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Dubai crisis shakes markets

By Chip Cummins

DUBAI — Persian Gulf bonds tumbled and the cost of insuring against default across the region jumped, a day after the government of Dubai said it would ask to postpone debt of its corporate flagship Dubai World.

Credit agencies late Wednesday cut ratings of Dubai debt, as investors and analysts reassessed the region's willingness to bail out troubled borrowers.

Dubai's action also shook global markets, with analysts blaming worry over international exposure to Dubai debt. European shares recorded their biggest one-day drop since April on Thursday, with banks leading a broad tumble. The U.K. FTSE 100 index closed down 3.2%, while the French CAC-40 index ended down 3.4% and the German DAX index closed down 3.3%.

In recent years, Dubai's ruler, Sheikh Mohammed bin Rashid Al Maktoum, has overseen the Gulf state's rapid expansion.

Analysts and bankers, however, also downplayed the notion of significant exposure by any one institution or any systemic risk from the announcement.

Sheik Ahmed bin Saeed al Maktoum stepped in late Thursday to try to ease investor concerns that the standstill might lead to a default on its debt. "Our intervention in Dubai World was carefully planned and reflects its specific financial position," said Sheikh Maktoum, who heads a key Dubai finance committee and is chairman of its airline Emirates.

The shock to confidence in the region was dramatic, even accounting for light trading because of the start of the Muslim Eid holiday in the Persian Gulf and Thanksgiving in the U.S. Even cash-rich governments such as Qatar and Abu Dhabi, a fellow member with Dubai in the United Arab Emirates, saw investors flee sovereign credit.

Reflecting the nervousness over exposure to Dubai at regional banks, default insurance for Mashreqbank, one of Dubai's biggest, more than doubled my mid-afternoon London time, compared to Wednesday's New York close. A representative wasn't reachable late Thursday.

Standard & Poor's put four of Dubai's biggest banks on credit watch with negative implications because of their large exposure to Dubai World debt, and more generally Dubai-related credit.

The government of Dubai said Wednesday it will take over restructuring its largest corporate entity, Dubai World, a conglomerate spanning real estate and ports. As part of that effort, it said it intended to ask lenders for at least a six-month delay on

Please turn to page 7

Agence France-Presse

The ruler of Dubai, Prime Minister of the United Arab Emirates Sheikh Mohammed bin Rashid Al Maktoum had signaled to investors that the city-state would pay the remainder of its debts on time.

Pinched U.S. retailers started their Black Friday on Thursday

By Miguel Bustillo And Andria Cheng

U.S. retailers kick off their traditional holiday selling season the day after the Thanksgiving holiday, hoping to lure customers with early promotions and discounts.

But with the retail industry expecting another challenging holiday season, store chains jumped ahead with carefully calculated promotions designed to entice consumers into shopping in advance of Black Friday—named because tradition holds it is the day that retailers turn a profit for the year.

In Manhattan's Soho district this week, **Gap** Inc.'s Old Navy chain has a prominent window sign telling shoppers it's open for business on Thanksgiving Day. Across the street, British retailer Topshop promised early birds a free English breakfast today.

Major retailers including **Target** Corp., **J.C. Penney** Co. and **Best Buy** Co. started Black Friday discounting early online this year in another sign chain stores are eager to avoid the one-day spike in sales of years past, and keep customers shopping throughout the holidays.

"You have to make your plan" for Black Friday weekend, said Barclays Capital analyst Robert Drbul in an interview, adding this weekend can be expected to generate 10% of total holiday-season sales. "It's hard to play catch-up. A lot of what you are seeing [in terms of store promotions] is surgical and tactical. It's well-planned."

Dozens of retailers were dangling special pre-Black Friday offers on their Web sites, though not all were identical to what could be found today in stores.

Overall, U.S. households are expected to spend about 7% less on gifts this season, shelling out an average of $390, according to a report released Monday by the Conference Board. This year, 39% of households are planning to spend less than $200, up from 35%. The Conference Board survey covers a sample of 5,000 U.S. households.

The Quirk

In Michigan, the unemployed bring their bowling shoes with their résumés Page 29

World Watch

A comprehensive rundown of news from around the world Pages 30-31

Editorial & Opinion

How the climate-change consensus was forged. Page 12

U.K. tax amnesty deadline extended

By Laurence Norman

The U.K. government will extend a tax amnesty deadline for offshore accounts by five weeks in a move tax experts say may not be enough to make the amnesty a success.

A person familiar with the matter said the deadline for disclosing that unpaid taxes are owed will be extended to Jan 4. It was originally due to expire on Nov 30. Individuals then have until March 12 to pay what is owed. A spokesman for Her Majesty's Customs and Revenue Agency said "the reason we have extended the deadline is to allow more time for banks to write to their customers. This is what they have told us they need."

The New Disclosure Opportunity amnesty started on Sept. 1 and was part of a broader effort by the U.K. and other leading governments to crack down on offshore tax havens. Amid the global recession, cash-strapped governments have launched a series of efforts to stamp out tax evasion and avoidance in a bid to replace lost tax revenue and reduce deficits. Under the amnesty, individuals with offshore accounts must pay all outstanding taxes and duties, interest and penalties plus 10% penalty of the unpaid amount. That's a much lower penalty than would be imposed if someone were successfully prosecuted.

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Booms, busts and fiscal policy: steps to deal with current challenges

[Agenda]

By Ludger Schuknecht

Many current policy challenges have their root in the boom years. In the run-up to the present crisis, the credit-financed housing boom precipitated a large private-sector debt built up in many economies. Meanwhile, public finances and underlying policies were often insufficiently prudent so fiscal imbalances quickly became very large when boom turned to bust.

As matters stand, public deficits have been rising, in some countries to near or above 10% of gross domestic product. Public debt ratios are increasing rapidly, sometimes by 30% or 40% of GDP in just a few years. Expenditure ratios will average about 50% of GDP in industrial countries and are often near or above historical highs. Moreover, government obligations related to financial-sector support and population aging are looming large. The boom legacy also contributed to distorted economic structures that will require a reallocation of resources away from the boom's main "profiteers," such as finance, real estate and construction.

My new study, "Booms, Busts and Fiscal Policy: Public finances in the Future?" published by Politeia in London today, argues that the central task will be to return to healthy and stable economies with sound and sustainable public finances. Major fiscal policy reforms and spending restraint will be needed and four central issues should be tackled.

First, deficits and debts must be returned to a sustainable path. Only if deficits are reduced significantly will debt stabilize and decline relatively quickly. In many countries, deficits will need to fall by one percentage point of GDP per year and in some by much more. Even then, a balanced budget would be reached in about 2015 for the average of the euro area and even later in the U.K.

