said there might not be enough funds to cover all salaries.

As a result, the Bank of England has established new bank facilities to help PWC make payments such as salaries, Mr. Lomas said.

All the roughly 4,500 employees here will get paid by month's end, but they have to show up for work. Employees expect to be notified then if they still have jobs. There is still hope for some that they will stay employed, if Barclays or another bank buys Lehman's European operations. But as more time goes by without a deal, that becomes less likely.

PricewaterhouseCoopers and Lehman officials declined to comment.

Some units or banking teams may yet be bought or hired. PricewaterhouseCoopers said Wednesday that there have been "expressions of interest" in Lehman Europe's asset-management business and its corporate-finance-advisory businesses, which it said "are solvent and continue to operate, and we have begun discussions with interested parties." It isn't clear who might buy them.

Some London employees said they hadn't received an email from outgoing Lehman Chairman and Chief Executive Richard Fuld Jr. that went to U.S. employees, many of whom forwarded it to colleagues overseas. In the email, Mr. Fuld trumpeted the future of the U.S. unit and its combination with Barclays Capital. As for European and Asian units, Mr. Fuld said that hopefully those businesses might end up with Barclays.

"The past several months have been extraordinarily challenging," Mr. Fuld emailed. "For some of you, the firm has been your home for decades. For others, less than a year. For all of us, it has been far more than a place of employment. It has been a source of pride."

Edouard d'Archimbaud, a 24-year-old Frenchman who was supposed to start a new job at Lehman on Monday, says he is planning to move back to France at the end of the week to look for work. "I want to work in a bank, but I am sure it will be too difficult," he said Wednesday. "Probably I will apply for a job in hedge funds. I work in systematic trading, a field of banking that works pretty well at the moment."

U.S. lawmakers consider reviving a 1980s plan

By Michael R. Crittenden And Patrick Yoest

WASHINGTON—Staring down the worst financial crisis in decades, U.S. lawmakers are strongly considering whether they need to dust off a 1980s-era plan to help save the banking industry and stabilize the economy more broadly.

Democrats and Republicans have shown interest this week in the idea of creating a government corporation to help deal with the toxic assets that have already brought down financial behemoths Bear Stearns Cos. and Lehman Brothers Holdings Inc., and forced the government to take over Fannie Mae and Freddie Mac.

"We need to create an institution or a mechanism of a supertrustee to handle incredibly large institutions which may be allowed to fail and how those assets get managed and handled in an expeditious way," said Rep. Paul Kanjorski (D., Pa.). "If we don't do that, we'll just go from one failure to another, and keep blossoming."

His comments came the day after House Financial Services Chairman Barney Frank (D., Mass.) suggested that lawmakers need to consider creating a government entity akin to the Resolution Trust Corporation, which was formed amid the savings and loan crisis in the 1980s. The RTC, as it was known, resolved and liquidated the assets of 747 thrifts with total assets of $394 billion.

House Speaker Nancy Pelosi (D., Calif.) said she had discussed the idea of an RTC-like entity with Treasury Secretary Henry Paulson in the past, and Republicans also seemed open to the idea.

Despite the groundswell of interest in the idea of a government entity buying up billions of dollars of tainted assets, an immediate fix is unlikely. Mr. Frank himself said enacting legislation this year is "unlikely," a reflection of the political landscape of an election year.

—Corey Boles and Jessica Holzer contributed to this article.

CORPORATE NEWS

AIRLINES

EasyJet repeats forecast, expects a chilly winter

Associated Press

U.K.-BASED low-cost airline **easyJet** PLC reiterated its outlook for the year ending Sept. 30 but said it expects slower growth this winter. EasyJet, Europe's second-largest budget airline by passengers carried after Ryanair Holdings PLC, had warned in March that its pretax profit for the full year would miss earlier forecasts if fuel prices didn't retreat.

The company said it still expects full-year pretax profit of £120 million ($214 million), up from £110 million the previous year. It said it expects fiscal-second-half revenue per seat to be up by a percentage in the "midteens" from a year earlier.

—Erica Herrero-Martinez

AUTOMOBILES

Tata executives to discuss making cars in India state

Associated Press

TATA MOTORS Ltd. executives, led by Managing Director Ravi Kant, left, will meet B.S. Yeddyurappa, the chief minister of Karnataka, on Thursday to discuss the possibility of making the world's least-expensive car in the southern Indian state, a senior state government official said.

Debasis Ray, a spokesman for Mumbai-based Tata Motors, declined to comment.

The meeting comes after Tata Motors suspended the construction of a factory on Sept. 2 to produce the $2,500 Nano minicar in Singur in the eastern state of West Bengal because of violent protests and threats to its workers over disputed farmland.

COMPUTERS

Executive says H-P sees some worry by customers

Associated Press

A SENIOR executive from **Hewlett-Packard** Co. said the company hasn't seen significant deterioration in demand for personal computers, but has seen greater anxiety from Asian customers from the slowing global economy.

See Chin Teik, H-P's senior vice president of the Personal Systems Group for Asia Pacific and Japan, said "it's too early to tell" how the current turmoil in the U.S. financial market will play out.

"But what we see is certainly heightened level of anxiety, especially on the business side," he said.

Mr. See said there hasn't been a significant fall in demand for H-P's products yet.

—Se Young Lee

AIG's plane-leasing unit in play

Chief of operation expected to seek deal; insurer needs cash

BY J. LYNN LUNSFORD AND DANIEL MICHAELS

STEVEN UDVAR-HAZY, the chairman of **American International Group** Inc.'s highly successful aircraft-leasing unit, is expected to lead an effort to buy back the company that he founded 35 years ago, according to people familiar with the situation.

A move to buy back International Lease Finance Corp. could give the insurance giant much-needed cash while stabilizing one of the pillars of the airline industry.

It is unclear whether Mr. Udvar-Hazy will be successful or who the investors might be, but much is riding on whether the 62-year-old entrepreneur can pull it off. With more than $17 billion worth of orders on its books, the firm, commonly referred to as ILFC, is the single largest buyer of new jetliners for both **Boeing** Co. and Airbus, a unit of **European Aeronautic Defence & Space** Co. In addition, the company has played the role of white knight a number of times in recent years, providing capital to troubled airlines.

On Wednesday, Airbus said it is closely monitoring the AIG rescue. A spokesman for the Toulouse, France-based company said that, in view of the unsettled situation regarding AIG and ILFC, he wouldn't comment further.

In recent days, the fate of the leasing company has been the subject of much speculation as New York-based AIG came under increasing pressure to raise massive amounts of capital.

With a fleet of more than 1,000 jetliners on lease to airlines worldwide, ILFC is among the insurance company's most valuable noncore assets. The fleet is valued at roughly $55 billion, and ILFC has continued to post double-digit increases in revenue and profits even while its parent has struggled.

AIG couldn't be reached for comment about a possible sale of ILFC. According to people familiar with the situation, ILFC officials haven't approached the parent company with any proposals, in part because it wasn't clear what AIG's fate would be.

Associated Press

Chairman Steven Udvar-Hazy does not think ILFC can stay competitive if the company remains a part of AIG, whose credit rating is deteriorating.

International Lease Finance Corporation

Founded: 1973
Bought by AIG: 1990
Total employees: 170
Number of airline customers: 203
Total fleet: 1,000*
Value of fleet: $55 billion

Revenue, in billions
2007: $4.73
First-half 2008: $2.53

Net income, in millions
2007: $604
First-half 2008: $363.6

*As of June 2008 Source: the company

Late Tuesday, the U.S. government reached an agreement to provide an $85 billion short-term loan that would help restore AIG's credit ratings and help it avoid bankruptcy. According to people familiar with the situation, the government would require the insurance company to dispose of some "noncore" assets, such as ILFC.

Extricating the Los Angeles leasing company from AIG could be difficult because of the intricate web of financing and tax considerations that make the leasing business so profitable. Federal filings show that ILFC is carrying more than $31 billion in debt, as well as a number of other obligations, leaving the company with roughly $7.36 billion in equity.

Depending on how a sale could be structured, AIG's profit could be negatively affected by the $4.2 billion in deferred income taxes on ILFC's books, raising the possibility that the company might net no more than $2.5 billion on a sale.

According to people familiar with the situation, Mr. Udvar-Hazy and other top ILFC officials have been in around-the-clock discussions with potential investors since late Sunday. Among the candidates for capital are private equity, pension funds, European banks, sovereign wealth funds and other non-U.S. equity. The discussions have involved a variety of options, ranging from an outright purchase to the potential of buying the bulk of the leasing company's assets.

