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THE WALL STREET JOURNAL.

# As money is pumped in, cash flows out

## Central banks inject dollars to try to ease tensions and fuel lending

By Joellen Perry

FRANKFURT—The U.S. Federal Reserve sharply expanded its efforts to provide dollars to continental European central banks and used new tools to give central banks in the U.K., Canada and Japan access to dollars.

Most notably, the Fed boosted its currency swap lines—through which it gives foreign central banks access to U.S. dollars—by $180 billion, to allow central banks to meet fierce dollar demand from commercial banks outside the U.S.

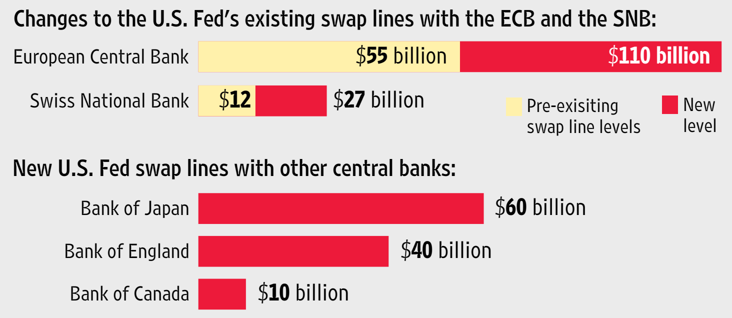
Markets world-wide have been throttled by financial-sector gyrations in recent days, from the collapse of **Lehman Brothers Holdings** Inc. to the crisis at insurer **American International Group** Inc.

One measure of the tensions has been a resurgence in banks' unwillingness to lend to one another, which has prompted central banks to launch massive cash injections, in their own currencies, into money markets. Those injections continued Thursday. But the beefed-up dollar programs are designed to ease the tensions in dollar-denominated funding markets, which have been especially acute.

In a joint statement, the central banks said, "These measures, together with other actions taken in the last few days by individual central banks, are designed to improve the liquidity conditions in global financial markets. The central banks continue to work together closely and will take appropriate steps to address the ongoing pressures."

### Global power boost

The U.S. Federal Reserve expanded currency-swap lines with other central banks so they could meet fierce demand for dollars from commercial banks outside the U.S. In all, the swap lines were increased to $247 billion from $67




Sources: The central banks; WSJ research

Investors continued to worry about the health of the global financial system. But the moves helped turn around sharp drops on Asian stock markets. Hong Kong's benchmark Hang Seng Index ended the day down only slightly after having dropped as much as 7.7% intraday on worries over bank stocks. European stocks fell for the fourth straight day, despite gains for much of the session. The pan-European Dow Jones Stoxx 600 index shed 0.5% to 256.77.

A benchmark reflecting the rates at which banks lend to one another in dollars—the overnight Libor, or London interbank offered rate—fell to 3.843% from 5.031% Wednesday as banks greeted the flood of dollars with relief. On Tuesday morning in Europe, that rate had more than doubled, its sharpest spike on record. But the three-month lending rate rose Thursday, suggesting that fears about banks' longer-term soundness remain.

"Today's coordinated intervention shows that the [central banks] are acting to address market liquidity failure—this is itself reassur-

*Please turn to page 27*

## *Conservative funds see big withdrawals; rates remain high*

By Carrick Mollenkamp, Neil Shah And Aaron O. Patrick

A coordinated effort by the world's central bankers to get banks lending again did little to calm global markets Thursday, indicating that the financial crisis may be moving beyond policy makers' ability to contain it.

The U.S. Federal Reserve, the European Central Bank and other major central banks banded together, flooding markets with $180 billion in hopes of taming a major source of the tensions rocking the financial system. But money flowed out of the markets as fast as the central banks could pump it in, as banks and investors around the world rushed to get their hands on one of the safest assets of all: cash.

In the U.S., shares in respected money-management firms such as **State Street** Corp. and **Genworth Financial** Inc. plunged as investors pulled their cash out of money-market funds, previously considered one of the most conservative investments available. In Russia, officials suspended stock-market trading for the second straight day as the Russian government promised to inject $20 billion to halt a vertiginous fall in share prices. In China, government officials directed purchases of bank shares and encouraged companies to buy their own shares in efforts to prop up a falling market. (Article on page 17.)

For the day in the U.S., stocks did manage to recover some. The Dow Jones Industrial Average rose 410.03 points, or 3.86%, to settle at 11019.69.

Overall, however, "I think this is probably the worst I've seen," says Robert Bishop, a portfolio manager at SCM Advisors in San Francisco, referring to the exodus from money-market funds.

One key problem: Cash isn't getting where it needs to go to keep markets operating and fuel the broader economy. Despite the best efforts of central bankers to provide banks with money, the banks aren't lending it to each other, or to clients and investors who need it. Instead, they are using it to buy super-safe government bonds, or hoarding it amid uncertainty about how much

*Please turn to page 27*

# What's News—

## *Business & Finance*

**The Federal Reserve** sharply expanded its efforts to provide cash to central banks in Europe, Canada and Japan to meet fierce demand for dollars from commercial banks outside the U.S. Meanwhile, central banks launched massive cash injections to improve liquidity amid banks' unwillingness to lend to one another. **Page 1**

■ **The Fed, ECB** and other central banks flooded markets with $180 billion, but the effort did little to calm tensions rocking the financial system. **Page 1**

■ **Russia expanded** to $120 billion the aid package for its struggling financial system, as markets remained closed. **Page 1**

■ **U.S. stocks rocketed** after a whipsaw session, helped by reports of planned government action. In Europe, a rally inspired by central banks' efforts to restore liquidity fizzled. **Pages 18, 22**

■ **The combination** of Lloyds TSB and HBOS may leave consumers with fewer options for mortgages and take a toll on banking-sector jobs. **Page 2**

■ **Morgan Stanley,** seeking answers to its persistent stock-price decline, continues to talk to Wachovia about a possible deal. **Page 3**

**Markets** 4 p.m. ET

| MARKET | CLOSE | NET CHG | PCT CHG |
|---|---|---|---|
| DJIA | 11019.69 | +410.03 | +3.86 |
| Nasdaq | 2199.10 | +100.25 | +4.78 |
| DJ Stoxx 600 | 256.77 | -1.27 | -0.49 |
| FTSE 100 | 4880.0 | -32.4 | -0.66 |
| DAX | 5863.42 | +2.44 | +0.04 |
| CAC 40 | 3957.86 | -42.25 | -1.06 |
| Euro | $1.4378 | +0.0174 | +1.23 |
| Nymex crude | $97.88 | +0.72 | +0.74 |

*Money & Investing* > **Page 17**

## *World-Wide*

**Bush said** the U.S. is ready to make more moves to help financial markets deal with challenges of the credit crisis. He defended Washington's takeover of Fannie and Freddie and an $85 billion lifeline to AIG. McCain called for SEC chief Cox's dismissal. **Page 9**

■ **Defense chief Gates said** the U.S. is reviewing its war strategy in Afghanistan in the face of rising insurgent violence.

■ **A U.S. military helicopter** crashed in southern Iraq, killing seven soldiers. The U.S. aims to rehabilitate and release thousands of Iraqi detainees. **Page 7**

■ **Israeli Foreign Minister Livni** must pull together a ruling coalition after being elected by her party to be prime minister. **Page 8**

■ **Russian investigators ruled** out engine failure as the cause of Sunday's crash of an Aeroflot-Nord Boeing 737-500 jetliner.

■ **Yemeni police arrested** 25 militants with suspected al Qaeda links, and a U.S. FBI team was expected to join a probe of this week's U.S. Embassy attack.

■ **Pakistani officials made** conflicting statements about whether the U.S. had informed Islamabad before a missile attack. **Page 8**

■ **Kenyan elections that led** to bloodshed this year were so flawed that it isn't possible to know who won, an inquiry said.

■ **U.S.-North Korean talks** to end Pyongyang's nuclear-weapons program are in a state of "inertia," U.S. officials say. **Page 27**

### Editorial & Opinion

**Mugabe's last stand?**
Zimbabwe's dictator lost the election but is holding on to power . . . for now. **Page 11**

# Russian rescue package expands to $120 billion

By Gregory L. White

MOSCOW—With stock markets closed for a second day and fears of an economic slowdown growing, President Dmitry Medvedev unveiled an expanded $120 billion rescue package for Russia's financial system.

"It's a very powerful injection," said Pavel Teplukhin, president of Troika Dialog, a leading Russian investment bank. "In proportion to market capitalization, it could be the biggest globally," he said, noting that the total value of the government's plan amounted to about 20% of the current value of Russia's stock market.

Market players agreed with officials that the unprecedented measures—including up to $20 billion in government purchases of blue-chip shares—seemed likely to restore liquidity and steady financial markets when share trading resumes, probably Friday. Bankers said some lending between banks had resumed by late Thursday.

The emergency moves, worked out in marathon meetings over the past few days between top government officials and a small group of bankers, represent a humbling turnabout for the Kremlin, which had until recently insisted Russia's strong economy and ample reserves would protect it from the global financial turmoil.

But in televised comments announcing the new measures Wednesday, Mr. Medvedev's tone was very different. "In this situation, there is no task more important for the authorities in Russia than ensuring the stability of our financial system," he said.

Bankers and investors expressed criticism of the government's reaction privately, wary of

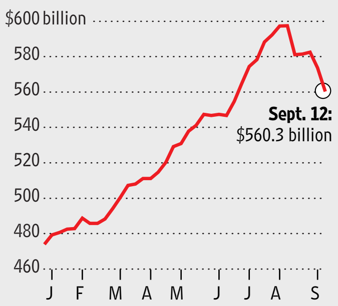
*Please turn to back page*

### Financial fallout



### Turnaround

Russia's central bank drained its reserves in recent weeks to protect the ruble as investors fled the country. Weekly data




NOTE: Since July 1, the bank now calculates reserves based on the market prices for securities of foreign issuers. Previously, the bank's calculations were based on the purchase price and the accrued interest of the securities

Source: The Russian Central Bank

### Weekend Journal

## Drawing power

*Cartoonist as auteur: Europe's visionary graphic novelists* > **Pages W10-W11**

# Gulf states gird for fallout

## *After years of growth, region awaits ripples from financial crisis*

By Chip Cummins

MANAMA, Bahrain—Persian Gulf governments are trying to shore up confidence in the region's so-far insulated economy, but the oil-fired boom is looking vulnerable amid the global-financial turmoil swirling around it.

In recent years, high oil prices have fed a binge of government spending and investment. At the same time, rulers of the Arabic-speaking Gulf states have pushed to diversify their economies away from petroleum. They have spent billions of dollars to build, often from scratch, industries such as financial services and tourism.

Now, all that is facing a three-pronged assault. Oil prices are falling. International credit markets have all but ground to a halt in recent days, drying up an important source of funding for companies and governments. And, suddenly, the region's push into the financial-services sector is starting to look like a liability as stock markets tumble.

"A week ago, I'd have said we were weathering this," said Sheik Mohammed Bin Essa Al-Khalifa, chairman of the government-backed Bahrain Development Bank and chief executive of the Bahrain Economic Development Board.

He said the country's central bank assured the government this week that the banking system is sound. But "it's too early to tell" what effect the crisis will have in Bahrain, he said.

Bahrain served as the region's banking center for decades before new financial players such as Dubai and Doha, Qatar, pushed into the industry. Now, all three are vying to become regional financial hubs. In Bahrain, the financial-services sector contributes more than a quarter of the country's economic output, according to official figures.

"So far, the fallout seems to be containable and our industry is strong," said Sheik Salman bin Hamad bin Isa Al Khalifa, Bahrain's crown prince, in a palace interview. But "as with all things, we will need to wait and see," he said.