Getty Images

Social-security reform should also be introduced to contain fiscal pressures

Second, spending reform should be the main way to reduce deficits and debt and restore sound public finances. Given the magnitude of deficits, a country would need to raise average and marginal tax rates enormously if it wanted to consolidate significantly via higher taxes. This would most likely have very adverse consequences for growth. The historical evidence is that mainly tax-based consolidation has limited chance of success.

Fiscal-policy reforms are central to restoring economic fitness in post-boom, post-bust economies

Spending ratios should be brought back at least to pre-crisis levels. Even this will be difficult, and much will depend on political determination. Experience has shown that a ratio below 40% of GDP and even below 35% can be sufficient and allow good outcomes in areas judged to matter in western economies: functioning markets, equal opportunity for market participants, essential public goods and services, infrastructure, economic stability and income distribution. A number of countries have shown ambitious reforms of government-spending obligations on public employment and other public consumption and on transfers and subsidies are the best and most successful way to bring down deficits and public spending at little cost to economic growth and well-being.

In fact, reducing deficit and reforming expenditure are complementary objectives. Expenditure reform can have a positive effect on long-term growth via incentives to work and invest, rather than to "seek rents." This in turn speeds up deficit and debt reduction, and it can allow a virtuous cycle to emerge.

Third, social-security reform should be introduced to contain fiscal pressures arising from aging populations. Unless there are further reforms, a growing tax burden or a crowding out of other spending is inevitable. Increasing the statutory-retirement age and eliminating early-retirement incentives will be important. Health and long-term care reforms should contribute in the future to the affordability of services.

Fourth, structural reforms including those in the fiscal area are needed to reduce the likelihood of future booms and bust. Fiscal policies, though not the most important way to reduce asset-price cycles, can play a part by eliminating undue incentives to take on debt and by avoiding stoking housing markets that are already buoyant. National fiscal rules and compliance with the EU's Stability and Growth Pact can help saving rather than spending the fiscal "rents" of good times.

All in all, although fiscal policy is not the only area where important reforms are needed, fiscal-policy reforms are central to restoring economic fitness in the post-boom, post-bust economies. Re-establishing sound public finances with lean government will be pivotal to regain economic stability and dynamism.

—Ludger Schuknecht is senior adviser in the Economics Directorate at the European Central Bank and author of "Booms, Busts and Fiscal Policy: Public finances in the Future?", published by Politeia. The views expressed are the author's and do not necessarily represent those of the ECB.

What's News

■ **Persian Gulf bonds fell** and the cost of insuring against default across the region rose, a day after Dubai said it would ask to postpone debt of Dubai World. The action also shook global markets, with European shares recording their biggest one-day drop since April. 1, 22, 32

■ **The chief of Germany's** armed forces resigned amid allegations that the military withheld information about an airstrike in Afghanistan that killed civilians. 3

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"The London Stock Exchange's technology has been found wanting."

Lauren Mills on the severe technical trouble at the LSE that stopped trading for several hours on Thursday.

Continuing coverage

The key U.S. holiday shopping season kicks off on Black Friday. **WSJ.com/Business**

Question of the day

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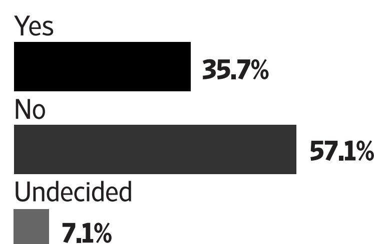
Yesterday's results

Q: Should governments more closely regulate consumer banking fees?



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Germany's military chief resigns

By Marcus Walker

BERLIN—The chief of Germany's armed forces resigned suddenly on Thursday amid allegations that the German military withheld information about an airstrike in Afghanistan that killed dozens of civilians.

The resignation followed media reports the military—contrary to officials' public statements at the time—knew the Sept. 4 airstrike had probably caused civilian casualties.

Germany's new defense minister, Karl-Theodor zu Guttenberg, told parliament on Thursday that army reports gathered after the bombing weren't passed on to Germany's political leaders. Gen. Wolfgang Schneiderhan, the most senior official in Germany's armed forces, or Bundeswehr, and an assistant defense secretary, Peter Wichert, were leaving their jobs as a result, Mr. zu Guttenberg said.

The renewed controversy about the airstrike puts the unpopular war in Afghanistan back in the center of German political debate, just as the U.S. is preparing to redouble its efforts there and Chancellor Angela Merkel's government is seeking to extend Germany's military deployment in the country.

Associated Press

Wolfgang Schneiderhan during a visit to Kunduz, Afghanistan, this month. Germany had requested the Kunduz strike.

The Sept. 4 airstrike by U.S. planes against two hijacked fuel trucks took place at the request of a German army officer in Kunduz, northern Afghanistan, who feared the trucks would be used in a suicide attack against his troops.

Roughly 100 people were killed in the bombing, including 30 to 40 civilians who had gathered around the fuel trucks after they became stranded in a river bed, an investigation by the North Atlantic Treaty Organization later concluded.

In the days after the airstrike, then-defense minister Franz Josef Jung said the bombing hadn't, to his knowledge, killed any civilians, claiming the local German commander in Kunduz had had strong intelligence indicating that the people surrounding the fuel trucks were all Taliban fighters.

NATO investigators partly called that into question in October, saying a grainy video feed from U.S. planes to the German commander made it hard to tell combatants from civilians.

On Thursday, German tabloid newspaper Bild reported that shortly after the airstrike, German military police found evidence of dead and wounded civilians, including children and local farmers. In addition, an Afghan informant who assured the German army that only Taliban fighters were standing near the fuel trucks wasn't actually there himself, Bild reported.

Mr. zu Guttenberg said Thursday that he hadn't known about the military police report and other internal documents until Wednesday, and that his predecessor Mr. Jung had never seen them.

The latest revelations about what the German army knew around the time of the airstrike are leading to intense pressure on Mr. Jung, who is currently labor minister in Ms. Merkel's cabinet. Opposition lawmakers called on Mr. Jung to resign and for the government to allow a full inquiry. Mr. Jung defended his pronouncements, saying they had reflected the information available to him at the time.

The controversy is unlikely to damage the popular Mr. zu Guttenberg, even though he has defended the airstrike, because he became defense minister only in late October, analysts said. Mr. zu Guttenberg, a 37-year-old rising star in German politics, has won plaudits for taking a more plain-speaking approach than other German politicians to the Afghanistan mission.

Mr. zu Guttenberg has admitted that the nearly 4,500 German troops in Afghanistan are operating in "war-like conditions." Previously, German leaders had insisted their soldiers were only peace keepers.