Mr. Udvar-Hazy and his management team are widely considered to be one of the most important ingredients behind ILFC's ability to move nimbly in a daunting credit market. According to people familiar with the situation, he and other senior executives at ILFC have concluded that it would be virtually impossible for the leasing company to remain competitive as long as it is part of AIG. The deterioration of AIG's once-impeccable AAA credit rating has raised ILFC's borrowing costs to the point that the company would be unable to prosper in an increasingly crowded leasing market, the thinking goes. Monday, **Standard & Poor's** Corp.'s Standard & Poor's Ratings Service cut AIG's long-term credit rating three notches to A-minus from AA-minus, and even with the federal loan it is unlikely that the insurer would be able to quickly restore its creditworthiness to previous levels.

ILFC officials have been frustrated for months that ILFC has been dragged down by the parent company's woes, even as the leasing unit turned in record profits. In March, Mr. Udvar-Hazy began pursuing a corporate divorce but was persuaded to hold off by AIG's new management team. As AIG's position continued to deteriorate in recent days, it put further pressure on ILFC to begin exploring options that would allow the firm to disentangle itself from its parent.

Because of the way ILFC is structured, a buyer would have to be able to shoulder ILFC's considerable debt. The company is carrying a total of $31.37 billion in debt in the form of public bonds, medium-term notes, bank debt and other sources. Much of it must be paid back in chunks of $4.1 billion to $4.8 billion a year between now and 2012.

Even though ILFC has $17 billion worth of jets on order from Boeing and Airbus, delays in programs such as the Boeing 787 Dreamliner mean the leasing company will have to spend little money on new deliveries between now and 2012. With expected yearly revenue of almost $6 billion, this would free up cash to allow it to pay down part of the debt, said a person familiar with the discussions.

Aircraft leasing specialist Douglas Runte, managing director of Piper Jaffray & Co., said while ILFC has "an attractive portfolio" of aircraft, the high borrowing costs implied by AIG's larger credit woes, as well as the coming debt payments, are "daunting" challenges. "But if anyone can pull it off, Steve can," he said.

A sale, however, would come as the airline industry is enduring its worst crisis in years.

Alitalia buyer threatens to drop offer over unions

BY STACY MEICHTRY AND ALESSANDRO TORELLO

Alitalia SpA was teetering on the brink of financial ruin Wednesday, after an employee strike forced the cancellation of 40 flights and a group of potential investors threatened to withdraw a bid aimed at rescuing the state-controlled airline.

The labor unrest, organized by one of the smallest unions at the airline, underscores the risks Alitalia faces as the Italian government tries to broker a deal to save the carrier. **Compagnia Aerea Italiana** (CAI)—a new company formed by a group of investors who want to buy Alitalia's healthier assets and merge them with Italian rival airline **Air One** SpA—has been negotiating with labor unions for weeks.

So far, the government has brokered a preliminary deal with Italy's four largest unions. However, small unions representing Alitalia flight crews and pilots remain opposed to the deal and have the firepower to sink it. The strike on Wednesday was called by CUB, a union that represents 600 ground crew at the carrier—a fraction of Alitalia's 18,000 employees.

Years of failed attempts by successive Italian governments to turn around the troubled airline have left Alitalia in dire straights. The airline is now running on just €30 million ($42.5 million) to €50 million in cash, and loses between €1 million and €2 million every day it remains in service.

CAI has pledged to inject €1 billion in capital into the merged company on the condition that Alitalia's unions accept new contracts.

CAI on Wednesday threatened to withdraw its offer if unions don't back its restructuring plan by Thursday. CAI plans to cut more than 5,000 jobs and put an end to numerous employee perks. CAI is also pushing unions to accept a single contract.

Prime Minister Silvio Berlusconi has revised Italy's bankruptcy laws to protect CAI from Alitalia's creditors. The EU is currently reviewing whether that move constitutes a form of illegal state aid.

Russians acquire a test for gas guzzlers

SUVs are embraced in nation where fuel is cheap, roads poor

By Will Bland
And Katharina Becker

MOSCOW—Auto makers finding it hard to sell large, gas-guzzling vehicles to Western Europe's increasingly environmentally and gas-budget-aware consumers have been thrown a lifeline by Russia.

Here, image-conscious consumers can't get enough of big cars. Russians bought 1.6 million vehicles in the first six months of the year, a 40% increase from the first half of 2007, according to figures compiled by PricewaterhouseCoopers LLP. An increasing proportion of those sales are large sedans or sport-utility vehicles. Sedans and SUVs have more prestige than hatchbacks and multipurpose vehicles, and they also cope better with some notoriously poor highways outside Russia's cities.

Some car makers are struggling to keep pace with Russian demand for their bigger models. Russians who want to buy a **Toyota Motor** Corp. Land Cruiser SUV, for example, face a waiting list of up to two years for delivery.

"The car is an ideal fit for the Russian market because of the roads, the weather and lifestyles," says Sergei Mishlyatesev, Toyota's head of marketing in Russia.

Reuters

Car buyers in Russia, where road conditions are poor, are prepared to wait up to two years for delivery of **Toyota's Land Cruiser**.

Higher oil prices have done nothing to diminish the appetite of Russian motorists for big wheels: A liter of gasoline here still costs less than half as much as in most Western European markets. While auto makers have to adhere to increasingly strict emissions standards for the vehicles they sell in Western Europe and the U.S., there are no such issues here.

More and more Russians have been enjoying the trappings of success as soaring commodity prices have swelled the value of the country's vast reserves of oil. Russia's markets have collapsed into crisis as Western investors and lenders have pulled out of them in the past few days, but economists Tuesday were still expecting relatively strong growth—roughly 6% next year, as opposed to the 8% expected this year. Riding that growth is a burgeoning middle class with aspirations—and a desire to flaunt its wealth.

"The development of the car industry had an important role in transforming the Soviet economy," says Stanley Root, leader of PricewaterhouseCoopers's automotive practice in Russia. "The market for foreign cars has unlocked pent-up demand from people who, in Soviet times, weren't able to express themselves through fashions or association with brands."

PricewaterhouseCoopers estimates the number of cars on the road in Russia has grown by five million in the past five years. Four million of those cars are made by foreign manufacturers. Only 188 people out of every 1,000 own cars in Russia, compared with 565 out of every 1,000 in Germany. But the pace of its growth puts Russia on track to overtake Germany as Europe's single-largest market for auto sales in 2008 or 2009.

Russians spend about $15,000 on average on their first foreign car. That is a big sum in a country where the average monthly wage is about $700.

"Not everyone in Russia can afford to buy a good apartment, and a lot of them have switched to buying a car," says Ivan Bonchev, the head of Ernst & Young's automotive unit in Russia.

"Typically, Russians spend more on cars than Europeans on the same income level, and they tend to trade up segments far faster," says David Thomas, president of Volvo Cars Russia, a unit of **Ford Motor** Co. Volvo's XE90 SUV accounts for about one-third of Volvo's sales in Russia.

Russian car makers are only slowly shedding their Communist-era reputations for shoddy workmanship, and the world's biggest auto companies—many of which have set up manufacturing plants or formed joint ventures in Russia in recent years—are finding customers very receptive.

Take Natalia Pivovara, who one day last month was shopping for a new car at the biannual Moscow International Motor Show. "I live in my car. I want it to be reliable and comfortable," says Ms. Pivovara, a working mother who lives an hour outside the capital and commutes into the city each day. She says she has owned six different foreign brands.

Ford, **General Motors** Corp., **Hyundai Motor** Co. and Toyota have sold more than 100,000 cars each this year in Russia, but the market has also been lucrative for the likes of **Mitsubishi Motors** Corp. and **Nissan Motor** Co. unit Infiniti, whose larger vehicles cope well with Russia's uneven roads and cold winters.

German manufacturers **BMW** AG, **Daimler** AG unit Mercedes-Benz and Audi AG, which is owned by **Volkswagen** AG, compete here in the market for high-end vehicles. All three sold about 15,000 vehicles each here last year, and each saw sales increases of more than 50% on 2006.

The trend toward bigger vehicles is noticeable even at German sports-car maker **Porsche Automobil Holding** SE. "More than half of the vehicles that we sell here are SUVs," says Russian sales manager Gennady Baranov. "In Europe the ratio is about a quarter."

For sale: BAA's Gatwick Airport

By Jonathan Buck

LONDON—U.K. airports operator BAA put Gatwick Airport up for sale, a move aimed at avoiding a breakup of the company by regulators.

The decision by BAA, a unit of **Grupo Ferrovial** SA of Spain, to give up Gatwick appears to be an effort to hang on to its two other London airports, Heathrow—the world's busiest international airport by passenger numbers—and Stansted.