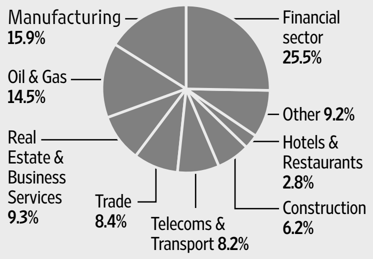
Kuwait's central bank governor and Qatar's finance minister both told reporters this week that the region isn't overly exposed to the financial storm buffeting New York and London. Sheik Mohammed bin Rashid Al Maktoum, the ruler of Dubai, one of seven emirates that make up the United Arab Emirates, was quoted Thursday by the pan-Arab daily Asharq Alawsat saying that the U.A.E. economy "will not be affected by this crisis."

Investors aren't buying those assurances. On Thursday, most Gulf stock markets ended lower, dragged down by banking and financial-sector shares. The region's main bourses are sleepy affairs, and the Muslim holy month of Ramadan means trading likely is lighter than usual, exacerbating volatility. But Thursday's losses cap weeks of softness as local and international investors reassess the region's economic prospects. Dubai's main index fell 3% to 3922.64 Thursday, down nearly 34% this year.

**Spreading the wealth**

Bahrain has moved away from oil, with the financial sector now contributing a quarter of economic output.

**Contributors to GDP in 2006**




Source: Bahrain Economic Development Board


Bahrain's Crown Prince, Sheikh Salman bin Hamad al-Khalifa

# HBOS-Lloyds deal may limit loan options for consumers

By Sara Schaefer Muñoz

LONDON—In prompting a deal for mortgage company **HBOS** PLC, the U.K. government may have staved off a crisis for the bank, but it could take a toll on banking-sector jobs and leave consumers with fewer options for mortgages.

On Thursday, smaller British rival **Lloyds TSB Group** PLC said, as expected, that it had agreed to acquire HBOS for £12.2 billion ($22.22 billion) in stock in what was essentially a rescue encouraged by the British government after HBOS shares fell 51% in the past week. The deal came amid worries about banks' financial health that have frozen the markets that HBOS relies on for cash. HBOS shareholders will receive 0.83 Lloyds share for each share they own.

The deal will create by far the U.K.'s biggest mortgage lender, with nearly a third of the mortgage and the retail-deposits markets. The U.K. government sought to move quickly on the deal to avoid a repeat scenario of Northern Rock PLC, which became the target of a bank run last year after the government didn't endorse a takeover by Lloyds.

While HBOS and Lloyds had flirted for about five to six weeks, the deal came together after Lehman Brothers Holdings Inc. filed for bankruptcy early Monday, people familiar with the situation said. Government efforts to help find a solution for HBOS's troubles began in earnest Monday evening when Prime Minister Gordon Brown met Victor Blank, Lloyds TSB's chairman, at an event in London's Mayfair neighborhood, and they talked over a dinner of quail, people familiar with the matter said. A spokesman for the prime minister declined to comment on the discussion.

Mr. Brown said in interviews Thursday that he encouraged both banks to increase mortgage lending once the deal is completed to help jump-start the U.K. home-lending market.

Some analysts, however, question the longer-term impact of one institution holding a 30% mortgage-market share, saying such a large company eventually could mean higher prices and less flexibility for consumers. The combined entity also would pose a greater risk to the entire mortgage market should it become troubled or fail, they said.

*—Alistair MacDonald, Dana Cimilluca and Ragnhild Kjetland contributed to this article.*

## CORRECTIONS & AMPLIFICATIONS

**The Zara unit** of **Inditex** SA is one of the world's biggest fashion retailers, and Zara Home is a smaller group of Inditex home-furnishings stores. A Corporate News page article Wednesday failed to include the larger Zara entity.

## 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.



## 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**





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CAPITAL JOURNAL ■ GERALD F. SEIB

# *Financial upheaval narrows options of next U.S. president*

Sometimes events reshape a presidential campaign. Sometimes they reshape the world the candidates seek to lead.

This week's Wall Street earthquake is such a big event that it is doing both. Much chatter is being devoted to how the market tremors are affecting the campaign—whether they help Sen. Barack Obama by reinforcing his "change" message, whether Sen. John McCain has hurt himself with his initial declaration that the fundamentals of the economy remain sound, and so forth.

Here's the more important reality: Already, even before it is fully played out, the crisis means the next president—that would be President Obama or President McCain—will enter office with handcuffs on. Options are being reduced for the next president every day, as the real and psychological costs of the crisis mount.

Consider just some of the ripple effects:

■ The domestic agenda of the next president is shrinking. Nobody, anywhere, knows how much of a financial burden the federal government has taken on in the past few weeks, but the cost of bailing out Fannie Mae, Freddie Mac and American International Group Inc.—to say nothing of the potential cost of riding to the rescue of American auto makers, which looks increasingly likely—could conceivably run into the hundreds of billions.

The government's cost for bailouts ultimately may turn out to be less onerous than some of today's darker projections, depending on how markets evolve, of course. But no matter. Whoever is putting together a new economic plan for a new administration in January won't dare to base it on a rosy scenario.

Instead, when the clouds are this dark, you budget to buy umbrellas, and that's what the next president will have to do. Something else he may have wanted to spend money on is going to have to wait. Can the government assume the cost of a large part of the nation's health-care system as well as the financial system right now, for example?

■ Tax increases will be harder to sell. Sen. McCain is right: A period of a shaky economy is a bad time to talk about increasing taxes. And the economy as well as the markets figure to still be shaking in January from the shocks delivered. That's a problem for Sen. Obama's proposal to increase the capital gains tax.

But tax cuts get problematic as well in this environment. Though tax cuts to juice up a lagging economy make a lot of sense, the amount of tax revenue the feds bring in also will be a bigger issue—especially if the Chinese and world financial institutions grow leery of continuing to loan money to finance American spending. Can the government afford to both bail out financial giants *and* take the big hit to its own revenues that would come from, say, eliminating the alternative minimum tax, as Sen. McCain proposes? Or are the government's needs for money now just too great? Either way, the next president's path on taxes is getting more complicated.

■ The federal deficit will become more than a footnote in the plans of the next president. Let's face it: Nobody has worried about the deficit very much in the past few years. Yes, the Congressional Budget office recently reported it more than doubled this fiscal year to $407 billion, and will rise to $438 billion next year. That's still only about 3% of gross domestic product, half as much in the dire budget days of the early 1980s.

But all that is before any bills for Fannie Mae, Freddie Mac and AIG are absorbed—and before the government absorbs any additional costs for the baby boomers now moving into Medicare and Social Security. Again, the nightmare cost scenarios for the government may not come to pass, but psychologically and politically the deficit figures are likely to get more attention going forward.

■ Anyone want to talk about privatizing Social Security in this environment? Not likely. Imagine the national wailing and gnashing of teeth that would be going on right now if Social Security funds were in the hands of failing private financial institutions instead of the government.

Yes, that's an overly simplistic and short-sighted view of the case in favor of a partial privatization of the Social Security system. But in political terms, the arguments for privatization just suffered a huge body blow, and it's likely going to be a while before Republicans put them back on the table.

■ The mega question—what is the role of the U.S. government in the nation's economy?—isn't just on the table, but at the center of the table. The next administration will have to decide not just what financial firms the government ought to own and run, but how heavy the government's hand should be. These are questions the country faced in the Great Depression, and to a lesser extent during the savings-and-loan crisis of the 1980s, but they are back with exclamation points, and will be dumped in the lap of the new president.

Sen. McCain started to address the issue Thursday in a speech calling for the creation of a new agency, the Mortgage and Financial Institutions Trust, to identify and fix weak financial institutions. Yet an even bigger question will hang over the next administration. In many ways, the election of Ronald Reagan in 1980 and his rousing advocacy of free markets ushered in a generation-long period in which Americans' confidence in the government as a vehicle for addressing problems sank, while their confidence in markets as the vehicle for doing so rose. Will events of 2008 begin to reverse that trend?

The question goes to the very relationship between the public and private sectors. The next president alone can't answer it, but he will have to lead the country in finding an answer.

# Morgan Stanley in talks

## *Deal with Wachovia is explored as option; stock declines again*

BY AARON LUCCHETTI, RANDALL SMITH AND JENNY STRASBURG

**Morgan Stanley**, searching for answers to its persistent stock-price decline, continued to talk Thursday to U.S. bank **Wachovia** Corp. about a possible deal as the big U.S. investment bank sought shelter from the financial storm.

The New York firm, which entered preliminary merger talks with Wachovia and other banks a day earlier, saw its stock plunge more than 40% intraday Thursday, the eighth straight decline in its share price, which sent the shares to their lowest level in more than a decade. The shares were down 24% at $16.49 in midafternoon trading on the New York Stock Exchange.

However, Wachovia's troubled mortgage portfolio was leading Morgan Stanley to look at a good-bank/bad-bank structure as part of a deal, a person familiar with the matter said.

Morgan Stanley CEO John Mack discussed the firm's options at a town hall meeting Thursday. The company may stay independent, but it increasingly looks like it needs to take a bold step to turn around sentiment about its stock and to stop customer defections threatening to harm its franchise.

Mr. Mack mentioned at the meeting conversations he had with **Citigroup** Inc. CEO Vikram Pandit about a possible combination between Morgan Stanley and Citigroup. The conversations started when a Citigroup executive, Stephen Volk, called Mr. Mack over the weekend, but ultimately haven't led anywhere.

Morgan Stanley is continuing discussions with **China Investment** Corp. about increasing its stake in the New York investment bank. CIC, China's year-old wealth fund, invested $5.6 billion in Morgan Stanley in December. The U.S. investment bank's shares have since fallen by more than half, although CIC was given certain financial protections in that deal. The plunging value of its stake in Morgan Stanley, and of an earlier investment in **Blackstone Group**, have prompted criticism of CIC within China.

A deal with CIC would give Morgan Stanley a vote of confidence and new capital without having to give up control of the firm. But the two parties would need to overcome regulatory obstacles limiting investments of sovereign wealth funds.

A Wachovia deal would unite two large American financial companies and potentially placate investors who believe investment banks need to be joined with deposit-taking institutions. But Wachovia's own mortgage exposure could be a sticking point in completing a deal, and some analysts have questioned whether Wachovia is the right partner for Morgan Stanley.

Morgan Stanley's Mr. Mack appeared at the regularly scheduled quarterly town hall meeting in the morning, speaking to a packed audience at the company's New York headquarters. The CEO, joined by Chief Financial Officer Colm Kelleher and fellow co-presidents Walid Chammah and James Gorman, said the company is exploring many options, including the Chinese investment and a Wachovia tie-up.

Mr. Mack has also been in close touch with White House chief of staff Joshua Bolten, the Securities and Exchange Commission, the U.S. Treasury, and others, in an effort to stop short-sellers from betting on declines in the Morgan Stanley stock price. He described short-sellers moves' in Morgan Stanley and other financial stocks as an "outrageous" problem with systemic consequences.

Morgan Stanley has other potential international and domestic partners, including **HSBC Holdings** PLC of the U.K., **Banco Santander** SA of Spain, Japan's **Nomura Holdings** Inc. or **Bank of New York Mellon** Corp.

For at least some of these firms, Morgan's strong global investment banking franchise could be a strategic asset at a cheap price. But a big obstacle is the short time in which Morgan Stanley may need to complete a deal.

*—Craig Karmin contributed to this article.*

# CORPORATE NEWS

PHARMACEUTICALS

## BTG snaps up Protherics as industry consolidates


Imagine

**BTG** PLC said Thursday that it agreed to buy **Protherics** PLC in an all-share deal the company valued at about £218 million ($397 million), marking further consolidation of the U.K. biotech sector.