Blair's envoy says Iraq plans set early

Associated Press

Former U.S. Secretary of State Condoleezza Rice raised the issue of Iraq with the U.K. hours after the Sept. 11 attacks, Britain's former ambassador told an inquiry into the Iraq war Thursday.

Christopher Meyer, who served as then-Prime Minister Tony Blair's envoy to Washington from 1997 to 2003, said he spoke with Ms. Rice on Sept. 11, 2001.

"She said there's no doubt this was an al Qaeda operation, we are just looking to see if there could possibly be any connection with Saddam Hussein," he told the panel.

Years later, President George W. Bush's administration was forced to acknowledge that they could find no connection between Saddam and the attacks.

Mr. Meyer said that prior to the attacks, Bush's foreign-policy circle—who he said were known as "the Vulcans"—were most concerned about Russia, not Iraq.

He said that in first talks after the terrorist attacks, Mr. Blair believed there should be a "laser-like focus on al Qaeda and Afghanistan."

But Mr. Meyer said that by the time of a key meeting at Mr. Bush's ranch in Crawford, Texas, in April 2002 attitudes were hardening on Iraq—a year before Parliament's approved of involvement.

Messrs. Bush and Blair spent a "large chunk of time" without advisers present, Mr. Meyer said.

"I'm not entirely sure to this day what degree of convergence was signed in blood" at the meeting, Mr. Meyer said, referring to Mr. Blair's acceptance that Saddam would need to be deposed by force.

The British inquiry, billed as the most sweeping look yet at the conflict, was in its third day of hearing public evidence.

It is examining Britain's involvement in Iraq, beginning with the run-up to the 2003 invasion and concluding in July 2009, but will not establish criminal or civil liability.

Mr. Meyer said that before he won office, Mr. Bush had acknowledged his weakness on foreign policy and saw Russia and missile defense as his priorities.

Prior to Sept. 11, the issue of Iraq was "like a grumbling appendix," Mr. Meyer said.

Asked at what point war with Iraq was inevitable, Mr. Meyer told the panel: "That is a damn hard question to answer."

"What was inevitable was that the Americans were going to bust a gut to carry out the mandated policy of regime change," he said.

But until December 2002, regime change by force was not the only option. Mr. Meyer said Ms. Rice had hoped "the pressure of coercive diplomacy" would force Saddam into exile, or prompt an internal coup.

He said Britain argued that attempts to increase pressure on Iraq through the United Nations weren't "pitiful, European lack of will," but rather a "cunning plan to get the guy."

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Bloomberg News

Dilek Yasar shopped for a coat in a Tisapeh store in Frankfurt last month. German consumer prices are stabilizing.

Lending is still weak

Growth will be slow, but euro zone's brush with deflation seems over

By Geoffrey T. Smith

FRANKFURT — The euro-zone economy is starting to grow again, but bank lending to businesses and households remains weak and is likely to act as a drag over coming months.

Figures released by the European Central Bank on Thursday showed business and household loans in the euro zone fell again in October, and at the fastest rate on record.

The report suggests an absence of inflationary pressures in the euro zone, and comes one week before the ECB meets to consider interest rates. Officials are widely expected to hold their key interest rate unchanged at 1% next week and well into 2010, a forecast supported by Thursday's lending data.

Credit to the private sector was down 0.8% in seasonally adjusted terms from a year earlier, the ECB said, after a 0.3% decline in the year through September. The weakness of corporate lending, which dropped 1.2% year-on-year, compared with a 0.2% decline in September, was chiefly responsible for the drop. The decline in credit to households eased marginally during the same timeframe, to 0.1% from 0.3%.

The global financial crisis and subsequent recession have led to the sharpest drop in credit growth in recent history. Corporate demand for investment has shrunk, while banks struggling to repair their balance sheets have been reluctant to lend.

"In all ... there is still little evidence that banks are becoming more willing to lend to the wider economy," said Ben May, an economist at Capital Economics. "This should provide a warning to the ECB not to be too hasty in changing the conditions of its provisions of liquidity to banks."

The data on corporate lending contrast with the sharp rise in business confidence in countries such as Germany in recent months. The ECB has blamed weak demand for the flaccid credit data, but the recent developments in business confidence are slowly putting the spotlight back on the issue of credit supply.

Credit conundrum

Germany's IFO business confidence index rises, but the volume of bank loans to euro-zone companies falls

Note: January 2009 = 100
Source: European Central Bank, Ifo Institute

"Even though the credit cycle has not turned yet, the signs are mildly encouraging, as some of lending aggregates are no longer in free fall," Federico Loredana, an economist with Unicredit, said in a note to clients.

The euro-zone economy grew in the third quarter, having contracted since early 2008. One consequence of that is that the currency area appears to be emerging from its brush with deflation, or a period in which consumer prices are lower than in the same period a year earlier.

Preliminary data Thursday showed that German consumer prices fell 0.2% in November from October, but were up in year-on-year terms for the first time since the summer, rising 0.3% from November 2008.

The figures appear to signal the end of a brief period in which the collapse in energy prices in the wake of the global financial crisis dragged the overall cost of living down, and they bear out widespread expectations that the rate of change in prices will stabilize above zero in the coming months.

In October, prices had risen 0.1% on the month and were unchanged from a year earlier. The Federal Statistics Office, Destatis, is now due to release a preliminary figure for the whole of Germany for November.

Timo Klein, an analyst with IHS Global Insight in Frankfurt, said the reports reinforce his expectations that core inflation is settling around an annual 0.5% in the near term, but added that he expects it to rise in 2010, prompting the European Central Bank to withdraw its non-standard monetary stimulus measures gradually.

With unemployment on the rise, it is unlikely that consumer spending will start to push prices higher any time soon. A survey released on Wednesday by research firm GfK showed a second successive decline in consumer confidence in Europe's largest economy, after six months of improvement.

Figures released Thursday also showed Spanish retail sales continued to fall in October, as one of Europe's fastest-rising unemployment rates undermines consumer spending.

Spanish consumer spending, a key pillar of Spain's formerly buoyant economy, has plummeted following last year's collapse of Spain's labor-intensive construction industry.

Government stimulus measures, including an €8 billion ($12 billion) infrastructure plan, have helped stem job losses and stabilize the fall in Spanish consumer spending.

According to Eurostat, Spain had a 19.3% unemployment rate in September, the second highest of the European Union behind Latvia.

Fast rising unemployment and bleak economic prospects have led Spanish households to pay down formerly high debt levels and build up their savings.