The U.K. Competition Commission said in a report last month that BAA's common ownership of London's three major airports created competition problems, hurting both passengers and airlines, and recommended that BAA sell two of the airports. A final decision is expected early next year.

It remains to be seen whether BAA's concession of Gatwick will satisfy regulator concerns. The Competition Commission said Wednesday that its inquiry continues.

In addition to the three big London airports, BAA also owns airports in England's Southampton and Scotland's Glasgow, Edinburgh and Aberdeen. In its report, the Competition Commission recommended that either Edinburgh or Glasgow airport should be sold.

BAA said Wednesday that a change of ownership at Stansted would interfere with the process of securing planning approval for a second runway at the busy airport. It also said it will continue to present its case for its ownership of the airports in southeast England and in Scotland.

"BAA will continue to change in many respects," Chief Executive Colin Matthews said in a statement. "We have a new management team. Our priority is to improve the quality of service we offer passengers and airlines."

Associated Press

Gatwick Airport, above, is the busiest single-runway airport in the world and **the second-largest airport** in the U.K., according to BAA.

A sale of Gatwick could fetch between £2 billion and £3 billion, or between $3.57 billion and $5.35 billion, analysts said. BAA said it will appoint financial advisers soon, but potential bidders have been circling for some time.

Manchester Airport Group PLC, which is owned by local authorities, said Wednesday it "remains interested in one or more of BAA's airports," while airline **Virgin Atlantic** said it would like to bid for Gatwick as part of a consortium. German airport operator **Fraport** AG and German construction company **Hochtief** AG both said they remained interested.

Gatwick, which opened in 1958, is the busiest single-runway airport in the world and the second-largest airport in the U.K., BAA said. "Gatwick has long been an important and valuable part of BAA and the decision to sell was not taken lightly," Mr. Matthews said. "We believe that the airport's customers, staff and business will benefit from the earliest possible resolution of current uncertainty."

Inditex profit advances 3% as new stores bolster sales

By Jason Sinclair

MADRID—**Inditex** SA, the owner of the Zara Home housewares chain, said its fiscal first-half net profit increased 3%, as new stores helped offset slower sales growth from existing stores.

AFP

Spain-based **Inditex** owns the Zara Home housewares chain.

The Spain-based fashion retailer said net profit for the six months ended July 31 rose to €406 million ($574.2 million) from €393 million a year earlier. Total sales rose 11% to €4.56 billion from €4.12 billion.

Both profit and sales growth have slowed from earlier levels, reflecting a weakening macroeconomic environment for retailers in Europe—particularly in Inditex's Spanish home market, where a slowdown in consumer spending and higher inflation are eroding retailers' profits.

Looking ahead to the second half of the year, Inditex said it doesn't expect any risks or significant uncertainties for its business. The first six weeks of the second half were similar to the first half and in line with management expectations, the retailer added.

Investors were cheered by the company's relatively solid results and positive outlook, and Inditex shares rose 27 European cents to close at €29.04.

Still, some analysts expressed concern about the slowing sales growth from existing stores, which was masked in the overall sales results by the opening of new stores.

The company's like-for-like sales, or sales from stores open more than a year, rose 1% in the first half from a year earlier—a slowdown from the 3% growth recorded in the second half of last year.

"Like-for-like sales are a little disappointing, and could imply that they were flat in the second quarter," said Société Générale analyst Anne Critchlow. Inditex didn't break out fiscal second-quarter results.

The retailer said it will continue to open new stores in the second half, including in Asia and Eastern Europe, projecting annual average space growth of 15%. In the first half, it invested €475 million in its operations, mainly on opening 249 stores. The company, which operates in 70 countries, expects to open its 4,000th store this month in Tokyo.

Inditex's stable of eight retail concepts includes upmarket Massimo Dutti, teen brand Bershka and housewares chain Zara Home, allowing the company to add more stores to shopping streets and malls than chains that operate fewer brands.

U.S. bans Ranbaxy drugs

Scrutiny on medicine made at two plants is a hit to India's boom

By Geeta Anand

MUMBAI—The U.S. ban on some medicines made by India's largest pharmaceutical company adds a black mark against India's booming drug and drug-testing industries, which already have been under pressure over the country's lax monitoring of drug safety.

India's pharmaceutical industry was once the nemesis of U.S. drug companies, producing knock-off versions of patented drugs that grabbed market share. But the two sides have developed a symbiotic relationship in recent years, as India has agreed to enforce international patents and sales of generics have soared world-wide. The U.S. pharmaceutical industry, struggling with patent expirations and too few new products, has cut costs by outsourcing manufacturing and parts of the drug development process to India, China and other low-cost countries.

This year, Indian pharmaceutical exports are projected to hit $10 billion, up from just $1.9 billion in 1999, according to Global Trade Information Systems, a U.S. supplier of international trade data, and IDFC-SKKI Securities, a Mumbai brokerage firm.

But as the industry has grown, so have questions about whether India is ready to play an expanded role in sensitive areas such as early-stage clinical trials—and whether its manufacturing standards are up to international standards. Tuesday's warnings by the U.S. Food and Drug Administration about two of **Ranbaxy Laboratories** Ltd.'s Indian facilities will add to those concerns, especially after China suffered a serious blow over the deaths earlier this year in the U.S. of patients taking contaminated heparin, a blood thinner, that was produced in that country.

"With the backdrop of China, this increases scrutiny of India and of foreign suppliers," said Nitin Agarwal, an analyst at IDFC-SKKI Securities, though he added that the problems at Ranbaxy "are isolated cases and no other company has come into the limelight."

The FDA said it had found problems in manufacturing processes at two Ranbaxy plants in India. "Because of the extent and nature of the violations," the FDA said, it was banning the U.S. sale of medicines made using ingredients from the two facilities.

It is the second time in less than three years that the FDA has issued warning letters to Ranbaxy. In 2006, the agency cited Ranbaxy for violations of manufacturing processes at one of the two facilities named in Tuesday's action. Ranbaxy is also under investigation by the U.S. Justice Department into allegations it manufactured substandard generic drugs, including AIDS medicines given to thousands of patients in Africa.

Ranbaxy said Wednesday that it was "very disappointed in the action the FDA has taken." The company, which derived 23% of its $1.62 billion in world-wide sales last year from the U.S., said it had responded during the investigation to every concern raised by the FDA and "had thought that progress was being made." Ranbaxy also has denied the allegations that it produced substandard AIDS medicines. The company's shares fell 6.6% to 379.10 rupees on the Bombay Stock Exchange.

The Ranbaxy warnings also come on the heels of a public rebuke to India from the chief of a 40-year-old World Health Organization program that aims to monitor the safety of marketed medicines through reports filed by national governments. India has failed to report a single adverse reaction to a marketed medicine in the WHO database since 2006, according to Sten Olsson, chief of the Uppsala Monitoring Center in Sweden, which collects the data for the WHO.

"India is in a special case because of a lack of commitment to patient safety," said Mr. Olsson in an interview. India's recent record was first reported by Mint, a New Delhi-based newspaper that has a content-sharing agreement with The Wall Street Journal.

Mr. Olsson said that in the WHO's monitoring system, even China's record of reporting on drug safety far surpasses India's. Between 5% and 10% of all patient admissions to hospitals world-wide are caused by bad reactions to medicines, he says. China reported 1.2 million adverse drug reactions during the past five years. India has reported 2,500 in the past decade—and none in the past three years, Mr. Olsson said.

India's deputy drugs controller, A.B. Ramteke, whose office oversees drug safety, said the country is deeply committed to drug safety, but acknowledged that no reports of adverse drug reactions had been made in recent years. He said his office collected the data but lacked the computer software to file the reports, and the Uppsala center hadn't provided it.

India is considering new regulations to allow foreign pharmaceutical companies to run more clinical trials in the country. The change would permit foreign firms to conduct the earliest stage of human testing of new chemical entities in India. Currently, they can only conduct later-stage testing; only Indian firms are allowed to perform first-stage human testing of new medicines. If those limitations are lifted, the clinical-trials industry in India is expected to expand. The change requires a vote of the national Drug Technical Advisory Board. That vote hadn't yet been scheduled.

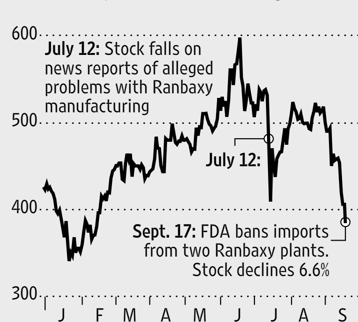
But some analysts fear that with concerns mounting about the safety of the drug industry as a whole, the government could impose a restrictive regime that stifles drug trials rather than nurtures them. "If the regulations become too strict, and there's a hue and cry and a backlash, it would seriously hurt the industry's growth," said Mr. Agarwal of IDFC-SKKI Securities.