Protherics shareholders will receive 0.291 new BTG share for every share they own—valuing Protherics at 60 pence a share, a premium of 45% to its closing price Wednesday. On Thursday, Protherics shares rose 13%, while BTG shares fell 15%.

BTG Chief Executive Louise Makin said the purpose of the deal is to build a "sustainably profitable specialty pharmaceuticals" business.

*—Jason Douglas*

TELECOMMUNICATIONS

## Alcatel-Lucent board loses 2 directors as it revamps

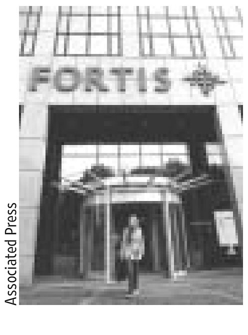
Associated Press

ALCATEL-Lucent SA said directors Ed Hagenlocker and Jean-Pierre Halbron will leave the Franco-American telecommunication-equipment maker.

Alcatel-Lucent said in July it would cut the size of its board after Serge Tchuruk and Patricia Russo said they were stepping down as chairman and chief executive, respectively. Mr. Tchuruk and Ms. Russo said they were leaving the company, formed by the 2006 combination of Alcatel and Lucent Technologies, to let it acquire "a personality of its own." Former BT Group PLC Chief Executive Ben Verwaayen took over for Ms. Russo. Philippe Camus will succeed Mr. Tchuruk on Oct. 1.

BANKING

## Fortis share fall is probed for possible manipulation



Associated Press

DUTCH AND BELGIAN regulators are investigating if there was market manipulation involved in the precipitous fall in shares of **Fortis** NV this week.

Fortis's shares have been falling since last year as it struggles to digest the acquisition of ABN Amro. While European financial shares generally have suffered during this week's turmoil, Fortis shares were among the hardest-hit, plunging 27% in Amsterdam by Wednesday's close. The company said the decline had been aggravated by false rumors of a rights issue.

Fortis has headquarters in Brussels and Utrecht, Netherlands.

*—Associated Press*

# Investors withdraw offer to rescue Alitalia

### *Tense negotiations with unions failed to produce job cuts*

BY STACY MEICHTRY

A LAST-DITCH EFFORT to rescue **Alitalia** SpA went up in smoke after a group of Italian investors withdrew an offer to privatize the struggling state-controlled carrier, a move that leaves the Italian government with little choice but to ground the airline.

An immediate shutdown of Alitalia appears unlikely. The airline's government-appointed liquidator, Augusto Fantozzi, was expected to meet with Italy's civil-aviation authority Monday to determine whether to pull the airline's operating license. And a spokeswoman for Mr. Fantozzi said the airline would continue to operate as long as it could afford fuel—which is about a fortnight.

**Compagnia Aerea Italiana**, or CAI, withdrew its offer to invest €1 billion ($1.44 billion) in a plan to restructure the ailing carrier following weeks of tense negotiations with Italy's unions that failed to produce a compromise on proposed job cuts and contract changes.

In a statement, CAI said union resistance, the "dramatic state" of international markets and Alitalia's overall decline in recent months "will not allow us to further prolong talks that have been explored and that produced numerous concessions."

The pullout leaves Alitalia, the airline of popes and a national symbol, at the threshold of liquidation with no safety net in sight.

For weeks, Mr. Fantozzi has kept the airline in service, burning through the carrier's depleted cash reserves to give the Italian government time to broker a deal between Italy's restive unions and the investors.

Without a deal in place, Mr. Fantozzi has no apparent option than to shut the airline down—a move that could paralyze the country's airports and put Alitalia's 18,000 employees out of work. A shutdown would be so politically bruising that Italian Prime Minister Silvio Berlusconi may still try to come up with some 11th-hour gambit.

Last night, a spokeswoman for Mr. Fantozzi said the commissioner is likely to keep the airline running as long "as long as there's money to pay for fuel."

Alitalia's end could come sooner than that. With between €30 million and €50 million of cash on hand, the airline has money to operate until the end of the month. However, Italy's civil aviation authority, ENAC, on Thursday said it had called a meeting with Mr. Fantozzi on Monday to determine whether to pull Alitalia's operating license.

Alitalia's meltdown represents a major blow to Mr. Berlusconi, who was elected on a pledge to save the carrier and preserve a place for Italy in Europe's cutthroat airline industry.

Mr. Berlusconi pushed Italian investors to line up in support of the airline and rewrote Italy's bankruptcy laws to shield them from Alitalia's creditors.

Mr. Berlusconi's rescue operation, however, seems to have backfired, creating the expectation among some unions that the government will not allow the airline to go bust.

"We don't know how, but Berlusconi must now certainly get involved, because there's a transport problem at this point," said Fabio Berti, chairman of Italy's ANPAC pilots union.


Reuters

Alitalia workers protest against the sale of the airline to a consortium of investors at **Fiumicino airport in Rome**.

The European Union has repeatedly warned Italy that it will block any further attempts to prop up the airline with illegal state funding. Numerous attempts to sell the airline to a foreign carrier have failed.

If Alitalia shuts down, Italy risks seeing some of Europe's most lucrative takeoff and landing slots end up in the hands of foreign carriers.

Within the EU, airlines have recently won the right to buy and sell slots. If the rescue plan had gone forward, Alitalia's liquidator planned to sell the slots to CAI and use proceeds to pay down Alitalia's debt.

Among these, slots at Heathrow Airport in London and Charles de Gaulle in Paris would be among Alitalia's most valuable assets. Industry officials say one pair of Heathrow slots can sell for up to £30 million ($55 million).

If Alitalia is liquidated, however, the slots cannot be sold and will instead be returned to pool for redistribution to other airlines. Italian airports such as Linate, near Milan, currently have pools of airlines ready to snap up Alitalia's slots, says Carlo Griselli, president of Assoclearance, a government agency in charge of allocating slots within Italy. Mr. Griselli says Alitalia owns up to 45% of Linate's 300 slots.

The potential loss of Alitalia also poses broader risks to Italy's economy. The carrier ships most of Italy's air cargo and flies a sprawling network that keeps many of Italy's far-flung cities connected to the rest of the nation.

Although demand for space at airports in Milan, Rome and Venice is high, airports in other cities are unlikely to attract other airlines to replace Alitalia, Mr. Griselli noted.

*—Daniel Michaels and Giada Zampano contributed to this article.*

# Bank of China to get stake in France's Rothschild

*By* **Nicolas Parasie** *in Paris and* **Rick Carew** *in Hong Kong*

**Bank of China** Ltd. and France's **La Cie. Financière Edmond de Rothschild** on Thursday unveiled a partnership deal that marks the first strategic investment of a Chinese bank in a euro-zone peer.

Under the deal, Bank of China will acquire a 20% stake of the French firm, known as LCFR, for €263.3 million ($377.9 million). Bank of China, the world's fifth-largest bank by market value, said it aims to bolster its European product expertise and distribution capacity in private banking and asset management.

Edmond de Rothschild will significantly expand internationally by gaining access to investors in one of the world's fastest-growing economies.

"China is experiencing an economic big bang that is comparable to the United States in the 20th century," Michel Cicurel, chief executive of LCFR told a news conference. He likened China to the "El Dorado of emerging markets" and expressed confidence in the continuation of strong growth there. In 2007, China saw the second-largest growth of the number of high-net worth individuals, or very rich people.

Zhu Min, group executive vice president at Bank of China, said Chinese banks need to internationalize and expand their product knowledge.

He also underlined that this deal didn't mean Bank of China would necessarily start targeting investments in big investment banks. Rather, he said, the Rothschild deal would allow Bank of China to "channel Chinese money in France and Europe."

China's cash-rich banks have been on an acquisition spree over the past two years.

The biggest overseas investment by a Chinese bank so far was in October 2007, when Industrial & Commercial Bank of China Ltd. bought a 20% stake in one of South Africa's largest banks, Standard Bank Ltd., for $5.5 billion

Bank of China, one of the country's Big Four banks, with nearly 11,000 branches, has the largest overseas presence of any Chinese lender.

As well, it operates three branches in the U.S. and spent just under $1 billion in Dec. 2006 to acquire a Singapore-based **Singapore Aircraft Leasing Enterprise** Pte. Ltd., which is one of Asia's largest aircraft-leasing firms.

LCFR is the French arm of the **LCF Rothschild Group**, which was created in 1953 by Edmond de Rothschild and which is headed and owned now by his son, Baron Benjamin de Rothschild.

Both are part of the Rothschild dynasty that has been part of the banking landscape for almost 250 years.

The LCF Rothschild manages more than €100 billion in assets. LCFR manages about a third of this, and is active in asset management, private banking as well as mergers and acquisitions services. It has operations in Italy, Israel and China, as well as France.

China's banks have had limited exposure to the global subprime-lending fallout because they still derive most of their income from China, whose economy has maintained a brisk pace.

# Pernod Ricard profit flat

## *Shares fall 9.9% on cautious outlook for earnings growth*

BY GERALDINE AMIEL AND MIMOSA SPENCER


PARIS—French spirits giant **Pernod Ricard** SA on Thursday said net profit for the year ended June 30 was virtually flat and gave a cautious target for the current fiscal year, sending its shares down.

The maker of Ballantine's gin, Martell cognac and Absolut vodka said it aims for organic profit growth from recurring operations of about 8%, barring "severe deterioration in the global business environment." The forecast excludes recent acquisition Vin & Sprit, through which Pernod gained the Absolut brand.

Analysts said the company's targeted growth rate was less than some had expected, and investors responded by selling Pernod Ricard shares, sending the stock down 9.9% to €55.89 ($80.21). Since the start of the year, Pernod shares have lost 29% amid worries regarding the integration of Vin & Sprit and concern the current financial crisis will lead to a drop in sales.

The spirits company also said it expects revenue growth in the first quarter of the current fiscal year in the low- to mid-single digits.

Many analysts who cover the company said they had difficulty determining whether it was being overly cautious or realistic about expectations for consumption in the months to come, with some noting the company's tradition of providing prudent forecasts early in the fiscal year.

"We believe Pernod strategically decided to get rid of negative [first-quarter] news to keep positive announcements for the coming months, namely noncore brand disposals and faster-than expected synergies" from the integration of Vin & Sprit, Landsbanki analyst Laetitia Delaye wrote in a research note to clients.

Pernod said that net profit rose 1% to €840 million from €831 million the previous year, hurt by charges related to the Vin & Spirit acquisition and restructuring costs. The company announced in July that full-year revenue rose 2.3% to €6.59 billion.

Chief Financial Officer Emmanuel Babeau said in an interview that in the long term, he remains confident about Pernod's prospects. Some Western markets, such as France and Germany, remain resilient in spite of the economic slowdown, he said.

The recent rebound in the dollar, particularly against the euro, is good news for the company as it saw a €106 million negative impact from currency fluctuations in the year 2007-08, Mr. Babeau said.

Pernod said that it expects its debt to decline sharply in the second half of this fiscal year, thanks to the disposal program of €1 billion of assets it announced at the end of July, along with strong cash-flow generation.

# Tate & Lyle warns of flat profit

BY MICHAEL CAROLAN AND MONICA MARK


LONDON—Sugar and industrial-ingredients company **Tate & Lyle** PLC, the maker of artificial sweetener Splenda, Thursday forecast first-half profit would be flat as it warned of extra costs at a corn mill in the U.S.

In its trading update for the six months ended June 30, the company added that its performance in the second half is more difficult to predict than usual because of volatile energy and commodity costs and a deteriorating economic environment. Still, it said it is on track to make progress for the full year.

In a surprise announcement, the company also said Finance Director John Nicholas is stepping down Sept. 30. Tim Lodge, director of investor relations, will become acting finance director until a permanent successor is found.

Tate & Lyle said the installation of new technology at its Loudon, Tenn., corn wet mill was taking longer than expected and would hit profit by £15 million ($27.3 million) in the first half, with a further £10 million to £15 million impact predicted for the second half.