"De-leveraging should continue to limit the scope for a quick rebound in consumption," Citigroup economist Giada Giani said.

—Jonathan House contributed to this article.

An old solution applied to new problem - hedge funds

[Brussels Beat]

By Stephen Fidler

For politicians, crisis often creates opportunity, a chance to polish up ideas that had been growing dusty for lack of attention and present them as the answer to the problem the world now confronts.

It happens all the time. Attacks are mounted against New York and Washington, plotted by terrorists from Afghan soil, and senior figures in the U.S. government take out a long-nurtured plan from their back pockets and use the crisis to invade Iraq.

It has happened already in the current financial crisis. The Group of 20 leading economies decided this year they would clamp down on tax havens and pretend they were doing it to make the world financial system safer.

There may be plenty of good reasons to bash these jurisdictions – just as there were lots of good reasons to oust Saddam Hussein – but one of them is not to prevent a repeat of their role in the genesis of the financial crisis. Their contribution as tax havens to the financial turmoil of 2008 was close to zero. That can also be said of private equity funds, venture capital funds and—with a possible caveat about the way in which they may have helped expand leverage in the financial system as a whole—hedge funds.

The crisis originated with banks, the traditional and supposedly the most heavily regulated sector of the financial economy. Hedge funds, as Adair Turner, chairman of the U.K. Financial Services Authority, found, "did not play a significant role in the crisis."

But that hasn't stopped some European governments and politicians from behaving as if they had. Hence the proposed legislation on alternative investment funds that is currently meandering its way through the European Union law-making machine. The original proposal that came out of the European Commission in April was "one of the most political documents I've ever seen come out of here," said one commission official.

The reason it was so political, according to this person and others, that the funds were long-standing *betes noires* of the French and German governments and heartily hated by many members of the European Parliament. The funds were viewed on the continent as extending their malign tentacles into the European economic fabric from their lairs in London and New York.

What emerged, according to an official involved in subsequent negotiations, was a proposal designed to deal (rather clumsily) with hedge-fund managers that was widened at the last moment to include managers of other investment vehicles such as private equity funds, for which it was even less well suited. A lot of the work done by governments since then has been to better differentiate between the different types of funds, this person says.

The legislation focused on fund managers and designed to make sure they register and provide a huge amount of information to shareholders, investors and regulators. The original proposal would bar non-EU funds from marketing across the bloc and set leverage caps. The proposal, greeted predictably with an outcry in London, then moved on its two tracks through the European Parliament and through the European Council, where the national governments convene under the rotating president: currently Sweden. Eventually, the two versions will be reconciled to become law.

This week, two new versions of the text have emerged from each track. On Wednesday, Jean-Paul Gauzès, a former senior banker with Dexia who is the *rapporteur* of the parliament's economic and monetary affairs committee, published his proposal. Like all such proposals, it was viewed by the industry as a mix of good and bad, with some proposed solutions raising fresh questions.

Mr. Gauzès proposed to drop the exemption on funds that manage less than €100 million ($151 million) —or €500 million in the case of funds that do not borrow. This would bring into the net a host of small venture-capital and other vehicles that the industry argues have no significance.

He also suggested that the funds from outside the bloc could market in EU countries if allowed by national regulation, but could not use that entry to market to all EU countries. Some in London say this raises the prospect of less onerous responsibilities for non-EU funds than, say, for a U.K. fund that wants to market only within the U.K.

His proposals to limit fund managers' remuneration in a similar way to bankers are seen by some people as making it more difficult to encourage the necessary migration of financial speculation from banks—which carry implicit government guarantees—to hedge funds, which don't. A day later, the latest compromise text emerged from the Swedish presidency. According to people who have examined the two, they have in some important respects moved in tandem, though significant differences remain. Mr. Gauzès, for example, would now allow the commission to set leverage caps only "in exceptional circumstances" while the Swedish compromise has limits set by national regulators following broad guidelines set by the commission.

But the the process is far from over. Sweden will have to pass management of the discussions to Spain, which has in the past supported regulation of funds rather than of fund managers.

How Madrid will decide to manage this legislation is one more unknown. Indeed, the rotating presidency is just one more factor that makes predicting outcomes in the complicated and often mind-numbing process of European law-making even more hazardous.

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THE DUBAI DEBT CRISIS

Agence France-Press; Bloomberg News; Reuters

What Dubai owns

With revenue estimated at more than $30 billion, holding company Dubai World has vast investments, including DP World, the world's third-largest port operator; special economic-zones firm JAFZA, and real-estate projects in Dubai. Dubai World, wholly owned by the city-state's government, has interests in real estate, transportation, logistics, financial services and natural resources. Its principal shareholder is Dubai's ruler, Sheikh Mohammed bin Rashid al-Maktoum.

Here are some of its biggest investments in recent years:

- **P&O:** The British shipping-and-logistics company was sold for £3.9 billion in March 2006. It became a subsidiary of DP World.
- **HSBC Holdings:** In May 2007, Dubai International Capital, owned by the ruler of Dubai, said it bought into HSBC Holdings for a fund it manages, making the fund one of the largest investors in Europe's biggest bank. The holding company didn't provide details of the purchase made by the $2 billion fund, set up in 2006 to invest in the world's largest listed companies.
- **EADS:** In July 2007, Dubai International Capital said it acquired a 3.12% stake in Airbus parent EADS for its Global Strategic Equities Fund. The stake is currently worth $921 million.
- **Islamic Bank of Asia:** In May 2007, Dubai International, part of Dubai World, acquired a 5% stake in the bank, one of the largest in Asia and one of the highest credit ratings in the region.
- **Deutsche Bank:** In May 2007, Dubai World said it bought a 2.2% stake in Deutsche Bank through DIFC Investments, becoming the fifth-largest shareholder in Germany's biggest listed bank. The stake was around $2.01 billion at the time.
- **Barneys:** In 2007, Istithmar, an investment arm of Dubai World, bought Barney's, owned by Jones Apparel Group, for $942.3 million after Japanese retailer Fast Retailing pulled out of the bidding.
- **Sony:** In November 2007, Dubai International Capital said it made a "substantial investment" in Sony.
- **MGM Mirage:** In August 2007, Dubai World said it was investing up to $5.2 billion in MGM Mirage by buying shares and half of a major Las Vegas project.
- **Zimbabwe luxury-game project:** A consortium led by Dubai World invested $17 million for a stake in Zimbabwe's Bubye Conservancy in Matabeleland South province. The resort hosts game and luxury lodges and remains a favorite haunt of American big-game hunters.
- **Turnberry Resort:** The Scottish hotel resort, a favorite with golfers, was bought in October 2008 for £50.2 million.