Mr. Ramteke said his office was planning to improve clinical-trial monitoring by fingerprinting patients. He says India might also mandate the videotaping of participants giving their consent to enroll and being advised of the risks of the experimental medicines.

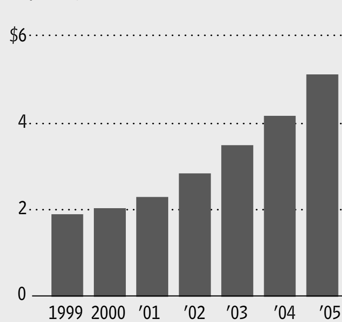
—Tariq Engineer contributed to this article.

India's pharma

Ranbaxy performance, year-to-date. Wednesday's close: **379.10 rupees**



Total value of India's pharmaceutical exports, in billions of dollars



Source: Thomson Reuters Datastream (share price); World Trade Atlas (exports)

ArcelorMittal to reduce steel output, curb costs

By Kris Maher And Tim Aeppel

ArcelorMittal, the world's largest steelmaker by output, is ready to cut production by 15% or more in response to weaker demand.

The Luxembourg-based steelmaker also unveiled a plan to cut $4 billion in costs in the next five years, through productivity improvements and by curbing energy consumption, which also suggests the company expects growth to slow.

Steelmakers and producers of raw materials such as iron ore and copper face growing headwinds in the global economy. Slowdowns were already under way in the U.S., Europe and Japan before the recent financial turmoil on Wall Street, which has clouded growth prospects further as companies worldwide hunker down. Oil and commodity prices have slipped, which, in turn, could slow investments in infrastructure projects and industrial investments that gobble up steel.

Curbing output in part would be aimed at keeping steel prices firm. Steel has been one of the few metals whose price stayed near historical highs as prices of other metals fluctuated and, more recently, trended downward. ArcelorMittal recently announced price cuts in South Africa of as much as 8% across all its steel products as a result of lower international prices, the first such cut by the company in a year.

ArcelorMittal said it has cut steel output by 15% to 20% in Ukraine and Kazakhstan and hasn't decided what cuts to make in Europe and the U.S., where demand has fallen by far more than in emerging markets. "We believe this is temporary," said Aditya Mittal, the company's chief financial officer. Mr. Mittal said the cutbacks will occur during the fourth quarter, and that he expects to "normalize production levels" at the beginning of 2009.

The cutbacks began in Kazakhstan and Ukraine, Mr. Mittal said, because operations there are heavily focused on exporting steel to other markets. ArcelorMittal exports 90% of the steel it makes in Kazakhstan and 50% of its output from Ukraine. "The first thing you do when you do a production cut is try to reduce the level of exports," Mr. Mittal said.

The company said it expects to see global demand for steel grow 5% this year, with that growth edging down only slightly next year, to 4% or 4.5%. Other steelmakers don't appear to be following suit. German steelmaker **ThyssenKrupp** AG expects stable steel output. A **U.S. Steel** Corp. spokesman said, "We keep our supply in line with our customers' demand."

"Controlling production is probably a wise move," said John Anton, a steel analyst at research firm Global Insight. He said a broad 15% cut might not be needed to bolster prices, because steel consumption in developing countries, including China, which uses more steel than the U.S., Europe and Japan combined, will continue to grow next year.

The problem for steel producers is that some markets are slowing more rapidly than others, which can push steel prices toward a free fall as producers begin shipping more of their product across borders to other relatively stronger markets and cutting prices to snare buyers. Raw-material prices also remain high relative to historical levels, which makes it all the more crucial to cut output if prices are weakening.

Mr. Mittal said the company had expected that the credit crisis might prompt customers to cancel orders. "We were prepared to extend credit, but none of our customers availed themselves of it," he said. "So, from a customer point of view, we do not feel a credit crunch."

Samsung mulls its next step after SanDisk rejects offer

By Evan Ramstad

SEOUL—**Samsung Electronics** Co., facing rejection by **SanDisk** Corp.'s board of a $5.8 billion cash buyout offer, must now decide whether—and how—to persuade the U.S. company to reconsider.

Samsung could pursue further talks with SanDisk executives, appeal to its major investors, launch a hostile tender offer or walk away. Wednesday, a Samsung spokesman said the company had made no decisions but was willing to continue talks with SanDisk.

Earlier in the day, Samsung made public a takeover bid that placed a huge premium on SanDisk shares. Shortly after the announcement, SanDisk publicly rejected the offer, saying it "undervalues" SanDisk and was an "opportunistic attempt" to take advantage of the company's depressed stock price.

The offer marks the first time Samsung, one of the world's largest electronics makers, has attempted a major acquisition. It bought a U.S. personal-computer maker in 1995 for about $380 million and, last year, a small Israeli chip-design firm for $70 million.

Otherwise, the South Korean company has relied on organic growth to become a sprawling giant that leads the world in the production of TVs, memory chips and flat-panel screens. It also is the world's second-largest producer of cellphones after **Nokia** Corp.

But sales growth is leveling off in memory chips, Samsung's largest business. Profits in the memory-chip business are cyclical, and they have been climbing to lower peaks after each downturn, creating long-term pressure.

Samsung executives believe that SanDisk, a Milpitas, Calif.-based maker of consumer products such as flash-storage cards, can expand its profitability by reaching into the goods that use memory chips. In addition, SanDisk holds patents on flash-memory technology for which Samsung pays several hundred million dollars in annual royalties.

In its offer letter, Samsung said the takeover would solve some challenges that are facing SanDisk, including how to pay for expensive new factories.

—SungHa Park in Seoul and Don Clark in San Francisco contributed to this article.

Telenor drops Altimo from U.S. suit

By Gustav Sandstrom

Altimo, the telecommunications arm of Russian conglomerate **Alfa Group**, said Wednesday that Norway's **Telenor** ASA dropped a lawsuit it filed against Altimo and affiliate Eco Telecom in U.S. District Court in New York.

The announcement marks the latest move in a long-running dispute between Alfa Group and Telenor. Altimo accuses Telenor of holding up the expansion of OAO **Vimpel Communications**, a Russia-based mobile operator, into the Ukrainian market. Altimo and Telenor are the largest shareholders in VimpelCom, with stakes of 44% and 29.9%, respectively.

Telenor calls the argument an attempt by Alfa Group, Altimo's parent company, to exert pressure on Telenor over shared Ukrainian mobile operator **Kyivstar**.

Telenor Vice President Pal Kvalheim confirmed his company has dropped Altimo and Eco Telecom from its claim against **Farimex Products** Inc.

The lawsuit alleged that a suit brought by Farimex—also a VimpelCom shareholder—accusing Telenor, Eco Telecom and Altimo of blocking VimpelCom's attempt to buy Ukrainian Radiosystems, had been initiated in collusion with Altimo.

That claim was partly based on "various erroneous press reports" that said Farimex's director is affiliated with Alfa Group, Altimo said.

However, Telenor's Mr. Kvalheim said the Norwegian company will "pursue its claims against Altimo and Eco Telecom relating to the Farimex case in other forums," including continuing arbitration proceedings in Geneva. It also said that it will continue to pursue its claims against Farimex in New York.

Altimo welcomed Telenor's decision to drop the case, and said "strategic cooperation between Altimo and Telenor is the most beneficial approach."

CORPORATE NEWS

Former executive at handbag firm pleads guilty

By Teri Agins

A former chief financial officer of Tommy Hilfiger Group's handbag licensee pleaded guilty to fraud charges in the theft of more than $19 million over a seven-year period.

The U.S. attorney for the Southern District of New York said Tuesday that Martin S. Bodner, former finance chief of **Tommy Hilfiger Handbags & Small Leather Goods** Inc., an independently owned licensee of Tommy Hilfiger Group, pleaded guilty to mail fraud and wire fraud charges. According to court papers, the theft occurred while Mr. Bodner was employed by the handbag licensee from the middle of 2000 to the end of December 2007.

Mr. Bodner, 60 years old, agreed to repay the licensee an amount no less than $19.6 million minus the $2.5 million Mr. Bodner has already returned to the company. He also agreed to forfeit a home in Sands Point, N.Y., a Manhattan apartment, three cars and various other property. Mr. Bodner is scheduled to be sentenced on Nov. 5. The sentencing guidelines in the plea agreement said a prison sentence within "the range of 63 to 78 months is reasonable." The court may also impose a fine ranging from $12,500 to $125,000, the plea agreement says.