Separately, Danish enzymes and food ingredients maker **Danisco** A/S Thursday posted stronger-than-expected fiscal first-quarter net profit, helped by healthy margins. It also raised its forecast for the financial year and said it plans to buy back one billion Danish kroner ($192.4 million) of its shares.

The company, which in July agreed to sell its sugar division to German company **Nordzucker**, posted net profit of 265 million kroner for the three months ended July 31, down 66% from 785 million kroner a year earlier, when it booked a 430 million kroner gain related to the divestment of its flavor division. The results beat analyst expectations of 246 million kroner. Sales fell to 3.24 billion kroner from 4.67 billion kroner. Danisco was up 11 kroner, or 3.5%, at 323.50 kroner.

*—Gustav Sandstrom contributed to this article.*

# GM reshuffles product plans for U.S.

BY JOHN D. STOLL AND SHARON TERLEP

**General Motors** Corp. has suspended plans to build a small, seven-seat crossover wagon for its Chevrolet brand in North America and instead plans to bring another small car to the U.S. from Asia. The moves come as it continues to reshuffle its product plans amid a rapidly shifting U.S. market.

The canceled Chevrolet vehicle, code named the "Delta MPV7," was originally intended to be built in Hamtramck, Mich., beginning next year, according to the auto maker's recent agreements with the United Auto Workers union. The MPV, or multipurpose vehicle, would have been based on GM's compact-car architecture but would have been capable of seating seven people.

The vehicle could still be built for markets outside North America, such as Europe, where smallish MPVs are more popular. A concept version of the model—called the Chevrolet Orlando—will debut at the Paris auto show next month.

"That's no longer an option for us," UAW Local 22 President George McGregor, based near the Hamtramck plant, said of the Orlando. A spokesman confirmed that GM has no concrete plans to bring the model to the U.S.

With the Orlando off the table, Mr. McGregor said local union officials are focused on making sure workers get to build the Chevrolet Volt, a battery-powered electric car the auto maker plans to manufacture in 2010. The UAW is still trying to hammer out a local agreement with GM.

In recent months, the auto maker has suspended plans for several new models that GM told the UAW last September it would eventually build in North America. These suspended model programs include new generation full-size trucks and sport-utility vehicles; large, rear-wheel-drive luxury cars; and a redesigned flagship sedan, known as the Aura, for the Saturn division.

In the U.S., larger minivans, such as the Toyota Sienna or Dodge Caravan, are popular alternatives to MPVs.

# A wave of consolidations is possible in oil industry

BY RUSSELL GOLD AND BEN CASSELMAN


The Wall Street credit crisis and a drop in energy prices from their recent highs are setting the stage for a wave of oil-industry consolidation.

Current market conditions could reshuffle the industry because they are helping some oil and natural-gas companies and hurting others. Large, global oil companies have amassed plenty of financial clout but need to continue growing, and they now sense a buying opportunity. Smaller, mostly North American producers have lots of drillable land but need access to Wall Street's debt and equity markets to grow.

If this smaller group faces a rising cost of borrowing, the result could be substantially more companies putting themselves or key assets on the market.

"I think we'll find the smaller, cash-constrained companies start to consider very seriously those alternatives, which for the larger firms with better balance sheets presents a great, great buying opportunity," said Dan McSpirit, an energy analyst with BMO Capital Markets.

Energy executives and bankers say they are seeing the outlines emerging of a buyers' market for the first time since before the commodity boom of the past few years. The buyers are expected to be large, well-financed energy companies such as European majors **Royal Dutch Shell** PLC and **BP** PLC, U.S. majors such as **Exxon Mobil** Corp. or large conservative energy producers such as **Devon Energy** Corp. or **Occidental Petroleum** Corp.

Occidental President and Chief Financial Officer Steve Chazen said the Los Angeles company has been paying down debt and amassing cash for exactly this kind of situation. "It provides opportunity in the current environment because people who got extended will have to sell properties," he says. The company with the greatest financial strength, Exxon, had about $39 billion in cash at the end of last quarter and holds 2.8 billion shares, worth roughly $216 billion, in its treasury.

The big oil companies have had this financial firepower for several years. What has changed is the potential for smaller companies to face distress.

Many companies focused on drilling in North America for natural gas have for years spent more than they generate, issuing equity and taking on debt to keep up their torrid pace of drilling. Questions are growing about whether these companies will have to cut capital spending in coming weeks or face a rising cost of borrowing commodity prices.

Investment bankers are trying to determine which companies might be gobbled up. None have disclosed financial troubles, and experts cautioned not to expect a sudden rush of deals. Companies that have seen their share prices plummet in recent weeks may demand large premiums, believing newly depressed prices don't represent fair value.

Still, speculation has focused on companies such as **Petrohawk Energy** Corp., a Houston company with a $5.5 billion market capitalization and an attractive amount of land leased in Louisiana's Haynesville gas field. Credit Suisse recently pointed out that Petrohawk plans to spend $2.30 this year for each dollar its operations generate at current commodity prices. Its shares dropped 0.5% in late-afternoon trading on the New York Stock Exchange, compared to a 5% rise for an index of comparable companies. Another company attracting interest is **Southwestern Energy** Co., which has a strong position in an Arkansas gas field.

In recent weeks, Exxon Mobil won the rights to drill on Pennsylvania state land, marking its entry into a natural-gas field there. BP spent $3.65 billion on gas wells in Arkansas and Oklahoma this summer and Shell acquired a Canadian oil-and-gas company for $6 billion.

Turning to the haven of North America makes sense, says Tom Petrie, vice chairman of Merrill Lynch & Co. "In my view, it's not an illogical area of focus for any of the players with access to capital and excess cash generation," he says.

# Hong Kong bank blames trader

BY AMY OR

HONG KONG—**Bank of East Asia** Ltd. alleged Thursday that an equity-derivatives trader falsely recorded 93 million Hong Kong dollars (US$11.9 million) in losses as HK$38 (US$4.9 million) in profits, forcing the lender to restate first-half earnings.

Hong Kong police said Thursday that a 29-year-old man had been arrested for investigation of fraud and would be detained overnight.

Bank of East Asia called the case "an isolated incident involving possible fraudulent conduct of one of its employees" that came to light during a regular independent-control review.

Bank of East Asia alleged the trader has been suspended. Neither the bank nor the police would identify the suspect by name.

The bank said the manipulation amounted to HK$131 million, and it revised its after-tax profit for the first half of 2008 to HK$821 million from HK$930 million as previously reported. The profit attributable to shareholders was revised to HK$785 million from HK$894 million. That translated into a 58% decline in earnings—worse than the bank had reported earlier, when it cited investment losses and higher impairment charges on subprime-related exposure for a drop in profit.

Bank of East Asia said the trader had manipulated the valuation of certain equity derivatives held by the bank, but that it had sustained no further losses from those derivatives.

## CORPORATE NEWS

# EDF may revive U.K. bid

## *French utility looks at sweetening offer for British Energy*

BY DAVID GAUTHIER-VILLARS

PARIS—French utility **Electricite de France** SA is preparing to launch another attempt to buy nuclear power plant operator **British Energy** PLC, marginally sweetening a £12 billion, or about $22 billion, bid that failed in July, people familiar with the situation said Thursday.

The French power company is considering calling an extraordinary board meeting next week, where it will ask the board to approve a new offer worth 774 pence ($14) per British Energy share, these people said. EDF made an offer worth 765 pence per share in July. But the transaction collapsed at the last minute on July 31 when two large British Energy shareholders said this offer was too low.

It isn't certain that the latest offer will result in a deal either, as technical issues remain, and some major British Energy shareholders could hold out for a higher price, said the people familiar with the situation.

The July draft bid would have given British Energy shareholders a choice of either about 765 pence a share in cash, or a combination of about 700 pence plus a certificate valued at roughly 65 pence that might have risen in value depending on performance. The British government, which has a roughly 35% stake in British Energy, supported EDF's July bid, because it would like the French company to help revive the U.K.'s nuclear industry.

Associated Press

The attempt to buy British Energy is key to EDF's expansion plans. It says it wants to **use its nuclear expertise** in the U.K., the U.S., China and South Africa.

The attempt to buy British Energy is key to EDF's international expansion plans. The French company is the world's largest operator of nuclear power plants, and has said it aims to use its expertise in four countries: the U.K., the U.S., China and South Africa.

Separately on Thursday, EDF confirmed that it had looked into how it could help rescue its U.S. joint-venture partner **Constellation Energy Group** Inc., with which it plans to build nuclear plants in North America. Constellation Energy's stock price has fallen sharply recently because of concerns over its cash situation.

EDF said it eventually refrained from making a move, partly because of U.S. state and federal rules limiting the ownership of nuclear assets by foreign companies.

Later Thursday, billionaire Warren Buffett said his MidAmerican Energy Co. had reached a tentative agreement to buy Constellation Energy for $4.7 billion in cash, a nearly 60% discount to where the company was trading just days ago.

*—Rebecca Smith in San Francisco contributed to this article.*

# Aluminum producers change plans as prices, demand fall

BY ROBERT GUY MATTHEWS

MOSCOW—The aluminum industry faces a shakeout as prices and demand sink and inventories build at ports around the world.

In the last three months, prices have fallen more than 20% and inventories have swelled by 40% at key shipping centers. Warehouses in St. Petersburg, Russia, one of the major ports for exporting aluminum, are filling as buyers delay purchases, anticipating further drops in prices. There is enough uncertainty about metal prices, and how long and how far they will continue to drop in the current world economy that some aluminum makers are making contingency plans for hard times.

Alexander Bulygin, chief executive of **Rusal**, the world's largest aluminum producer, said it expects prices to fall further and several high-cost smelters will likely be forced to shut down, especially plants in China where energy costs are highest. "Falling prices will help companies cut their production," he said. "Some companies will go bankrupt." Most vulnerable are high-cost smelters that used relatively high-cost fuels, such as coal, that were viable when aluminum was selling in the range of $3,300 a metric ton to $3,500 a metric ton. Prices have fallen to about $2,500-$2,600 a metric ton.

Mr. Bulygin said prices will remain strong in the long term once inventories are worked through and high-cost smelters are closed. In the short term, however, he said if prices took a steeper tumble, say as far down as $2,000 a metric ton, the company could dial back some of its expansion plans. Planned projects in Africa and Russia "in the worst case scenario, could be postponed for a year, he said. Those projects don't have financing currently. Privately-held Rusal has said that it wants to launch an IPO by the end of next year. That date could be pushed back to 2010, he said, depending on how long the financial markets remained depressed.

To be sure, the big companies that produce aluminum, such as **Alcoa** Inc., **Rio Tinto** and **BHP Billiton** are strong enough to ride out any shakeout in the aluminum market, say analysts.

Rio Tinto said this week that despite the drop in aluminum prices, long-term demand will be strong, with China's domestic growth expected to hover around 9% next year, according to metals forecaster Neal Brewster who expects a rebound in certain markets such as industrial equipment which use aluminum to make turbines. BHP, though, has said that it expects aluminum demand to remain steady but could drop if the big aluminum markets, such as U.S. and Europe continue to be soft. Rusal said it has no plans to shut down any smelters or significantly reduce production of the metal because it relies on lower cost hydro power at its aluminum plants.

# U.S. may wait to award contract for helicopters

BY AUGUST COLE

The Pentagon may hold off on awarding a $15 billion U.S. Air Force rescue-helicopter contract this fall if it is likely that the losing bidders could successfully protest the decision for a third time, the Pentagon's top weapons buyer said Wednesday.

During an interview, John Young said he had no reason to believe the selection won't pass muster, but his office isn't taking any chances. "If we think there's risk there, it won't go forward," he said.