Warning signs were ignored

By Neil Shah
And Cassell Bryan-Low

Bonds of Dubai World's real-estate subsidiary plunged in value Thursday, a day after the troubled Gulf city-state rattled investors throughout Europe's financial markets by delaying the state-run conglomerate's debt payments.

Roughly $3.5 billion of Islamic bonds, called sukuk, from Dubai World real-estate subsidiary Nakheel dropped from around 110 cents on the dollar before the news Wednesday to around 70 cents, in a sign Dubai's decision caught investors completely off guard. The bonds are due to mature Dec. 14.

Investors may have assumed emergency support from the U.A.E. would ensure Dubai would pay all its obligations.

European stock markets also fell sharply in the wake of the Dubai World news, with investors fretting over the possibility of losses for European banks exposed to Dubai. In the bond markets, worries grew over the ability of riskier government borrowers from Russia and Turkey to Greece and Italy to pay back their debts.

Nakheel bond holders sought legal advice Thursday on their options, including whether they could seize some assets.

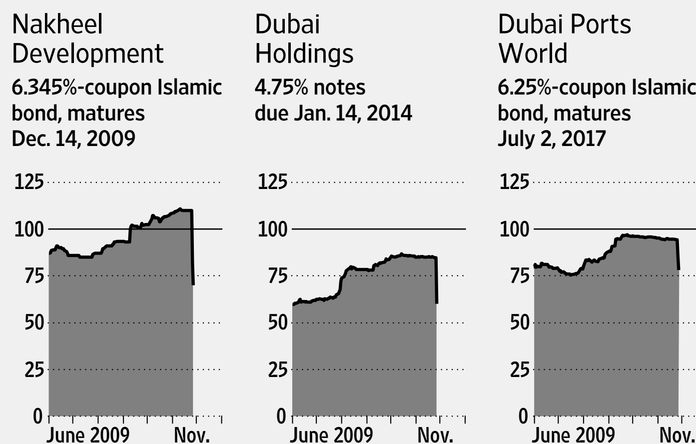
Significant bond holders include QVT Financial LP, a New York-based hedge fund which manages about $8 billion in total assets, according to people familiar with the matter. Other recent holders of Nakheel bonds include money managers BlackRock Inc., of New York, and London's Ashmore Group PLC, according to holdings disclosed on Bloomberg. BlackRock and Ashmore declined to comment.

The question now: Why were holders of Nakheel's bonds surprised?

For months, investors have harbored concerns about Dubai, one of seven semiautonomous emirates that make up the United Arab Emirates. After years of riding the credit boom, Dubai is struggling to overcome an economic crisis triggered by the collapse of its real-estate sector.

Investor complacency amid the global economic recovery may partly explain the rude surprise. But a deeper reason is that investors may have mistakenly assumed that recent emergency support coming from the broader United Arab Emirates would ensure Dubai would pay all its obligations on time.

The new fear: Any help from Dubai's oil-rich neighbor, Abu Dhabi, may be used to help Dubai, but not its state-run corporate entities.



"I think people made the linkages they wanted to make," says Jeremy Brewin, head of emerging-market debt at Aviva Investors in London. "We need to distinguish between sovereign and "sub"-sovereign debt."

Mr. Brewin doesn't own Dubai-related debt, but he does hold bonds from Qatar, which also fell on Thursday.

Dubai said Wednesday it raised $5 billion from two lenders, the latest installment in what has effectively become, since February, a multibillion dollar bailout by the United Arab Emirates, which is led by Abu Dhabi. The price of Nakheel's bonds initially rose on the news.

But bond prices sank after Dubai said it will restructure its biggest corporate entity, Dubai World, and ask lenders to put off debt maturities until at least May 30.

Mr. Brewin says many investors assumed that the cash coming from the United Arab Emirates would give Dubai ample ability to pay off the Nakheel bond. Dubai had also sent signals that it was willing to support its corporate entities.

A problem now, observers say, is that the circumstances behind Dubai's moves are murky, making it hard to gauge the exact risk to the bonds and Dubai's own general creditworthiness.

"The uncertainty may drag on for some time yet, before we have a clear idea as to how issues will be resolved," said Huw Worthington, an analyst at Barclays Capital in London.

Dubai's debt troubles sent ripples through European markets Thursday, fueling concerns about European banks' exposure to Dubai. It also enflamed growing concerns about the ability of other financially-stretched countries to pay their own debts.

In the derivatives market, investors had to pay higher prices to insure themselves against a debt default. The cost to insure $10 million of Abu Dhabi government bonds for five years jumped about $60,000 to $160,000 annually, a massive move.

Similar costs for Qatar rose $27,500 to $120,000, while Turkey's costs rose by $9,500 to $207,500. Russia's debt-default insurance costs rose $12,500 to $207,500.

The cost of insuring $10 million of Dubai's own debt from default for five years jumped about $120,000 on Thursday to roughly $560,000 annually.

THE DUBAI DEBT CRISIS

Monarch is patron of sport of kings

Dubai's ruler is considered the most powerful individual in racing, with more than 700 horses in training

By Jonathan Clegg

As a hereditary ruler it is only natural that he should be attracted to the sport of kings. But Sheikh Mohammed bin Rashid Al Maktoum, the ruler of Dubai, has eclipsed other monarchs with his love of the turf. He's the world's largest owner and breeder of horses, one of four Maktoum brothers to have invested heavily in British racing. He is widely considered the most powerful individual in the sport today.

His patronage of the sport has been credited with shifting the balance of racing power from the U.S. to Britain. The vast sums he has invested since purchasing his first stud farm in 1981 are unquantified. But he has more than 700 horses in training, 7,000 acres of paddocks and 5,000 acres of farmland at Newmarket, the home of British racing. The land and facilities are currently valued at £130 million ($216.5 million).

In short, his investment in British racing is such that his withdrawal would represent a crippling blow to the sport. "It is impossible to underestimate his influence on British racing. He has transformed the landscape of the sport," says Jon Ryan, director of communications at the British Horseracing Authority.

"To own and breed on the scale that he does is a pretty extraordinary commitment and now an integral part of racing in this country. If he wasn't there he would be hugely missed." Sheikh Mohammed's racing empire extends beyond Britain, however, and he owns similar swathes of land in Ireland, the U.S. and Japan, while his £210 million purchase of Australia's biggest and most successful owner-breeder operation in March last year saw him hailed as the most powerful figure in the country's racing industry.

His influence has helped the Gulf secure a prominent position on the world racing scene. All of his horses are trained in Dubai during the winter, while the annual Dubai racing carnival he established has become the world's richest series of horse races.