Mr. Bodner's attorney, Matthew Menchel had no comment. Ludo Onnink, chief financial officer of Tommy Hilfiger Group, said in an email message that Tommy Hilfiger Handbags & Small Leather Goods—which changed its name from Dickson North America in 2000—has been a licensee to Hilfiger Group for nine years. "We are not involved in the fraud of this guy and have no ownership or interest in Tommy Hilfiger Handbags & Small Leather Goods," Mr. Onnink said.

Mr. Bodner was arrested in connection with the fraud on Dec. 21, 2007, by the Federal Bureau of Investigation. According to court papers, Mr. Bodner supervised the handbag licensee's payroll, which gave him control over the amounts the company paid to its employees through a third-party payroll service.

Court documents state that Mr. Bodner began stealing money from the licensee by secretly increasing his salary and bonus as well as getting reimbursed for phony business expenses. Court papers state Mr. Bodner directed the firm's payroll service to increase his compensation by $14,712,000 during his six-and-a-half-year tenure.

Mr. Bodner also put one of his sons on the payroll during 2004 and 2005, with a salary of $225,500, "when in truth and in fact [Mr.] Bodner's son did not work," for the licensee, according to court papers.

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GLOBAL BUSINESS BRIEFS

Monsanto Co.

Profit forecast is increased amid global grain boom

Biotechnology seed company **Monsanto** Co. said profit from its corn-seed business this year will exceed $2 billion for the first time, a reflection of the company's ability to cash in on the global grain boom. Monsanto, based in St. Louis, raised its 2008 outlook for earnings excluding items to between $3.58 and $3.60 a share, compared with its previously announced $3.37. This is the sixth time this year that Monsanto has raised its earnings forecast. "The fundamentals of agriculture and our businesses are strong and getting stronger," Monsanto Chief Financial Officer Terry Crews told investors Tuesday.

Woolworths PLC

U.K. retailer **Woolworths** PLC reported a record first-half loss as sales dipped. Its net loss for the 26 weeks ended Aug. 4 widened to £68 million ($121.3 million) from a £44.2 million loss a year earlier. Revenue fell to £1.11 billion from £1.14 billion, while sales at Woolworth stores open more than a year dropped 3.2%. Chairman Richard North said Woolworth's entertainment units, 2 Entertain and EUK, are performing ahead of expectations. However, Mr. North and Chief Executive Steve Johnson, who took the post Sep. 1, told reporters Wednesday that deteriorating conditions in the credit-insurance market are likely to increase Woolworths' working-capital requirements.

BHP Billiton Ltd.

BHP Billiton Ltd. boosted the size of the ore reserves at its giant Olympic Dam copper, gold and uranium mine in South Australia state by 18.5% as it continues drilling work ahead of a planned expansion. In its annual report to U.S. investors, BHP said total ore reserves at the mine in South Australia are 473 million metric tons, up from 399 million tons at the same time last year. The copper grade of the total reserves has dropped slightly, to 1.86% from 1.87% a year ago, but the uranium grade has risen slightly to 0.6 kilogram a metric ton, from 0.58 kilogram.

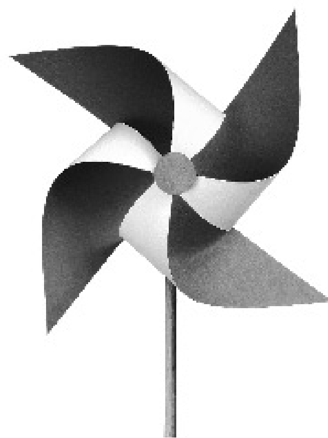
Philip Morris International Inc.

Philip Morris International Inc.'s planned 2 billion Canadian dollar (US$1.87 billion) acquisition of **Rothmans** Inc. moved closer to completion as more than two-thirds of shares outstanding have been tendered in favor of the deal. Rothmans, Canada's second-largest tobacco company, agreed to the takeover in late July, marking Philip Morris International's first move since spinning off from **Altria Group** Inc. earlier this year. Rothmans's sole holding is a 60% stake in Benson & Hedges. Philip Morris owns the other 40%. As of the deadline Wednesday, approximately 68% of shares were tendered in favor of the takeover, exceeding the two-thirds threshold needed, Philip Morris said.

Olympic Airlines

The European Commission approved a plan to restructure deficit-ridden **Olympic Airlines** as part of a long-awaited plan to privatize the state-owned airline. Under the plan, a new company—currently named Pantheon Airlines—would absorb 65% of Olympic Airlines' assets. Pantheon would adopt the Olympic Airlines name and logo and then, early next year, be sold to private investors. Other assets will be sold off, while the government is expected to foot the bill for a reported €1 billion ($1.41 billion) voluntary-retirement program to reduce the airline's current 8,000-strong work force by two-thirds.

—Compiled from staff and wire service reports.



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ECONOMY & POLITICS

EUROPEAN UNION

Countries vote against extending tariffs on shoes

EUROPEAN Union countries voted against extending antidumping tariffs on imports of Chinese and Vietnamese shoes.

The European Commission must make a decision before Oct. 7 on whether to extend the tariffs. The commission still has the power to extend them, but that would anger the 15 countries that voted against the tariffs, especially Germany. EU countries are increasingly worried about inflation, and antidumping tariffs drive up prices.

Italy and other southern European countries have been lobbying for the duties to protect their shrinking shoe industries. *—John Miller*

GERMANY

Poll gives 13% advantage to Merkel's conservatives

GERMAN Chancellor Angela Merkel's conservatives kept a large lead over their center-left rivals after they nominated the foreign minister to challenge her in next year's election, according to a new poll.

The center-left Social Democrats chose Foreign Minister Frank-Walter Steinmeier as their candidate for the chancellery Sept. 7, but a poll conducted Sept. 8-12 by the Forsa agency found Ms. Merkel's conservative bloc had support of 38% of respondents, versus 25% for the Social Democrats, its partner in an uneasy "grand coalition" of Germany's biggest parties that both hope to end after the election scheduled for Sept. 27, 2009. *—Associated Press*

U.S.

Falling home construction suggests slow stabilization

A STEEP DECLINE in U.S. new-home construction last month to a 17-year low suggests that the hoped-for stabilization of the housing market—key to boosting the U.S. economy—is still a ways off.

Construction of new homes dropped by 6.2% in August to a seasonally adjusted 895,000 annual rate, the Commerce Department said. Construction of multifamily units fell sharply. Single-family home construction fell by a smaller amount but remained low.

Newly issued building permits also declined, suggesting construction could fall further. The latest data, combined with gloomy sentiment among home builders, suggest conditions could worsen.

Bomb rocks Yemen U.S. Embassy

Blast fails to lance compound, kills 16; second 2008 attack

By MARGARET COKER
Abu Dhabi

MILITANTS DETONATED a car bomb outside the U.S. Embassy in Yemen and launched what appeared to be coordinated follow-on attacks Wednesday, killing 16 but failing to penetrate the American compound.

In the assault on Sana'a, Yemen's U.S. embassy, pictured above in the aftermath, Arab TV said some attackers were dressed in **Yemeni police uniforms**.

The morning assault marked the second attack this year against the U.S. Embassy in Sana'a, the Yemeni capital, and raised fresh questions about claims by the Yemeni government that it is capable of stamping out al Qaeda-influenced militants on its own turf.

The Yemeni state-run news agency reported the dead included six attackers, six Yemeni security guards and four civilians, including an Indian national visiting on business. The U.S. Embassy couldn't confirm those figures but said its American staff was safe.

Yemen's government has sought to stamp out militants and declared itself a U.S. ally in the war on terrorism. The U.S. has recently praised Yemen for some of its counterterrorism operations, but has also called for more measures to deny international terrorists safe haven. Islamic militants still operate with considerable freedom in the impoverished country, where much of the mountainous countryside is lawless.

In a statement, the embassy gave few details about the incident, other than to say "armed terrorists" had assaulted the compound.

In Washington, State Department spokesman Sean McCormack said, "After talking to the security personnel, the attack bears all the hallmarks of an al Qaeda attack where you have multiple vehicle-borne devices, along with personnel on foot." But no conclusions had been made on who was to blame.

Yemeni officials couldn't be reached for comment Wednesday.

Arab news agencies reported that a group called Islamic Jihad in Yemen claimed responsibility for the attack, but that couldn't be independently confirmed. The impoverished country is the ancestral home of Osama bin Laden and is seen by many as a fertile ground for militancy.

Al Qaeda claimed responsibility for the USS Cole bombing in 2000, at the Yemeni port of Aden, that killed 17 American sailors. In March, unknown militants fired mortars at the U.S. Embassy in Sana'a. A guard at a nearby school died and more than a dozen school girls were wounded.