Mr. Young said his deputy and a team of advisers are making sure the Air Force has closed any shortcomings similar to those that recently fouled a $40 billion aerial-tanker contract, now postponed until the next presidential administration.

"If we can assure the secretary of the Air Force and the secretary of Defense that we believe the government has done its work properly and should prevail in a protest, I think that award will be made," Mr. Young said.

The contract has been successfully protested twice since the government picked **Boeing** Co. to build the helicopters. Losing bidders **Lockheed Martin** Corp. and **United Technologies** Corp.'s Sikorsky both filed protests with the Government Accountability Office that were upheld, resulting in a new competition.

## GLOBAL BUSINESS BRIEFS

### Airbus

#### Union disrupts air traffic to protest cost-cutting plan

Airbus employees disrupted air traffic at the airport at Toulouse, in southern France, for over an hour to protest new cost-cutting measures being planned by management at the commercial-aircraft builder, with the biggest union worries focused on a plant in Saint-Nazaire in western France. Several dozen protestors invaded the airport perimeter in the morning and the airport management was obliged to halt landings and takeoffs and divert some flights to nearby Tarbes, a spokesman said. The protest was led by the CGT labor union. Brief work stoppages were also reported at other Airbus plants in France Thursday morning. Airbus is part of **European Aeronautic Defence & Space** Co.

### Ryanair Holdings PLC

**Ryanair Holdings** PLC's chief executive said he is "fairly confident" of breaking even in the full year with oil at $100 a barrel in the fourth quarter, even if fares fall 5% this winter. Michael O'Leary honed his forecast for a net result of "break-even to minus €60 million" ($86.1 million). Mr. O'Leary added that Ryanair could make cost savings of €300 million next year with oil around $100. The budget airline has hedged most of its third-quarter fuel needs at $124 a barrel, well below the July high of about $147 a barrel, and said it remains unhedged for the fourth quarter. But the savings could be eaten up by lower yields this winter "as the U.K., Irish and European economies go into recession and consumer confidence plummets," the company said.

### Kingfisher PLC

**Kingfisher** PLC, Europe's biggest home-improvement retailer by sales, posted better-than-expected fiscal-first-half earnings and said cost cuts would help it cope with the "very tough times ahead." The positive news, delivered amid gloom in the broader retail sector, sent its shares up 9.7% to 131.40 pence ($2.39) each. U.K.-based Kingfisher said net profit fell 8.1% to £147 million in the six months ended Aug. 2 from £160 million a year earlier. However, adjusted pretax profit from continuing operations, excluding exceptional items—the figure analysts track when assessing its underlying performance—rose 23% to £214 million from £174 million, thanks to wider margins, underpinned by a favorable product mix and fewer markdowns.

### Tata Motors Ltd.

**Tata Motors** Ltd., India's biggest auto maker by sales, said it has received an offer from Karnataka to relocate a factory for producing the world's cheapest car to the southern Indian state. Tata originally planned to build the $2,500 Nano minicar in Singur in the eastern state of West Bengal, but it suspended work at the site of a $350 million factory earlier this month because of violent protests and threats to its workers from a political party and farmers' groups over disputed farmland. "We are watching the situation in Singur closely and we are looking at all alternatives," Tata Motors Managing Director Ravi Kant said after a meeting with the Karnataka Chief Minister, B. S. Yeddyurappa. Tata Motors had planned to introduce the Nano from the Singur factory in October.

### Mediobanca SpA

Italian merchant bank **Mediobanca** SpA said its fiscal-year net profit rose 6.5%, lifted by higher net-interest income, and it announced a return to single-board governance. The Milan-based bank said net profit came to €1.01 billion ($1.45 billion) in the year ended June 30, up from €953.2 million the previous year. Total revenue—which includes net-interest income, net trading income, net fee and commission income and other items—rose 7.7% to €1.74 billion from €1.61 billion. Net-interest income rose 12%, while net commissions rose 7.2%. Following months of discussions between members of the bank's governance committee, Mediobanca said it is returning to a single board, just a year after the introduction of a dual-board structure.

### Hitachi Ltd.

**Hitachi** Ltd. said it will start sourcing plasma-display panels from **Matsushita Electric Industrial** Co., hoping to ride out competition in the flat-panel television industry by cutting costs. Their deal will make Matsushita, the maker of Panasonic-brand products, the dominant manufacturer of plasma TV screens as Hitachi pulls out from in-house panel production and rivals focus on liquid-crystal-display TV sets. Pioneer Corp. has already stopped making plasma screens on its own. Hitachi has been trying to revive its TV operations by moving away from mass retailers and focusing on high-end, superthin models. In the year ended March, it booked a 58.13 billion yen ($555 million) loss, hit by hefty restructuring charges in its flat-panel TV business.

### Sinosteel Corp.

**Sinosteel** Corp. said it has a 98.5% stake in its takeover target **Midwest** Corp. and will move to compulsorily get the remaining shares and take the company off the Australian Stock Exchange. Sinosteel President Tianwen Huang said the Chinese government-backed metals trader's move would drive further growth in the midwest region of Western Australia state. The Australian government has raised concerns about the buyers of commodities winning control of Australian sources of supply, but Mr. Huang said Sinosteel will seek to maximize the price received for Australian iron ore from its steel-making customers.

### Telstra Corp.

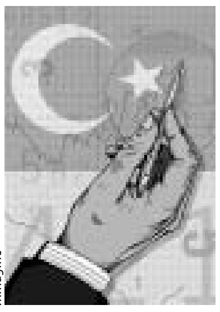
**Telstra** Corp. said it will cut 800 jobs as part of a continuing streamlining strategy. The jobs to be cut are in senior management, middle management and professional services, Australia's largest telecom provider said. Customer-facing jobs will be unaffected. Telstra also said it will form a new business unit, Telstra Media, to focus on online and mobile content as the group continues to overhaul its operations. Chief Executive Sol Trujillo said the company was taking advantage of new database and systems capabilities that enabled it to reduce duplication and bureaucracy and improve cooperation between divisions. "In November 2005, we announced every part of our business would be transformed to make it more productive and customer focused, including a large reduction in our work force," Mr. Trujillo said.

*—Compiled from staff and wire service reports.*

# ECONOMY & POLITICS

**TURKEY**

## Inflation trumps growth for wary central bank


Inmagine

TURKEY'S central bank left its short-term interest rate at 16.75%, opting to combat double-digit inflation rather than aid flagging growth.

Turkey's annual inflation rate fell to 11.8% in August from 12.1% in July, and sliding food prices are expected to push the inflation rate down further in coming months. But the economy's year-on-year growth in the second quarter was its slowest rate in six years. Still, Turkish interest rates have probably peaked and rate cuts may come as early as the fourth quarter, analysts said. "Political pressure on the central bank to ease its monetary policy is expected to increase," said Luis Eduardo Costa, a strategist at Commerzbank. *—Christopher Emsden*

**MALAYSIA**

## Opposition raises stakes with confidence-vote call


Associated Press

OPPOSITION leader Anwar Ibrahim demanded an emergency session of Malaysia's parliament to seek a vote of no confidence against Prime Minister Abdullah Ahmad Badawi's National Front government.

Mr. Anwar's gambit is the latest in a chess match that has clouded Malaysia's political future. Mr. Abdullah—who has labeled Mr. Anwar a national-security threat and hinted he might take action against him—rejected the initiative. Mr. Anwar said leaders of a three-party opposition have written to Mr. Abdullah asking that he convene Parliament in an emergency session no later than Tuesday. *—Raphael Pura*

**SWITZERLAND**

## SNB keeps rates steady, as well as growth forecast


Reuters

THE Swiss National Bank left interest rates unchanged and reaffirmed most of its growth and inflation projections, but it said it stands ready to act.

"The SNB will keep a close watch on developments in the global economy, the financial markets and oil prices, so as to be in a position to react swiftly, if the need arises," the central bank said.

It kept its key interest-rate target at 2.75% for the three-month Swiss franc London Interbank Offered Rate, or Libor. The freeze on rates was expected by market watchers. The SNB slightly raised its inflation-rate forecast for next year to 1.9%, from 1.7% previously. *—Martin Gelnar*

# U.S. shifts tack to prepare for postwar Iraq

### *Detainees get classes in moderate theology to temper their beliefs*

BY YOCHI J. DREAZEN
*Baghdad*

THE U.S. FOCUS in Iraq is fast shifting from fighting a war to preparing for its aftermath.

The cornerstone of the transition is an effort to rehabilitate and release thousands of Iraqi detainees, including many former insurgents. According to the military, there are more than 19,000 Iraqi detainees in American custody, down from 26,000 in November 2007.

The effort, centered in Baghdad and Basra, includes courses in literacy, mathematics and moderate Islamic thought. The military hopes the courses will temper the detainees' religious beliefs and help them find and hold steady jobs.

"The idea is to move from punishment to rehabilitation," said Lt. Col. Paul Yingling, one of the officers leading the push. "It's not enough to simply lock these guys up and hope they somehow turn into productive members of Iraqi society."

Few in the military question the need for the rehabilitation effort, but some wonder whether troops should be leading it. Some officers privately complain the program is turning them into social workers who coddle violent extremists. But few are willing to voice those criticisms because the effort is a favored project of Gen. David Petraeus, the former commander of U.S. forces in Iraq. Gen. Petraeus believes the country's stability will be shaped by how well former insurgents are integrated back into Iraqi society. He sees the rehabilitation push as a powerful weapon in that fight.

The military has made such noncombat efforts before. When U.S. forces were embroiled in a long and bloody insurgency in the Philippines early last century, American commanders mounted a largely successful push to rehabilitate thousands of former Filipino rebels.

But the scale of the effort in Iraq is unprecedented and influenced by nonmilitary sources. U.S. officials said they drew from a Saudi Arabian model in developing the American rehabilitation effort. The Saudi government recently launched an initiative to temper the religious extremism of many of its prisoners through classes in moderate Islamic law.


Yochi Dreazen/ The Wall Street Journal

The U.S. hopes rehabilitation of detainees at Camp Cropper near the Baghdad airport and elsewhere will make for a **safer release**.

If the U.S. military's efforts don't succeed in tempering extremism, skeptics worry that many of the released Iraqis will rejoin the fight and threaten recent security gains.

The program marks a shift away from early U.S. detention policies in Iraq. When the insurgency first flared in 2003, the U.S. military resorted to mass arrests of thousands of Sunni men, sometimes with little or no evidence. The arrests contributed to the violence by persuading many Sunnis that the U.S. was prejudiced against their community.

"We still live in the shadow of Abu Ghraib," said Capt. Jason Reed, an officer overseeing Camp Cropper, the main U.S. detention facility in Baghdad.

The thousands of Iraqis in American custody are a major source of public anger, and politicians regularly demand that the U.S. release the detainees or transfer them to Iraqi control. This year, more than 12,000 detainees have been released.

Maj. Jay Gardner, the executive officer for Task Force al-Amal, which runs the rehabilitation effort, said the military thinks some detainees would need to be held for the long term. Others "simply made bad choices" and could be freed, he said. "The thin line we have to walk is figuring out which is which."

Today, newly detained Iraqis are brought to trailers at Camp Cropper for 20-minute interviews with Iraqi clerics and social workers.

The Iraqi officials complete 15-page reports assessing whether detainees have extremist religious or political views. Militants are moved into separate facilities that operate like conventional U.S. prisons. The remaining detainees are allowed to take part in the rehabilitation courses, which also include carpentry and sewing classes.

The segregation is meant to counter a flaw in earlier American detention operations. In the past, the military failed to separate extremists from the general detainee population. Each American detention facility inadvertently became an "insurgent university," Command Sgt. Maj. Edgar Dahl, the top enlisted soldier at the Camp Bucca detention facility in Basra, wrote in a recent essay in Army Times.