In the past two years alone, he has poured £150 million into buying 10 superior thoroughbreds, which are transported to his training facilities across the globe in a custom-built 747 jet, and his acquisitions have been credited with maintaining the bloodstock market.

"His pursuit of thoroughbreds has had a trickle-down effect throughout the whole industry and really supported the market," says Mr. Ryan.

Sheikh Maktoum's money has bought success. Godolphin Stables, which he created in 1994, has won every major event in horse racing, with the lone exception of the Kentucky Derby.

Agence France-Presse

Sheikh Maktoum tips his glasses in the parade ring during the first day of Royal Ascot earlier this year

Markets finally react

Continued from first page

debt payments.

The "standstill announcement" came after local business hours Wednesday and just before a long-weekend holiday across the Muslim world. It surprised bankers and analysts, who had been reassured by positive statements from Dubai officials over the city-state's finances, and the recent willingness of Dubai and the federal government based in Abu Dhabi to step in and plug financing holes.

"The most negative effect of yesterday's announcement is a major shock to confidence in the U.A.E., and the region more generally," said Richard Fox, a credit analyst at Fitch Ratings in London. "People will now question government support."

The Dubai World restructuring represents the most significant fallout so far in the city-state's yearlong economic crisis, triggered by a collapse in Dubai's once-booming real-estate sector late last year. Regional banks were already hobbled by a global credit freeze late last year and exposure to Dubai's wilted property market.

Late Wednesday, Moody's Investors Service and Standard & Poor's heavily downgraded the debt of various other Dubai government-related entities. Moody's slashed to junk status several Dubai entities, including the property developer Emaar PJSC, which is slated to open the world's largest skyscraper next year.

Agencies have been downgrading Dubai entities for the better part of a year, as they reassess the willingness and ability of the government to support its indebted corporations. Standard & Poor's said Thursday the Dubai World restructuring "may be considered a default under our default criteria, and represents the failure of the Dubai government ... to provide timely financial support to a core government-related entity."

The market moves are all likely to translate into much higher borrowing costs for Dubai entities as they face looming debt maturities over the next few years. Standard & Poor's recently estimated Dubai's government and its corporations have some $50 billion in debt coming due just in the next three years.

Holders of a $3.5 billion sukuk, or Islamic bond, issued by Dubai World property subsidiary Nakheel, due next month, face the most immediate threat of delayed payments. Several Nakheel holders had scheduled a conference call to discuss options later Thursday, according to Zawya Dow Jones.

The bond was seen as a crucial test of Dubai's ability to pay its debts.

The standstill request is one more troubling development for international banks, which turned in recent years to the oil-rich Middle East as a fresh source of income. While banks across the region have been relatively insulated from the worst of the financial crisis, international lenders have been burnt by some of the region's once high-flying developers and conglomerates.

Local and international banks are also licking their wounds from the debt troubles this year of two big family-run Saudi Arabian conglomerates, which owe more than 100 lenders a conservatively estimated $15 billion.

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U.S. NEWS

Firms turn to overtime before hiring

U.S. manufacturers call extra hours the most cost-effective way to increase output, but trend prevents new jobs

By Kris Maher
And Timothy Aeppel

CLEVELAND—Overtime is returning at many manufacturers, boosting workers' battered wages and helping companies increase output during a period of uncertain growth. But the trend could prevent the improving U.S. economy from creating new jobs—at least for now.

Executives say boosting overtime is the most cost-effective way to handle tentative increases in demand as the U.S. emerges from a severe recession. Overtime enables companies to increase productivity to meet rising customer orders without adding fixed costs such as health-care benefits for new hires. If business suddenly slows, they can dial back hours without having to make costly layoffs.

And for workers who are still employed after an extended period of job cuts, reduced hours and unpaid furloughs, overtime offers a chance to catch up to their prerecession income and pay off debt.

"Since overtime is more costly than straight time, there comes a point that it makes sense to take on new workers," said Sophia Koropeckyj, managing director of Moody's Economy.com. She notes that coming out of the recession earlier this decade, the machinery and fabricated-metals sectors began adding jobs 18 months after they started increasing overtime.

Tim Harrison for The Wall Street Journal

Dave Gibney at Jergens Inc. in Cleveland Wednesday. He is among about 10% of Jergens workers receiving overtime regularly.

In October, the manufacturing sector shed 61,000 people, while those still employed were working more hours: Overtime increased 6.5% to 3.2 hours per week in October from September's level of three hours and 14% from the 2.8 hours of overtime averaged in the second quarter.

"That's still light compared to the norm," said James Meil, an economist at Eaton Corp., a diversified manufacturer in Cleveland that turned to furloughs during the slump. Mr. Meil said overtime at manufacturers averaged as high as 4.6 hours a week during the most recent boom.

Executives also view overtime as a motivational tool, and say that if workers are eager for fatter paychecks from overtime, they will likely be more productive.

"So much of production is attitude. Just adding pockets of overtime when it's appropriate tends to" improve workers' attitudes, said Jack Schron, president of Jergens Inc., a 65-year-old family-owned machine shop that makes quick-release pins for everything from military machine-gun mounts to Nascar racing cars. The Cleveland company, which has a wall of framed pictures of employees with 25 years' service, shed more than 25 of its 300 workers and axed overtime hours early in the downturn.

But to the relief of workers such as Dave Gibney, Jergens recently added overtime. Mr. Gibney, a 35-year-old machinist, started peppering his supervisor three times a day with requests for overtime in late August, when he saw orders reviving. Working the standard 40 hours a week, he had fallen behind on his monthly $875 mortgage payment. He is now up to between 42 and 47 hours a week.

"Eventually they're going to hire new people. I just feel in the meantime, it's better to pay a few good people a little extra," he said.

About 10% of workers at Jergens receive overtime regularly now. "Right now you're not seeing a huge number of jobs being added because we're all going through this incremental growth," Mr. Schron said.

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Jobs and spending data point to growth in quarter

By Luca Di Leo

WASHINGTON—U.S. consumer spending and incomes rose in October and initial jobless claims last week fell to the lowest level in more than a year, boding well for economic growth in the fourth quarter.

Meanwhile, new-home sales unexpectedly climbed in October despite uncertainty at the time about the future of a big tax credit for first-time buyers. Sales of single-family homes increased 6.2% to a seasonally adjusted annual rate of 430,000.

In a sign that the recovery remains sluggish, however, demand for long-lasting goods unexpectedly fell in October and a barometer of capital spending by businesses tumbled.