Details of the attack, which coincided with the start of the workday, were sketchy. Yemen's state news agency SABA reported that guards stopped two cars outside the embassy's main gate just after 9 a.m. One car detonated at the security barrier, according to the agency.

The Associated Press said militants fired rocket-propelled grenades and automatic weapons at the gate.

EU leaders doubt Ireland will ratify treaty

By CHARLES FORELLE

BRUSSELS—European leaders are increasingly pessimistic that Ireland will ratify a key European Union treaty before next spring, potentially delaying the appointment of new commissioners to run the bloc's executive body and other projects.

The dour mood was expressed Wednesday by Luxembourg's prime minister, Jean-Claude Juncker, who is among the most gung-ho of the 27-nation EU's pro-integration politicians. He told an economic conference here the treaty would likely come into effect no sooner than January 2010, a year later than originally expected.

Plans to have the Treaty of Lisbon in place at the start of next year were dashed in June when Irish voters rejected it in a referendum, 53% to 47%. The treaty was already a watered-down version of the EU's first attempt at a draft constitution, which was rejected by French and Dutch voters in 2005.

Proponents argue the treaty, which would create an EU president and diplomatic service, is needed to make the bloc a more-effective global player. They also warn that without it, projects such as the EU's further expansion would be hampered, in part because the treaty resolves issues such as how many top posts there should be in the European Commission as the bloc includes more countries.

Jean-Claude Juncker

Only Ireland put the treaty to a referendum, because of a constitutional requirement. After the treaty's rejection, other countries pressed Dublin to run the vote again quickly, so the treaty would come into force by next spring. Irish officials, however, have since pushed back, saying the country and the EU couldn't bear the risk of a second "No" vote, people familiar with the matter say.

"If I were the Irish prime minister, I wouldn't hold another referendum right now," said Mr. Juncker.

Ireland's prime minister, Brian Cowen, is due to brief fellow EU leaders at a meeting next month, but Irish officials say he won't present concrete plans.

A second vote so soon after the first is politically perilous, analysts say, because another "No" could seriously damage the EU's hope for closer integration and provide an opening for euro-skeptic countries like the U.K. to press for a loosening of the union. "The EU has to be very, very careful in how it plays this," said Philip Whyte, a research fellow at the Centre for European Reform, a London think tank.

The delay leaves uncertain the future composition of the European Commission, which runs Europe's antitrust, trade and other vital policies.

—Adam Cohen and Carolyn Henson contributed to this article.

U.S. censure of Bolivia raises heat on Morales

By JOHN LYONS

SANTA CRUZ, Bolivia—Days after President Evo Morales expelled the U.S. ambassador to Bolivia, Washington has added the country to its list of nations failing to fight illegal narcotics, a decision that could have economic consequences for the natural-gas-rich nation.

The move could embolden U.S. lawmakers who oppose the renewal of Bolivia's trade preferences, which are due to expire in the coming months. Such an economic blow would add to Mr. Morales's problems. Mr. Morales is battling provincial governors who have declared autonomy in the nation's gas-rich farmlands. They accuse Mr. Morales of trying to impose a Cuba-styled regime by nationalizing industries and pushing a new constitution that redefines property, centralizes power and grants rights based on ethnicity.

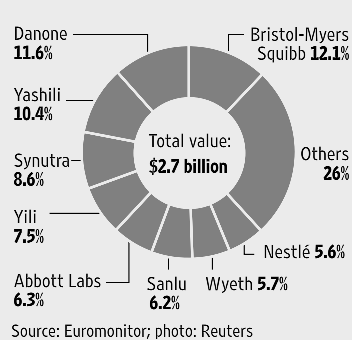
Late Tuesday, Mr. Morales and the governors agreed on a road map to end a weeklong crisis in the country, Reuters reported. The governors pledged to end occupations of government buildings, after a wave of violent protests left 17 dead last week, and Mr. Morales said he would discuss their demands for more autonomy and a greater share of state energy revenue.

Mr. Morales and his chief ally, Venezuelan President Hugo Chávez, blame the U.S. for Bolivia's troubles. Last week, Venezuela and Bolivia expelled their U.S. ambassadors, accusing Washington of orchestrating Bolivia's political opposition, a charge the U.S. denies.

The U.S. and Bolivia, a major cocaine producer, have clashed over drugs. The U.S. ambassador was expelled as he was questioning the Morales government about threats made to U.S. Drug Enforcement Administration officials in Bolivia, the U.S. State Department said. The populist Bolivian president leads a union of growers of coca leaves, the raw material in cocaine. Bolivia joins Venezuela and Myanmar on the U.S. list of countries not fulfilling obligations to stem drug trafficking.

Baby milk

China's milk formula market share by retail value, in 2007



Source: Euromonitor; photo: Reuters

A child receives a **medical check** for possible kidney stones at a hospital in Suining

Disclosure failure alleged

Formula company, Chinese officials knew about toxin

By Gordon Fairclough And Loretta Chao

SHIJIAZHUANG, China—A Chinese manufacturer and local-government officials failed to disclose the discovery that a popular baby formula contained a toxic chemical even while the maker was recalling the product, the company's foreign partner and some domestic distributors said Wednesday.

There is also mounting evidence that the kind of contamination that China's government says has already killed three infants and sickened more than 6,244, including 158 with acute kidney failure, is widespread in China's dairy industry, with unscrupulous suppliers adulterating ingredients to boost profits.

The lag between **Shijiazhuang Sanlu Group** Co.'s realization that its baby formula was tainted and the public announcement of a recall last week has drawn increasingly angry criticism from Chinese parents and others. On Wednesday, **Fonterra Cooperative Group** Ltd., a New Zealand dairy company that owns 43% of Sanlu, said the Chinese company told local health authorities in early August that Sanlu had discovered melamine, a poisonous chemical used to make plastics and fertilizer, in its baby formula.

Fonterra that instead of warning consumers, Sanlu and the local government in Sanlu's headquarters city here in northern China decided to quietly remove the toxic formula from stores. "We encouraged Sanlu, we encouraged the authorities, to go public," said Andrew Ferrier, Fonterra's chief executive. "They made their own judgment."

Authorities said this week that tests in recent days found melamine in baby formula from 22 Chinese manufacturers, including some of the country's biggest dairy companies. On Tuesday, a Hong Kong supermarket chain pulled a mainland Chinese brand of yogurt popsicles from its shelves, saying they had tested positive for melamine.

"It's not just a problem with Sanlu now. So many companies have been involved," said Sherry Meng, mother of a 5-year-old boy. "As a consumer and a mom, I feel really angry, and concerned. It makes it hard to believe in any dairy products produced by China."

Some critics in China have suggested on the Internet that a desire to avoid bad news around the Beijing Olympics may have prompted Sanlu to maintain its public silence in August. While there is no evidence of that, Chinese companies were under strict orders at the time not to be the source of bad news that could disrupt the Games, and Chinese reporters were told not to report negative news.

Sanlu executives have issued an apology but haven't responded to repeated requests for comment.

Some Sanlu distributors said the company asked them to recall baby formula in early August but didn't say the product could be unsafe. Yu Qingyang, a Sanlu distributor in the southern province of Guizhou, said that Sanlu said it was taking back the formula because it "planned to change the packaging."

China's central government said it became aware of the problem only last week. Authorities have since announced a well-publicized recall, arrested several suppliers and sacked several local officials, including the head of a local food-and-drug agency. On Wednesday they detained for questioning Sanlu's former chairwoman, who was fired this week.

Two of the companies whose products contained melamine have sold infant formula in Bangladesh, Burundi, Gabon, Myanmar and Yemen, according to the authorities. It isn't clear whether any of the exported formula was contaminated. Sanlu milk powder exported to Taiwan has been recalled there.

The magnitude of China's adulteration problem underscores the risks in the country's often-diffuse and poorly regulated supply chains for foods, pharmaceuticals and other products. China has struggled to tighten oversight after a series of high-profile safety lapses—including pet food contaminated with melamine and toothpaste tainted with a chemical used in antifreeze. Adulterated supplies of the anticlotting drug heparin from China were linked this year to more than 80 deaths in the U.S.

Many companies doing business in China strictly supervise suppliers to ensure their materials are safe. **Bristol-Myers Squibb** Co.'s Mead Johnson baby-formula unit said it imports all the milk it uses to manufacture formula at its plant in southern China because it considers the local supply chain too unsafe to use. **Groupe Danone** SA's International Nutrition Co. unit also says it uses only imported milk for the baby formula it makes in China. **Nestlé** SA said it buys milk from local farmers who are supervised daily by its own agricultural officers.