The centerpiece of the rehabilitation effort is the "tanweer" course, Arabic for "enlightenment." The courses combine short lectures on Koranic verses discussing peace or respect for other religions with open-ended discussions. The instructors are Iraqi contractors, paid by the U.S.

"Islam does not distinguish between the rights and freedoms of one sect or another," the course materials note, instructing teachers to "discuss why bloodshed is prohibited."

Qais, a soft-spoken Iraqi, began a recent session by telling the detainees that God created all humans, regardless of their religion or skin color. "God is saying, don't hate because of religion," he said.

He told the students they would be released soon, and the choices they made about whether to return to violence would determine their fate, as well as that of the country.

"You need to learn from what we've suffered through these past five years," he said. "Iraq has bled and suffered. Do you all understand?"

The detainees, who were arrested for offenses ranging from theft to planting bombs, nodded their heads silently. Several took notes. The caption on a poster on the back wall of the tent read: "You are the key to the future of Iraq."

The mood in the tent changed when Qais turned to politics. The instructor began talking about the need for a peace deal between the country's Arabs and Kurds when several detainees cut him off.

"That fight was in the past and it will be the responsibility of the Kurds if it starts up again," said a stocky detainee who identified himself as a former police officer. "The Kurds, they push too far."

Qais dropped the topic and ended the class with a simple admonition. "When you go home, forgive, like brothers," he told the detainees. "Put this all behind you and never look back."

Many of the instructors believe they are making an impact but concede they can't be sure their messages get through. Jamal, one of the tanweer teachers, said many prisoners told him what they knew he wanted to hear.

"I want to believe they will leave here and be good citizens, but I cannot tell what is in their heart," he said. "They are very good at pretending."

It will be years before the effort can be judged a success or failure, but military officials are cautiously optimistic. Lt. Col. Rod Faulk, the chief of staff at Camp Cropper, said that as of July the U.S. had released more than 14,000 detainees since the new programs went into effect and recaptured just 53.

"Anybody who's conservative gets angry and says, 'Why are we doing all of this for them? They're all insurgents,' " Col. Faulk said. "Well, the truth is, they're not all insurgents."

On the streets of Iraq, a murkier picture emerges. Haider, who didn't want his full name used for fear of being arrested again, was 18 when he was detained in Diyala province for ferrying weapons between insurgent hideouts. He spent six months at Camp Bucca and eight months at Camp Cropper before being released.

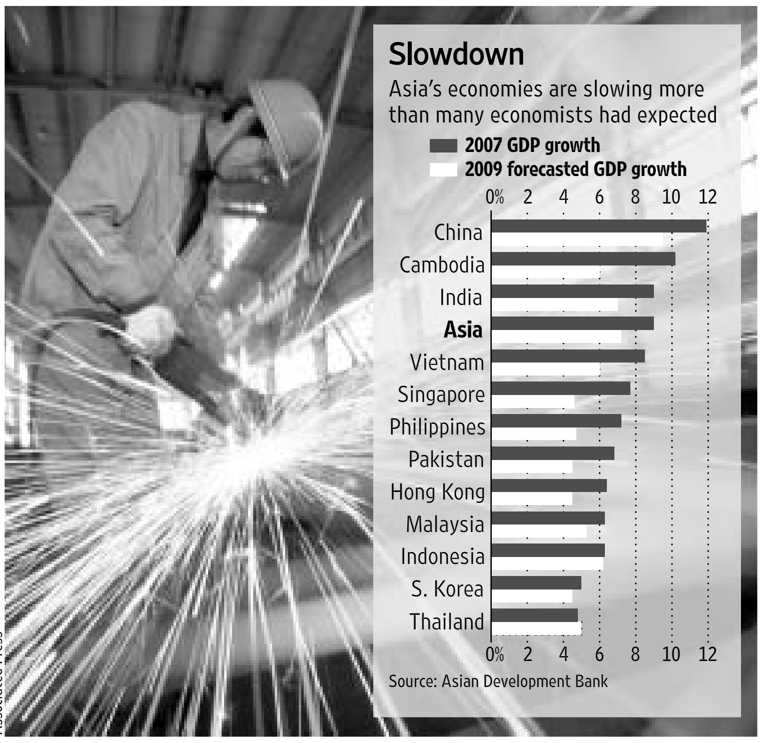
Haider said the classes initially forced him to re-evaluate whether attacks on American and Iraqi security forces were permitted under Islam. But the lessons seem less persuasive the longer he is out of prison.

"Definitely the classes made me see new parts of Islam, the peaceful parts," he said. "But things sound different out here than they did in there."

# World losing key support

## *Slowdown in Asia undercuts its ability to prop up growth*

BY PATRICK BARTA




Associated Press

BANGKOK—Economic growth in Asia is slowing more than many expected, undercutting the region's ability to keep other parts of the world from sliding into recession.

Asia remains the world's fastest-growing area, and its intense demand for commodities, cars and other consumer goods continues to help prop up growth elsewhere, especially emerging markets in Latin America and Africa as well as in manufacturing regions of the U.S.

But while most of Asia is far from recession territory, its economic troubles appear to be intensifying, in part because of the deteriorating global situation as the U.S. financial crisis escalates. In general, Asia is suffering because exports are weakening and consumer demand ebbing, which in turn puts pressure on corporate profits and increases investors' jitters.

In some countries, such as Malaysia and Thailand, falling commodity prices are adding to the pressure by threatening the results of big commodity exporters. Sharp corrections in share and currency markets also have dented investor confidence.

With the worrying developments, economists are ratcheting down their forecasts for this year and beyond.

In China, economists now expect growth in 2009 to be about 9% or slightly higher—impressive when compared with U.S. and European levels, but worse than expected as recently as two months ago and nearly three full percentage points below 2007. Growth in China also probably isn't enough to keep commodity demand at recent levels, analysts say, providing less support for commodity exporters from Congo to Brazil to Australia.

**General Motors** Corp. recently trimmed its outlook for auto sales in China, and prices of steel there have been sliding. Spot prices for iron ore, a big driver of export earnings for Australia and other countries, have leveled off after massive increases in 2007.

"Pessimism on commodities will become more generalized, spreading also to steel-making raw materials for the first time this cycle," analysts at Numis Securities in London wrote Thursday, citing a decline in Chinese steel consumption.

Many economists already believe Japan is on the verge of recession, while in South Korea, policy makers are scrambling to contain a sharp drop in the won. The country's central-bank governor said this week that Korea faces a "difficult time" in the coming months. Economists say the country's growth this year is likely to be just above 4%, lower than they earlier expected.

In Thailand, political troubles have weakened consumer spending and scared off foreign investors. Tourism, which accounts for about 6.5% of Thailand's economy, has dropped significantly.

Indian economic growth has slowed noticeably, too, as the central bank tightens monetary policy to try to stanch inflation ahead of national elections in the next few months. Some airlines have considered deferring orders of new planes amid media reports that the country's aviation industry could lose as much as $2 billion this year.

Tuesday, the Asian Development Bank revised down its estimate for Asia-wide economic growth in 2009 to 7.2%, from an earlier forecast of 7.8%, and growth of 9% in 2007. Economists at Merrill Lynch likewise cut their 2009 estimate for Asian growth recently to 7.3% from 7.9%.

"The key point on Asia is not that you're going to have a crisis, but you're going to have much more of a slowdown than people previously thought," says Duncan Wooldridge, chief Asia economist for UBS in Hong Kong. Because of that slowdown, he says, Asia "is not helping compensate for weaknesses in other parts of the world."

So far, Asian exports have held up surprisingly well, despite weak economies in other parts of the world. But results earlier were boosted by unexpectedly strong demand in Europe, where many countries are now flirting with recession. Wednesday, Singapore officials said exports dropped nearly 14% in August from the same month a year earlier, following a 5.8% decline in July.

**Asian exports have held up well despite weakness elsewhere.**

In past business cycles, the fate of Asia didn't matter nearly as much to the rest of the world. But over the past decade, Asia has emerged as the primary source of new demand for many products from elsewhere, especially commodities.

Not everyone is pessimistic. Unlike the 1990s, when Asian countries had huge deficits that helped lead to a region-wide financial crisis, Asia today is flush with an estimated $3.9 trillion in foreign-exchange reserves. That gives governments much greater leeway to spend their way out of trouble.

Officials have launched stimulus packages in Taiwan, Thailand and elsewhere, and more are expected. Hong Kong has rolled out billions of dollars of tax cuts and other concessions, including public-housing rent waivers, to boost spending.

"It's undeniable there has been some slowing in the Asian data since the beginning of the year," says David Cohen, an economist in Singapore at Action Economics, a forecasting firm. "But let's not get carried away," he says. "It's not exactly falling off a cliff."

A lot of companies remain bullish. **Noble Group** Ltd., a Hong Kong-based commodity-supply-chain manager, said this week it is proceeding with plans to build a grain- and sugar-export terminal in Brazil after reporting that net profit in the first six months of 2008 nearly tripled compared with a year earlier.

Still, economists note that Asia's growth numbers are in some ways deceptive. In developed-world economies like the U.S. and Europe, growth typically needs to slip to 0% or a negative figure before a recession is called. In Asia, some economists believe anything below 5% to 6% qualifies as a recession. One reason is that population growth is faster in Asia, and the region's economies need to grow more rapidly to create enough jobs.

Adding to the confusion: It is unusually hard to get an accurate reading of Asian commodity demand right now. China, by far the biggest source of new raw-material orders, closed many factories during the Olympics, muddying the latest data, and analysts say it could be months before long-term trends are clear.

Few people are expecting a return to the big growth numbers for commodities of a year or two ago. Citigroup analysts recently said they are postponing expectations of a new boom in copper and aluminum prices until the second half of 2009 because of "spreading economic malaise" and reduced likelihood of stimulus from China.

One big new fear is that an emerging slowdown in China's property market could significantly reduce the country's need for copper and other building materials. Government data indicated a decline in Chinese home prices in August, and a Morgan Stanley strategist recently warned of a possible "meltdown" ahead in the property industry.

# Israeli party's new leader must assemble coalition

BY CAM SIMPSON

JERUSALEM—Israeli foreign minister Tzipi Livni was elected by her party Wednesday to be the next prime minister and must now pull together a coalition government or leave the door open to months of uncertainty. Both outcomes carry potential consequences for regional peace efforts.

Ms. Livni, 50 years old, won a narrow victory to lead the Kadima party, which sits atop the nation's ruling coalition, and succeed Prime Minister Ehud Olmert.

Following a tense night of counting that continued until Thursday morning in Tel Aviv, official results showed Ms. Livni netted only 431 more votes than her nearest competitor, the more hawkish Shaul Mofaz, who is Israel's transportation minister. Almost 40,000 Kadima voters cast ballots. Turnout was about 53% for party members.

*Tzipi Livni*

President Shimon Peres is expected to make Ms. Livni the prime-minister-designate in the coming days. That will give her 42 days to form a government through negotiations with current coalition members or others in Israel's 120-seat parliament, the Knesset. If Ms. Livni fails to form a coalition, general elections must be held within three months after the deadline.

Ms. Livni had held large leads in opinion polls ahead of the election, and exit polls indicated she had won by a larger margin.

Leaders from the largest opposition party, Likud, quickly seized on Ms. Livni's narrow margin of victory, saying it wasn't right for 431 Israelis to have such a heavy hand in picking the nation's premier. Likud is pressing for new general elections. Polls show it would likely win the most votes.

Leaders of another right-wing party, Yisrael Beiteinu, also say they believe they could benefit in elections. The party pulled out of the coalition this year to protest Israel's participation in U.S.-backed peace talks with the Palestinian Authority. Ms. Livni has been Israel's lead negotiator in the talks.