Manufacturers' orders for durable goods decreased 0.6% in October, as demand for military goods plunged. While generally negative, the report had a few bright spots. September durables were revised much higher, to show a 2.0% increase. Importantly, a big moderation in the pace of inventory liquidation has positive implications for fourth-quarter gross domestic product.

Following Wednesday's data, economists at Morgan Stanley revised their fourth-quarter GDP growth forecast to 3.1% from 2.7%. Goldman Sachs economists said they now believe GDP could expand by more than the annualized 3% they have forecast for the current quarter.

Consumer spending, a key growth engine for the U.S. economy, bounced back to rise 0.7% in October, the Commerce Department said Wednesday. That came after a 0.6% decline in September, when spending was hurt by the end of the federal "cash for clunkers" automobile-rebate program.

A separate report showed that initial claims for unemployment benefits declined by 35,000 to 466,000 in the week ended Nov. 21. It was the lowest claims figure since September 2008 and the first time initial claims have fallen below the 500,000 mark since early January.

The four-week moving average of new claims, which aims to smooth volatility in the data, also fell, by 16,500 to 496,500 from the previous week's revised average of 513,000. That is the lowest figure since Nov. 8, 2008.

J.P. Morgan economist Abiel Reinhart said November's payroll decline, due to be released Dec. 4, should show a moderation to around 100,000, following drops of nearly double that level in recent months.

Last month, spending by Americans rose as incomes increased by 0.2% for the second-straight month and inflation remained low, a positive sign ahead for the Thanksgiving and Christmas shopping season. Personal-income data for the previous months was revised up. Consumer spending accounts for about 70% of U.S. economic output.

Meanwhile, a key gauge of prices that is closely watched by the Federal Reserve to set monetary policy reinforced the view that inflation wasn't a threat as the economy recovers slowly. The core price index for personal-consumption expenditures, which excludes volatile food and energy, rose a monthly 0.2% in October and by 1.4% year-on-year.

—Sarah N. Lynch and Jeff Bater contributed to this article.

WORLD NEWS

Going nuclear

Mohammed ElBaradei's 12-year tenure as Director General of the International Atomic Energy Agency has been marked by controversy and often-heated clashes with the U.S.

December 1997: ElBaradei, an Egyptian diplomat, succeeds Sweden's Hans Blix as chief of the U.N.'s atomic watchdog.

October 2002: ElBaradei asks the U.N. Security Council for an "impartial inspection" of Iraq's nuclear capability, following U.S. claims Iraq is hiding a weapons program. (CAN DROP THIS ONE)

January 2003: ElBaradei tells security council the IAEA found no clear evidence of Iraq possessing a nuclear weapon.

November 2003: Iran suspends enrichment of nuclear fuel; agrees to cooperate with inspectors.

February 2004: ElBaradei criticizes nations that demand strict proliferation controls of other nations, while continuing to maintain their own nuclear arsenals.

Early 2005: The U.S., citing what it considers ElBaradei's soft stance on Iran, opposes his re-election as director general but backs down when other nations support his candidacy.

October 2005: The Nobel Committee awards ElBaradei and the IAEA its Peace Prize.

December 2005: ElBaradei begins third term as director general. (CAN DROP THIS ONE)

January 2006: Iran resumes enrichment of uranium fuel in defiance of previous agreements.

June 2007: IAEA inspectors return to North Korea more than four years after they were ordered out.

April 2009: North Korea expels IAEA inspectors.

May 2009: North Korea tests suspected nuclear weapon.

September 2009: Iran discloses a previously undeclared nuclear installation.

Nov. 30 2009: ElBaradei set to step down.

Mohamed ElBaradei at a news conference in Berlin, Nov. 20, 2009.

Agence France-Presse/Getty Images

Iran resolution looms

BY DAVID CRAWFORD AND MATTHEW KARNITSCHNIG

VIENNA—Iran appeared headed for further confrontation with the U.S. and other world powers over its nuclear program after the chief of the United Nations' atomic watchdog said the agency's cooperation with Tehran had reached a "dead end."

The declaration by Mohamed ElBaradei, departing director general of the International Atomic Energy Agency, sets the stage for the U.N.'s Security Council to impose new sanctions against Tehran.

Diplomats said the IAEA's 35-member board of governors would likely approve a resolution on Friday rebuking Iran for failing to comply with its international obligations. A draft of the resolution being discussed by IAEA governors Thursday expressed "serious concern" about Iran's course and called for the matter to be taken up by the Security Council.

German Ambassador Rüdiger Lüdeking told the governors that Iran's "disregard" of its obligations toward the IAEA "cannot be ignored" because the IAEA's outstanding questions presented to Iran "relate to possible military dimensions of Iran's nuclear program."

One Western diplomat said at least 22 governors, four more than required for passage, are expected to vote for the resolution. The resolution, put forward by Germany, is supported by governors from the five permanent members of the U.N. Security Council—the U.S., U.K., France, Russia and China, diplomats said.

It isn't clear whether the Security Council, which has already imposed some sanctions on Iran in connection with its nuclear program, would be willing to implement even stricter measures. China and Russia, for example, both have commercial ties to Tehran which might be threatened by such a step.

International criticism of Iran's nuclear program escalated in September after the existence of a previously undisclosed uranium-enrichment facility near the holy city of Qom came to light. U.S. President Barack Obama has said the operation appears to be designed to produce fuel for a secret military program.

The U.S. is worried that Iran's nuclear ambitions could further destabilize the entire Middle East. Of particular concern is that Israel could launch a military strike against the Iran's nuclear sites, a step that could lead to a broader war.

The impasse with Iran follows weeks of diplomatic efforts by the U.S. and other countries aimed at convincing Tehran to accept controls on its nuclear activities.

The failure of the diplomatic offensive is a blow to the Obama administration. The U.S., which accuses Iran of supporting terrorism, had declined for decades to hold bilateral negotiations with the country. But the Obama administration, arguing that the strategy of isolating Iran had failed, decided to change tack.

In recent weeks, the U.S. has pushed for a compromise that would have required Iran to ship much of its uranium stockpile out of the country. The uranium would have then been processed into fuel that could be used for peaceful purposes, Iran's stated intention for its nuclear program.

Tehran initially signaled it would accept the agreement, brokered by Mr. ElBaradei, but then backed away from it. Some analysts say they believe Iran's waffling was less political calculation than continued disarray in the country's government following the disputed presidential election in June.

Mr. ElBaradei put considerable effort into trying to seal a deal, expressing hope as recently as a week ago that Tehran would accept the terms.

U.S. hopes to use small idea to push big change in Iran

[Capital Journal]

BY GERALD F. SEIB

Sometimes the smallest ideas can have the biggest impact. And so it may be in helping push change in Iran.