Sanlu buys milk from many sources, including milk traders who buy raw milk from small farmers and mix it together before reselling it. Police have arrested three milk dealers, including two brothers who live in Sanlu's hometown. The pair began putting melamine in their milk last year to pass Sanlu's quality tests, according to China's official news agency, citing a police spokesman. Melamine can make milk appear to contain more protein than is present.

Agriculture experts say the way Chinese dairy farmers raise cows can result in protein-deficient milk. Some government officials have also surmised that dealers have been diluting their milk to maximize profits and using melamine to mask their actions.

Milk production has grown rapidly as farmers in recent years rushed to raise dairy cows, outstripping demand. As a result, many dairy farmers are struggling. Fu Guofang, a 48-year-old dairy farmer in Zhejiang province, said he sold about half his heard last year when milk prices dipped. "It is true milk farmers add water to raw milk when the purchasing price is too low," said Mr. Fu. But he said he doesn't think farmers know enough to add chemicals to the milk.

Sanlu began investigating reports of illnesses among children drinking its formula as early as March, according to Fonterra. Fonterra's CEO, Mr. Ferrier, said repeated lab tests over the following months failed to find any problems, until shortly before a Sanlu board meeting Aug. 2, when the company discovered melamine in the formula. Sanlu promptly informed its directors, including three Fonterra representatives. Mr. Ferrier said Fonterra urged an immediate public recall.

But local authorities said they "were not in a position" to make a public announcement, Mr. Ferrier said. "They were very clear about how they wanted to proceed." The company started its low-profile recall on Aug. 6, two days before the Olympics' opening ceremony.

Fonterra has been fiercely criticized for not going public. Mr. Ferrier said that after some "soul searching," it initially decided not to make a public statement on its own. When weeks went by with no public comment from the Chinese authorities, Fonterra reported the situation to the New Zealand government. New Zealand Prime Minister Helen Clark was informed, and she ordered her ambassador in Beijing to notify authorities there. The ambassador did so on Sept. 9, said Ms. Clark's spokeswoman.

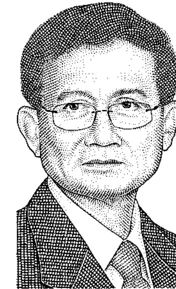
China's central government said it was informed of the problem by provincial authorities on Sept. 8 and quickly responded.

—Bai Lin in Shanghai and Kersten Zhang, Gao Sen, and Sue Feng in Beijing contributed to this article.

Thaksin brother-in-law set as Thailand premier

By James Hookway

BANGKOK—Thailand appears set for a prolonged political face-off between supporters and opponents of former leader Thaksin Shinawatra after lawmakers elected his brother-in-law as the country's new prime minister.



Somchai Wongsawat

Prime Minister Somchai Wongsawat appealed for unity shortly after the vote at Parliament made him Thailand's new premier on Wednesday. "It is now the time for Thailand to unite, to reconcile and solve the conflict," said Mr. Somchai, a 61-year-old career bureaucrat.

But Mr. Somchai's election—which still needs formal approval by Thailand's king—has done little to appease the thousands of antigovernment demonstrators who have occupied Government House, the country's main administrative complex, for more than three weeks, forcing the cabinet to meet at an airport terminal in northern Bangkok.

The protesters are demanding the dismantling of the country's one-man, one-vote democratic system, which they contend has been manipulated by populist politicians, notably Mr. Thaksin. They say the populists have undermined the traditional authority of Thailand's ruling elites, including the armed forces, the civil service, and its 81-year-old monarch, King Bhumibol Adulyadej.

The opposition's leaders argue that Mr. Thaksin—now in self-exile in Britain after being overthrown by a military coup in 2006—is still running the government from behind the scenes. Mr. Thaksin has denied such allegations.

On Wednesday, protest leaders slammed the election of Mr. Somchai as a means to prolong Mr. Thaksin's influence. Mr. Thaksin, a telecommunications tycoon, transformed Thailand's political scene when he became prime minister in 2001. He won a series of elections, using a populist platform to win over Thailand's poorer rural voters.

"Mr. Thaksin needs someone he can control," a protest leader, Somsak Kosaisuk, told demonstrators at Government House. He and other protest leaders vowed to continue the sit-in until "the remnants of Mr. Thaksin's regime are gone."

At first glance, Mr. Somchai has many of the establishment attributes valued by the protesters. Before getting elected to Parliament for the People Power Party and becoming education minister under Mr. Samak, he served 20 years as a judge. But political analysts say his family ties to Mr. Thaksin—he is married to Mr. Thaksin's sister—make him a target for the demonstrators, who call themselves the People's Alliance for Democracy.

Mr. Somchai said his priorities as prime minister include dealing with floods affecting Thailand and shoring up the economy against disturbances in the U.S. financial sector.

U.S. moves to ease tension on border raids into Pakistan

By Zahid Hussain

ISLAMABAD, Pakistan—America's top military commander said the U.S. will respect Pakistan's territorial sovereignty, an assurance intended to defuse tensions between the two allies following a cross-border Special Forces raid and repeated missile strikes from pilotless aircraft.

Mike Mullen

A senior Pakistani official said as a result of high-level talks with Adm. Mike Mullen, chairman of the U.S. joint chiefs of staff, Pakistan didn't expect any more U.S. cross-border commando raids from Afghanistan and expected to be informed about drone attacks in advance, even by just a few minutes.

"There will be more coordination now between Pakistan and the U.S.," the official said.

The official said the U.S. had informed Pakistan before drones fired four missiles at what the official said was a suspected Taliban ammunition depot in the border region of South Waziristan Wednesday. The strike killed five people, including some civilians, according to a Pakistani security official.

A spokesman from the U.S. embassy in Islamabad couldn't be reached to comment.

Earlier, the embassy released a statement that said: "Adm. Mullen reiterated the U.S. commitment to respect Pakistan's sovereignty and to develop further U.S.-Pakistani cooperation and coordination on these critical issues that challenge the security and well-being of the people of both countries."

Adm. Mullen met separately with Pakistan's army chief, Gen. Ashfaq Kayani, and Prime Minister Yousuf Raza Gilani for what the embassy statement called "extremely frank, positive and constructive discussions."

On the eve of Adm. Mullen's visit, Pakistan's military said its soldiers had orders to fire at any American troops raiding across the border. The military has said repeatedly it will defend Pakistan's sovereignty at all cost.

U.S. officials have complained that Pakistan has been unable to prevent the Taliban and other militant groups from recruiting and training in the tribal areas near the border and carrying out attacks on U.S.-led coalition forces in Afghanistan. Pakistan maintains that U.S. attacks that result in civilian casualties have strengthened support for the militants.

Pakistani troops backed by jet fighters continued targeting militant positions Wednesday outside Khar, the main town in the Bajur tribal area, killing at least 10 insurgents and wounding 13 others.

Energy royalties probed

Auditors question whether U.S. agency is collecting enough

By Stephen Power

WASHINGTON—Congressional auditors are questioning whether the Interior Department is collecting all the royalties energy companies owe for petroleum developed on federal property. The auditors' findings expand on concerns raised last week by a sex and drugs scandal at the department's agency in charge of managing offshore oil and natural-gas exploration.

How well the federal government manages its energy resources has taken on new importance as Congress debates proposals to expand offshore drilling.

The Government Accountability Office raised questions in audits released during the past week about the Interior Department's management of royalties. The GAO audits come on the heels of reports Wednesday by the Interior Department's inspector general alleging that some employees of the Minerals Management Service broke government rules and created a "culture of ethical failure" by accepting gifts from and having sex with representatives of the oil and gas industry, abusing alcohol at industry-sponsored functions and using drugs.

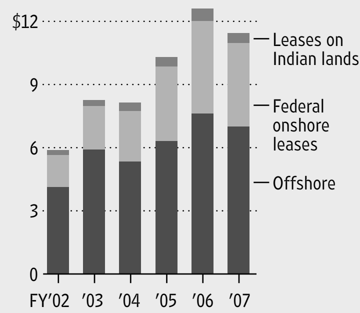
Taken together, the critical reports are giving more ammunition to lawmakers and outside critics who want to make the royalty-collection process more independent from industry influence.

A GAO audit published Friday found neither the MMS nor the Bureau of Land Management, which administers onshore-drilling leases, is meeting targets for inspecting leases and metering equipment used to measure oil and gas production, "raising uncertainty about the accuracy of oil and gas measurement."