The balance of power in the government is now held by the Shas party, which represents primarily ultra-orthodox Jews from Middle Eastern countries. Maintaining Shas support would be the easiest way for Ms. Livni to keep a Kadima government intact.

Ms. Livni was expected to meet the Shas political leader, Eli Yishai, Thursday night, according to a spokesman.

The question may be how steep a price Ms. Livni is willing to pay Shas in order to hold on to power. "It will not be an easy task," said Uriel Reichman, an Israeli academic leader who was among Kadima's founding members.

It is nearly impossible for a single party to gain an outright majority under Israel's political system, necessitating power-sharing deals. The system also makes it relatively easy for small parties to win seats, giving them outsized influence as kingmakers.

Shas has gained significant concessions from Mr. Olmert since it started holding the balance of power earlier this year. The party has won social benefits for its members and pressed the expansion of Israeli settlements in the occupied West Bank, despite Israel's pledges to cease all such activities as part of the peace process.

Shas has further complicated peace talks by threatening to bring down the government if the division of Jerusalem is even discussed. Israelis see the historic city as their capital. Palestinians want it to be their capital in a future state. Mr. Olmert has attempted to dance around the dilemma, announcing that Jerusalem wouldn't be broached until the very end of negotiations—allowing both his government and the talks to survive, at least on paper.

Mr. Yishai, the Shas leader, said Wednesday he wasn't planning to back down on Jerusalem. He also wants big increases in welfare benefits, which have been opposed by Kadima members and others in the ruling coalition.

# Pakistan's foreign minister says U.S. didn't warn of recent attack

BY ZAHID HUSSAIN

ISLAMABAD, Pakistan—The country's foreign minister said the U.S. hadn't informed Pakistan before it launched a missile attack from pilotless drones at a suspected militant hideout in Pakistan's border region.

The strikes provoked anger in Pakistan and criticism of the government that it was taking too soft a stance on heightened U.S. military action targeting the border region with Afghanistan.

Earlier, Pakistani officials had said the U.S. had informed Pakistan before the strike. After the foreign minister's remarks Thursday, a senior government official reaffirmed that there had been an understanding between the U.S. and Pakistan that the strikes would take place.

"The foreign minister's statement is aimed at calming down the public outcry," this official said. There's growing public anger within Pakistan against what is perceived as the government's military cooperation with the U.S.

Foreign Minister Shah Mahmood Qureshi said the attack had come after a clear commitment by U.S. officials to respect Pakistan's sovereignty. He said the strikes indicated "there is some sort of an institutional disconnect on their side, and if so, they will have to sort it out."

Two U.S. drones carried out four missile attacks in the South Waziristan tribal region Wednesday night, hours after Admiral Mike Mullen, chairman of the U.S. Joint Chiefs of Staff, assured Pakistani leaders that the U.S. would respect Pakistan's sovereignty.

A spokesman at the U.S. Embassy in Islamabad couldn't be reached to comment.

# Bush defends AIG bailout

## *President promises more steps to shore up U.S. financial sector*

By Henry J. Pulizzi And John D. McKinnon

Associated Press

President George W. Bush on Thursday **defended the government's takeover** of Fannie Mae and Freddie Mac and its bailout of AIG.

WASHINGTON—President George W. Bush on Thursday said the U.S. government is ready to make more moves to help financial markets deal with the "serious challenges" stemming from the long-running credit crisis.

Mr. Bush said he will closely monitor financial markets and consult with his economic advisers, including Treasury Secretary Henry Paulson.

"The American people can be sure we will continue to act to strengthen and stabilize our financial markets and improve investor confidence," Mr. Bush said in brief remarks on the economy.

Rather than unveiling any new policies, Mr. Bush used his comments to repeat his concern for the economy and defend the government's recent takeover of **Fannie Mae** and **Freddie Mac** and its $85 billion lifeline to **American International Group** Inc.

"These actions are necessary and they're important, and the markets are adjusting to them," Mr. Bush said, including overnight moves by the Securities and Exchange Commission and Federal Reserve. "Our financial markets continue to deal with serious challenges. As our recent actions demonstrate, my administration is focused on meeting these challenges."

Mr. Bush, defending the AIG bailout, said a failure of the firm "could have caused a severe disruption in our financial market" and threatened other sectors of the economy.

The president's remarks, which lasted two minutes, were his first on the economy since Monday, when he said the government was working to minimize the damage inflicted by the financial crisis.

"The American people are concerned about the situation in our financial markets and our economy, and I share their concerns," Mr. Bush said.

The president had scrapped an out-of-town trip to monitor the situation. The cancellation came shortly after 11 p.m. Wednesday night, a few hours before central banks in the U.S., Europe and Japan announced new coordinated moves. The banks' overnight announcement was designed to address increasing problems in global financial markets as weakness on Wall Street appeared to spread.

Mr. Bush had planned a politically oriented event Thursday to tout his energy program, with a tour of a waste-to-energy plant in Huntsville, Ala. He also had planned political fund-raisers in Alabama and Florida before returning to Washington later in the day.

"President Bush is canceling his planned travel to Alabama and Florida tomorrow, and will instead remain in Washington to continue to work with his economic advisers on the serious challenges confronting our financial markets," spokesman Tony Fratto said Wednesday night. "The health of our financial markets is critical to the nation's economy, and the president remains focused on taking action to stabilize and strengthen our markets and to restore investor confidence."

The president has maintained a relatively low profile on the financial crisis in recent weeks, allowing Mr. Paulson and Federal Reserve Chairman Ben Bernanke to take the lead in the government's public response.

# U.S. candidates call on big names

In the back of an SUV en route to a Hollywood fund-raiser this week, Democratic presidential nominee Barack Obama held a conference call with his financial advisers. On the line were a former Federal Reserve chairman, two former Treasury secretaries and a former economic adviser in the Clinton White House.

Sen. Obama wanted to know how to respond to the $85 billion rescue of **American International Group** Inc.

*By* **Michael M. Phillips** *and* **Elizabeth Holmes** *in Washington and* **Amy Chozick** *in New York*

With Wall Street in chaos, and the presidential race running neck-and-neck, Sen. Obama and his opponent, Republican Sen. John McCain, find themselves in need of quick responses to complex developments in financial markets. That means having a BlackBerry full of big-name advisers who can coach them on what to say—and defend them after they've said it.

Sen. Obama is relying on former Clinton administration heavyweights, while Sen. McCain is looking to veterans of the Reagan administration and both Bush presidencies. During Sen. Obama's conference call, former Treasury bosses Robert Rubin and Lawrence Summers, ex-Fed Chairman Paul Volcker and University of California at Berkeley economist Laura Tyson agreed: The message should be that the financial chaos stems from eight years of a Republican hands-off attitude toward financial regulation, a point of view they planned to pin on Sen. McCain.

Sen. McCain, long an advocate of small government, moved sharply toward the other end of the spectrum this week, promising to crack down on "the greed and mismanagement of Wall Street and Washington." In the text of a speech he delivered Tuesday in Florida, Sen. McCain said, "In short order, we are going to put an end to the reckless conduct, corruption, and unbridled greed that have caused a crisis on Wall Street."

Sen. McCain's financial team includes John Thain, the chief executive of **Merrill Lynch** & Co., who just engineered the firm's sale to Bank of America. Another aide, Harvard economist Martin Feldstein, is a former adviser to President Reagan and a current member of AIG's board, while Peter Wallison served as general counsel in the Reagan Treasury and Michael Boskin was an economic adviser to President George H.W. Bush.

When asked about a possible conflict of interest between his advisers and the campaign, McCain spokesman Tucker Bounds said he saw no such problem. Mr. Feldstein has "no unique influence on John McCain's policy and no unique influence on AIG's policy." As for Mr. Thain, Mr. Bounds said, "He took over a troubled company that eventually sold."

For a business perspective, Sen. McCain consults Republican National Committee Victory Chairwoman Carly Fiorina, the former chief executive of **Hewlett-Packard** Co., and Meg Whitman, the former head of **eBay** Inc. "He listens a lot," economist Douglas Holtz-Eakin, Sen. McCain's senior economic adviser, said.

One of Sen. McCain's most influential advisers had been former Republican Sen. Phil Gramm of Texas. During the 1990s, Mr. Gramm fought efforts to increase the budget of the Securities and Exchange Commission.

He was an architect of the 1999 Gramm-Leach-Bliley law, which allowed banks to take on additional risk by engaging in investment banking and insurance. Mr. Summers, the Obama adviser, was among those who negotiated the measure on behalf of the Clinton administration, and he praised it as a "major step forward toward the 21st Century."

Mr. Gramm was seen as a possible McCain Treasury secretary until he dismissed the economic troubles as a "mental recession" and branded the U.S. a "nation of whiners." These days, the McCain campaign representatives say they are no longer looking to Mr. Gramm for advice.

Sen. Obama can boast that Messrs. Rubin and Summers know how to deal with market crises. When instability rippled through Asia and Latin America in the late 1990s, Messrs. Rubin and Summers engineered a series of rescue packages and policies that helped calm investors and prevent the turmoil from leaking into the U.S.

# McCain blames SEC's Cox for much of finance crisis

By Laura Meckler And Kara Scannell

CEDAR RAPIDS, Iowa—Sen. John McCain called for the dismissal of Christopher Cox, chairman of the U.S. Securities and Exchange Commission, blaming him for much of the current financial crisis.

"The chairman of the SEC serves at the appointment of the president and has betrayed the public's trust," he told a rally. "If I were president today, I would fire him."

An SEC spokesman didn't respond to requests for comment on the McCain speech.

Trying to seize momentum in the unraveling financial crisis that has knocked his campaign off stride, Sen. McCain put much of the blame on the SEC. The agency, he said, allowed abusive short selling, or bearish bets on a company's stock, to turn "our markets into a casino."

Short sellers have been blamed for piling into commercial-bank and investment-bank stocks and driving stock prices lower. Investment banks have been suffering from heavy write-offs from subprime-mortgage debt, and their falling stock prices have made it harder for them to raise money.

*Christopher Cox*

Sen. McCain also criticized Mr. Cox for eliminating a trading rule that acted as a speed bump to prevent short sellers from pounding a stock. The rule, known as the uptick, said traders could only place short sales following a higher bid in a stock price. The SEC eliminated the uptick in July 2007, and market participants have been urging the SEC to reinstate it ever since. Mr. Cox has said the rule is ineffective today, because markets have changed since it went into effect around the Great Depression.

Despite the Republican presidential candidate's broadside against the SEC chairman, President George W. Bush appears to be standing behind Mr. Cox. White House spokeswoman Dana Perino said in an email that Mr. Cox still had Mr. Bush's backing.

With the economic turmoil enveloping the presidential campaign, the Republican nominee took his strongest stand yet against Wall Street and the Washington regulators who oversee financial institutions.

The fundamental problem is lack of transparency, he said. "Banks and brokers took on huge amounts of debt, and they hid the riskiest of all investments," Sen. McCain said. "Mismanagement and greed became the operating standard while regulators were asleep at the switch. The regulators were asleep, my friends, they were not working for you."

He also called for creation of a new agency modeled after the Resolution Trust Corp., which handled the fallout from the savings-and-loan crisis. He said the new agency would be called the Mortgage and Financial Institutions Trust.

"The priorities of this trust will be to work with the private sector and regulators to identify institutions that are weak and take remedies to strengthen them before they become insolvent," he said. "For troubled institutions, this will provide an orderly process through which to identify bad loans and eventually sell them."

Sen. McCain said the new agency, which he dubbed the "MFI," will work proactively with markets to prevent problems before they happen.

"The MFI will enhance investor and market confidence, benefit sound financial institutions, assist troubled institutions and protect our financial system while minimizing taxpayer exposure," he said.

Sen. McCain's senior policy adviser, Doug Holtz-Eakin, said earlier this week that the system for investment banks would be much like the system in place for commercial banks. Once the problems were identified, the government could "take control of them as a regulator matter and wind it down effectively."

Mr. Holtz-Eakin said that a Resolution Trust Corp.-like system could also be a "workout function" to the campaign's previously proposed housing policy. "You're going to have these things refinanced, put under reasonable terms that match both the income of the individual and the current valuation of the house," he said.

Sen. McCain promised further details on Friday about his plan for dealing with the crisis.

But he used the rally Thursday in the battleground state of Iowa to charge that his opponent, Sen. Barack Obama, sees the crisis as a political opportunity. Many analysts, as well as Obama advisers, say a return to economic issues is bound to help Sen. Obama in a race with fewer than seven weeks to go.

"My opponent sees an economic crisis as a political opportunity instead of a time to lead," Sen. McCain said. "Sen. Obama isn't change, he's part of the problem in Washington."

Sen. McCain's call for the ouster of Mr. Cox—who, before taking his current job, served with Sen. McCain in Congress as a Republican representative from California—follows mounting political pressure on the SEC as taxpayers have been asked to foot the bill for Wall Street bailouts. Sen. McCain's criticism comes one day after Sens. Charles Schumer (D., N.Y.) and Hillary Clinton (D., N.Y.) held a conference call with Mr. Cox asking him to halt short selling in the large financial companies.

In a short sale, a trader sells borrowed stock, hoping it will fall in price and can be repurchased later at a profit. There is an increasing belief that some traders are manipulating the market by placing multiple short sales in which they don't borrow the stock. Increased short positions often trigger more selling, as they are viewed as a bearish sign on the company.

After a weekend of negotiations as Lehman Brothers Holdings was heading toward bankruptcy and Merrill Lynch & Co. was seeking a buyer, Wall Street firms lobbied Mr. Cox to take greater steps to curb short selling. On Wednesday, the SEC responded with three new rules aimed at curbing abusive short selling.

Late Wednesday night, Mr. Cox announced that the SEC was also considering an emergency order that would require hedge funds—frequent short sellers—to report their daily short positions.

Jim Chanos, a well-known short seller and chairman of the Coalition of Private Investment Companies, a hedge-fund lobby group, called the move "akin to the government suddenly requiring Coca-Cola to disclose their secret formula for free to all their competitors."

*—Elizabeth Holmes contributed to this article.*

## REVIEW & OUTLOOK

# The Fed and AIG

If U.S. officials thought that nationalizing giant insurer AIG would stop the financial panic, markets gave them a rude reply Wednesday. Stocks fell sharply, gold rose $89 (!) an ounce, and spreads on Morgan Stanley and Goldman Sachs debt widened to canyons over Treasurys. Investors are wondering who's next on the Treasury-Federal Reserve list for a force majeure takeover, and are selling off accordingly.

Perhaps Secretary Hank Paulson was right that AIG had to be rescued to avoid a broader financial collapse. We aren't privy to what he and the New York Fed were hearing about AIG's credit default swaps or its insurance "wraps" for the commercial paper market; maybe unraveling those would have smashed the corporate debt market or caused a run on money-market accounts. So maybe he had no choice but to rescue the part of AIG that was a hedge fund wrapped around the world's largest insurer.

But it's precisely this opacity that is the problem for market psychology: These serial nationalizations are being done out of Mr. Paulson's hip pocket, based on his judgment of what constitutes a systemic risk (Bear Stearns, Fannie Mae, AIG) and what doesn't (Lehman). There's no transparency, and when Treasury decides to act it swoops in with a no-bid transaction that dictates terms to the target company. At the very least a Treasury Secretary should try to justify the nature of such risk when he puts $85 billion in taxpayer cash on the line.

All the more so if the takeovers inspire even more market fear. Three month T-bill yields plunged at one point Wednesday nearly to 0%, which means investors are willing to accept essentially no return to get a safe harbor. Gold's leap of more than 11% is also a flight to safety.

Nationalizations aren't stopping the financial panic.

The danger is that we will get these financial melodramas every week, if not more frequently. Each one only extends the panic. The two surviving big investment banks, Morgan Stanley and Goldman, continue to operate with enormous leverage yet profess to have enough capital to survive. That's also what Lehman and AIG thought. Markets are also punishing Washington Mutual, the big savings bank, and Wachovia, the regional bank, with others to follow if housing prices keep falling.

Sooner rather than later, the Fed is going to run out of money to pull off these government takeovers. Its balance sheet was designed to finance open-market operations, plus serve as the occasional lender of last resort for regulated banks. Its assets have long been mainly Treasuries.

Since last December, however, the Fed has made creative use of its discount window with the result that its balance sheet looks uglier all the time. The Fed has guaranteed $29 billion in dodgy Bear Stearns paper, opened its window to ever more colorful collateral, and as of Monday even agreed to accept equity. With its AIG stake, the Fed now owns an insurance company. By our calculations, the Fed has committed some $380 billion of its $888 billion in assets to these mortgage rescue operations. Wednesday the Treasury announced it will issue new debt to lend to the Fed, not merely to fund government operations.

These are all taxpayer obligations, and as such they pull the Fed ever more deeply into political decisions that compromise its independence. The Fed has been pushed into that situation because Treasury lacks the legal authority for such takeovers (except in the case of Fannie Mae and Freddie Mac), while the Fed could act under section 13(3) of the Federal Reserve Act. But this is unsustainable—and dangerous.

The first recourse going forward is for Treasury to help Morgan Stanley and other endangered institutions find new private capital, or, better, private merger partners. Merrill Lynch took itself off the run list by selling to Bank of America. More than a few Merrill shareholders griped about the price, but they did much better than AIG holders will with their 80% dilution to Uncle Sam.

If that fails, then the best and perhaps only recourse is to create an entity on the order of a new Resolution Trust Corporation. Such an agency could become a buyer at a fair and transparent price for distressed debt, as well as the workout home for institutions like AIG that failed because of accounting rules and bad subprime debt but retain great underlying value.

The details are crucial to making this work right—to avoid political meddling, for example, and to make sure it has an end date. But until home prices stabilize, it may be the only way to stop the panic and serial nationalizations.

* * *

We're told Treasury has a proposal ready to send to Congress, but that the Members have told Mr. Paulson they don't want to see it until after Election Day. Mr. Paulson fears that if he does call for action and Congress refuses, then the contagion would be even worse. Well, how much worse can it get than a failure or two a week of a major financial institution? The sooner a resolution agency is up and running, the fewer banks will fail and the lower the ultimate cost to the taxpayer.

Mr. Paulson ought to tell Congress that this authority is essential to stopping a panic, and that the need is urgent. If Harry Reid and Nancy Pelosi say they can't do it until December or later, then they can take responsibility for the nationalizations to come.

# Chinese Red Alert

Chinese product safety is in the headlines again, but this time it isn't about pets. At least three infants have died in China and thousands more have fallen ill after a joint venture with a foreign minority partner suppressed news of tainted baby food for a month and a half. The tragedy shows how exposed Chinese consumers still are to unscrupulous businessmen. It also demonstrates the pitfalls for foreigners doing business in a country where companies don't report to consumers or shareholders but to their political bosses.

Only a real market can fix product-safety problems.

Complaints of possible health problems stemming from the milk powder, used for feeding babies, first surfaced in March at Shijiangzhuang Sanlu Group, a major dairy processor 43%-owned by New Zealand's Fonterra Co-operative Group and majority-owned by the local government in Shijiangzhuang, Hebei Province. Fonterra says Sanlu embarked on a testing regimen that didn't detect anything amiss.

In late July or early August, however, some tests came back positive for melamine, a toxic chemical used to mimic the appearance of protein on chemical tests. It is now believed the contamination originated with Sanlu's suppliers, not in the Sanlu plant. In early August, Fonterra asked Sanlu to notify local health authorities and start a full public recall.

Sanlu's majority owner, the local government of Shijiangzhuang, refused, choosing instead a "trade recall" that would take the product off store shelves but not warn parents who had already bought it—or stoke bad publicity. The reason was probably political. Then-chairwoman Tian Wenhua was also the company's Communist "party secretary." With the opening ceremony for the Beijing Olympics only six days away and foreign press descending upon China, the local Party officials probably didn't want to be the bearer of bad news—no matter the cost in human life.

At that point, Fonterra should have stepped up and forced its JV partner to do a recall immediately. The fact that it didn't, and possibly couldn't, is a sign of the dangers of such JVs. As the minority partner it couldn't force the company into a recall on its own, and may even have had its hands legally tied by a confidentiality clause often included in joint-venture agreements. When we asked Fonterra for a copy of the agreement, it declined to provide one, citing confidentiality.

So instead, the New Zealand company dithered, hoping it could change its partner's behavior by working "inside the system," as chief executive Andrew Ferrier put it in a press conference Wednesday. They were wrong. Nearly six weeks later, Fonterra complained to the New Zealand government back in Wellington. At that point, New Zealand diplomats in Beijing alerted the central government, which overrode local officials and sanctioned a public recall.

Business ethics and business law do sometimes collide. But such problems are especially acute in China, where managers' interests are closely aligned to local Party bosses. Chinese managers' job performance is often based on how many jobs they create and how many widgets they churn out, not something as intangible as consumer protection, let alone "brand reputation."

Nor is there any self-correcting mechanism at work in China. Local health regulators often report to local government officials—the same officials who own the companies inspectors are supposed to be monitoring. Tort claims can't be brought by customers because the judiciary isn't independent. The state-owned press isn't free to ferret out corruption.

That leaves foreign JV partners as the last line of defense for their customers. Smart foreign firms have either installed their own people in China to supervise production or ditched minority stakeholdings altogether in favor of wholly owned operations. Mattel, for instance, owns many of its factories in China. That didn't avert a problem with lead paint in toys, but when problems were discovered, Mattel could move quickly to initiate a recall and regain its customers' trust. Fonterra, on the other hand, shared its safety-monitoring expertise with Sanlu and trusted it was being followed. It wasn't.

Now, Fonterra is paying the price. The global company's $107 million investment in Sanlu has taken an as yet unquantified hit. Its reputation has taken a severe blow from which it will take years to recover.

The Chinese government is making a show of its "justice," firing the local Party bosses and Sanlu's management team. National-level officials are scrambling to show that they're in control so people don't riot in the streets and demand their heads. Meanwhile the scandal spreads: In the past week, authorities have turned up contamination problems at as many as 21 other dairy companies. In the wake of disasters, as in the Sanlu case, Beijing usually tightens enforcement and introduces new regulations. But regulation can only accomplish so much.

It's the system itself, not just the company or the dairy industry, that's broken. Until the government—and the Communist Party—break their ties with business, managers' incentives will always be aligned with those of their political bosses, not their customers. In the meantime, made-in-China products will come under increasing scrutiny from foreign companies that make them there, and from consumers who buy them. None of this will begin to compensate the families who have lost their children.

On Taste

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■ **Damien Hirst continued** to break the art-business mold with his two-day sale at Sotheby's this week. Colin Gleadell explains why the event was a success.

**Pepper . . . and Salt**

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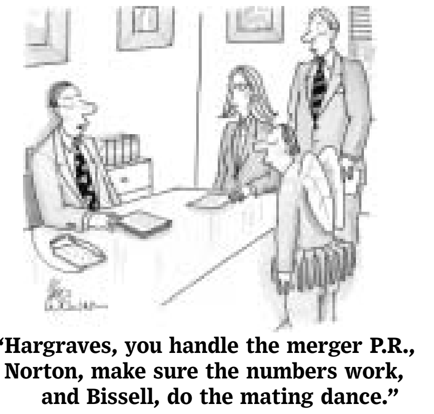

**"Hargraves, you handle the merger P.R., Norton, make sure the numbers work, and Bissell, do the mating dance."**