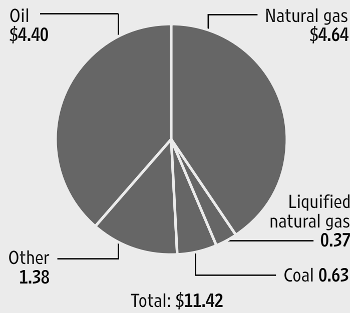
Revenue stream

Revenues from royalties collected by the U.S. Minerals Management Service for energy leases

By location, in billions



By source, FY2007, in billions



Note: Fiscal year ends Sept. 30

Source: U.S. Minerals Management Service

In 2007, the GAO said, MMS officials completed about half of the required 2,700 inspections of the meters in the Gulf of Mexico that measure production to determine royalty payments. MMS policy calls for annual inspection of all oil- and gas-royalty meters.

Interior officials say they are already moving to implement some of the GAO's recommendations for improving the MMS's royalty-collection process. The department has recently developed a "risk-based analysis tool" to help the agency of 1,700 people focus on companies and properties with the greatest risk of under-reporting production and royalties due to the federal government.

"The Interior Department has been responsive to recommendations made by various oversight groups," the department said in a written statement responding to the GAO report. Last year, the MMS collected more than $11.4 billion in oil, natural-gas and other mineral royalties, according to the Interior Department.

Congress this week is debating proposals to allow more offshore oil drilling. On Thursday, a congressional hearing is scheduled on federal oil- and gas-royalty collection.

The Interior Department said there will be "appropriate disciplinary actions" against individuals at the MMS who engaged in misconduct. The MMS also might implement a random drug-testing program. But continued bad publicity involving the MMS has given more ammunition to lawmakers who want broader organizational and policy changes at the bureau.

Late Monday, the Justice Department said a former senior MMS official pleaded guilty to violating post-government employment restrictions, becoming the second Interior official in as many months to plead guilty to a felony, prosecutors said.

Offshore-drilling bill clears House

By Siobhan Hughes, Stephen Power And Corey Boles

WASHINGTON—A Democratic bill to allow more oil drilling off the U.S. coasts passed the House of Representatives, but it faces an uncertain future in the Senate and a fresh veto threat from President George W. Bush.

The debate over whether to lift a 27-year-old moratorium on new offshore oil wells along the Atlantic and Pacific coasts, and certain areas of the Gulf of Mexico, has become a potent election issue. Jockeying over competing plans to expand domestic oil exploration could continue until the end of Congress's abbreviated pre-election session.

The House late Tuesday passed by a 236-189 vote a bill backed by Speaker Nancy Pelosi (D., Calif.) that would allow drilling in waters 50 miles from the shore along the Pacific and Atlantic coasts as long as coastal states agree—and beyond 100 miles regardless of what states want. The proposal represents a concession by Rep. Pelosi to the political success of Republican calls for more drilling.

But in contrast to proposals backed by Republicans and some moderate Senate Democrats, the bill approved in the House Tuesday wouldn't share any royalties gained from increased offshore oil drilling with coastal states.

Depriving states of a share of royalty revenue would eliminate a critical incentive for them to allow drilling off their coasts, Republicans say.

The White House announced late Tuesday that Mr. Bush's senior advisers would recommend that he veto the House measure, should it reach his desk. The White House cited the royalty issue among its objections.

The Senate appears unlikely to pass a drilling proposal, based on interviews with lawmakers in recent days.

If members of Congress and the White House can't agree on a drilling plan, it could lead to a showdown between Democrats and Republicans over legislation needed to keep the government running past Sept. 30, as the drilling ban is part of the expiring bill that funds the government.

The drilling debate has come down to money, reflecting the federal government's budget squeeze.

Democrats say sharing royalty revenue with states would put pressure on lawmakers to find offsetting budget cuts, because of an opinion issued this month by the Congressional Budget Office that sharing royalties with states would count as an increase in government spending. The bill also calls for eliminating $18 billion in tax breaks for large oil companies.

House Democrats say the oil taxes are needed to pay for extending tax credits for electricity produced from wind and solar energy and to pay for energy-efficiency and conservation programs.

Many Republicans object to the proposal to eliminate oil-industry tax breaks, saying that amounts to a tax increase that will discourage domestic production.

Some environmental groups also criticized the House bill Tuesday, though on different grounds. The groups objected to a provision championed by Rep. Jim Matheson (D., Utah) that would clear the way for energy companies to develop oil-shale operations on federal lands in states that agree to permit such leasing.

Opponents of oil-shale production say it could damage pristine wilderness lands, contaminate or deplete scarce groundwater reserves, and significantly increase greenhouse-gas emissions. Proponents say developing U.S. oil-shale reserves could yield 800 billion barrels of oil, triple the current proven reserves of Saudi Arabia.

Separately, Senate Democrats agreed Tuesday to significantly scale back a tax increase on major U.S. oil and gas producers in order to secure Republican agreement for a package of energy tax incentives. The proposal could clear the way for an extension of tax credits for a range of industries.

—Martin Vaughan and Ian Talley contributed to this article.

Amid U.S. campaigning, abortion issue is lurking

By Amy Chozick

Economic news has dominated the debate between U.S. presidential candidates Sen. Barack Obama and Sen. John McCain this week, but independent groups on both sides are betting that key segments of the electorate will base their decision on abortion.

A string of provocative advertising campaigns have made their debut, paid for by outside groups and focused on both candidates' views on abortion. The targets: undecided women and devout Catholics in key battleground states.

Republican vice presidential nominee Alaska Gov. Sarah Palin, who opposes abortion in most cases including rape and incest, has motivated pro-abortion-rights groups to launch their ads. "Her entry into the race has really shot up the stakes in a big way," says Kelli Conlin, president of the Winning Message Action Fund, the issue-advocacy arm of the National Center for Reproductive Health founded in February 2008.

The group launched an Internet campaign hitting Sen. McCain on abortion in August, and it plans to launch television ads in Ohio, Pennsylvania and other battleground states next month that criticize the Arizona senator and Gov. Palin on their opposition to abortion.

The multimillion-dollar campaign, targeted at Republican and independent women voters in key swing states, implies that if abortion is banned, women will be treated like criminals. The ads show images of prison bars closing on a young woman.

"When it comes to your personal freedoms, John McCain is worse than George W. Bush. Who's worse than John McCain? Sarah Palin," reads one of the new ads.

"The suggestion that John McCain and Sarah Palin want to put women behind bars is absurd," McCain-Palin spokesman Tucker Bounds says in response to the ad.

On Friday, Catholics United plans to unveil a new ad in heavily Catholic areas of Ohio, Michigan and Pennsylvania that urges Sen. McCain to adopt a "broad pro-life agenda" that stretches beyond the abortion issue to include support for more-accessible health care and ending the war in Iraq.

"John McCain, it's not enough to say you're pro-life," the ad says. "You voted for a war that has killed thousands of Americans."

Right-wing groups have their own efforts. Antiabortion group BornAliveTruth.org began airing an ad in New Mexico and Ohio on Tuesday featuring Gianna Jesson, a 31-year-old who survived a failed abortion. "If Barack Obama had his way, I wouldn't be here," Ms. Jesson says.

The Obama campaign rejects the premise of the BornAliveTruth.org ad, pointing out that Sen. Obama has said that had he been a U.S. senator at the time, he would have voted for the Born-Alive Infants Protection Act. The federal law, enacted in 2002, requires a fetus that survives a botched abortion to be considered a person. Sen. Obama opposed a similar law while in the Illinois state senate because he said the state already had a law on the books that would have required doctors to provide medical care in circumstances of failed abortions.

Sens. Obama and McCain have denounced advertisements by outside groups. But as the presidential race heats up, independent groups are upping their efforts to help promote their causes and their candidates.

Still, as of September, outside groups have spent just one-tenth of the $75 million they spent in the same period in the 2004 election cycle, according to the Campaign Media Analysis Group, which monitors political advertising. The ads that have emerged focus largely on specific issues such as abortion.

Last week, Vermont-based political action committee Democracy for America and Brave New PAC launched the first of a series of nationwide ads that question Sen. McCain's temperament and asserts that being a former prisoner of war "is not a good prerequisite for a president of the U.S."

McCain-Palin spokesman Michael Goldfarb has called the ads a "Swift Boat-style" attack, a reference to a controversial 2004 campaign that questioned Massachusetts Sen. John Kerry's military record.

"It's unfortunate that Sen. Obama has fallen so far, from opposing outside expenditures and supporting public financing at the beginning of this race to opting out of public financing and now 'looking the other way' on independent expenditures—no matter how vile," Mr. Goldfarb says.

The Obama campaign maintains that Sen. Obama is against these groups and has come down on Sen. McCain for not discouraging his supporters from donating to some of the same conservative groups that helped create the Swift Boat campaign in 2004.

Associated Press

Sen. **Barack Obama** has said that had he been a U.S. senator at the time, he would have voted for the Born-Alive Infants Protection Act.