Almost without notice, a small initiative to help democratic reformers in Iran is moving through the U.S. Congress. The notion is disarmingly simple: With a small investment of money, the U.S. government can help Iranian citizens get around efforts by the Iranian regime to block their use of the Internet to communicate with each other and the outside world.

The power of this idea became apparent amid the widespread anger in Iran over the country's disputed presidential election this summer. After President Mahmoud Ahmadinejad's re-election was announced, hundreds of thousands of Iranians took to the streets to protest the dubious circumstances, the largest showing of popular unrest since the 1979 Iranian revolution.

The most powerful tools the latest protesters had were the Twitter, Facebook, MySpace and text messages they could circulate to organize among themselves and to communicate to the outside world. And so the Iranian government, as part of a general campaign to suppress protest, stepped in to cut off or slow down the freedom marchers' Internet access, and to monitor traffic as a way of ferreting out leaders.

Throughout the months since the election, the question perplexing U.S. policy makers has been whether and how America might encourage the reform movement in Iran, without being so heavy-handed as to make the protesters appear to be foreign stooges. That was the question a bipartisan group of senators and their staff members began brooding over during the summer.

"One day we began brainstorming: What could we do?" recalls Richard Fontaine, who at the time was an aide to Republican Sen. John McCain of Arizona, and now is a senior fellow at the Center for a New American Security. "Something's happening in Iran, and we don't quite know where it's going to end up."

The initial impulse of most observers, Mr. Fontaine notes, was to impose economic sanctions on Iran's government to register displeasure at its suppression of democracy protesters. But the U.S. already has imposed broad economic sanctions, and there were bills in the hopper to do more. "So we started thinking what can you do on the positive side, not to just bombard Iran with messages from America, but to facilitate the kind of remarkable political discussion the world had seen after these protests broke out," Mr. Fontaine says. "Not as a regime-change thing, but in supporting the intrinsic values the U.S. stands up for."

The fruit of those discussions was the Victims of Iranian Censorship Act—or Voice—a piece of legislation that, at its core, authorizes the U.S. government to develop proxy Web servers and Web addresses beyond the reach of the Iranian government, and to deploy technologies that would allow Iranians to go to those sites anonymously to stay in touch with one another and the outside world via the Internet.

The beauty of the Voice idea is that it allows the U.S. to get around the two concerns, both valid in their own right, that have crimped Washington's ability to support the reform movement in Iran. The first concern was the worry that any overt American help would discredit the protesters in Tehran by enabling the Iranian regime to portray them as tools of a foreign government. The second was the difficulty in pursuing anything that looks like policy aimed at changing the Iranian regime at the very time the Obama administration and all its major allies were road-testing the idea that it's possible to use diplomatic engagement to change that same regime's behavior, particularly regarding its nuclear program.

To some extent, Voice skirts both problems. It doesn't give direct American assistance to the protest movement, but merely stands up for the universally applauded notion of free speech. And while it may give oxygen to the reform movement, it doesn't amount to anything like a regime-change policy.

So a group of senators from across the spectrum—Democrats Ted Kaufman of Delaware and Robert Casey of Pennsylvania, Republicans Lindsey Graham of South Carolina and Mr. McCain, and independent Joe Lieberman of Connecticut—introduced the legislation jointly. In late July it passed the Senate as part of a bigger defense-authorization bill.

The next step is to appropriate money to actually pay for the programs the act authorizes. The effort to do that is under way, largely behind closed doors, as the Senate and House work to wrap up a bill that funds the State Department and other foreign operations for next year. Sen. Sam Brownback, a Kansas Republican, has taken the lead in trying to ensure that money is put in place. The Senate's version, congressional aides say, includes $30 million for Internet countercensorship and similar activities, while the House version has $15 million.

The idea is uncomfortable for the Obama administration, largely because some advocates of Internet-freedom legislation have in mind helping Chinese dissidents, not Iranian democracy protesters. Wrangling with China's leaders, on whom the U.S. is depending for help with, among many other things, putting pressure on Iran, is a much trickier proposition. Still, some simple ideas are hard to resist.

Associated Press

Drop offs

Euro-zone exports to selected countries, rate of change from Jan. to Aug. 2008 compared to the same period this year

Country	Change
Russia	–40%
U.K.	–25%
Poland	–25%
U.S.	–21%
Japan	–18%
China	–2%

Source: Eurostat

French Finance Minister Christine Lagarde, right, extends a greeting to euro-zone finance minister Chairman Jean-Claude Juncker, European Commissioner for Economic and Monetary Affairs Joaquín Almunia, and ECB President Jean-Claude Trichet.

A push from the EU to free the yuan

Trichet to press Beijing as economists wonder if Europe's trade depends more on demand than currency rates

By Brian Blackstone

Top European officials will press China this weekend to allow its currency to rise against the euro, amid political fears that the euro's strength could undermine Europe's recovery from its worst recession in decades.

European Central Bank President Jean-Claude Trichet, euro-zone finance minister Chairman Jean-Claude Juncker and European Economic Commissioner Joaquín Almunia are due to meet Sunday with top officials from China's central bank and finance ministry in Nanjing, where they will lobby for a stronger Chinese yuan.

European officials made a similar excursion to China two years ago, with little result. The yuan—whose value China links to the U.S. dollar—has risen only about 7% against the euro since then.

China's vice foreign minister, Zhang Zhijun, reiterated his country's currency policy on Tuesday, saying China will keep the yuan "basically stable around reasonable, balanced levels." Such statements suggest that the visitors are unlikely to win China's agreement to allow a faster yuan appreciation, analysts say.

That might not matter as much as European officials think, analysts say. Despite the high-profile appeal, many economists and business leaders say Europe's exports may depend less on the euro's exchange rate than on China's ability to deliver economic growth and support a revival in world trade volumes.

Global demand is three to four times as powerful as exchange rates in determining exports, says Silvio Peruzzo, economist at Royal Bank of Scotland in London. So if the euro appreciates 5% and global trade expands by an equal rate, the net effect for the euro zone would be an extra one percentage point of gross domestic product, he says.

A higher yuan would be "nice to have," said Volker Treier, chief economist at the German Chambers of Industry and Commerce, since it would make European-made products more competitive on price against Chinese goods. However, "right now the demand side is the more decisive one."

J.P. Morgan economists also say global demand for European goods is a more important determinant of the euro zone's exports than currency rates, and estimate it would take a very large rise in the euro's level to prevent strong export growth over the next few quarters.

Business leaders agree. "The volume to be generated throughout the upturn is more important than the exchange-rate hurdle," noted Karl Haeusgen, chief executive of **HAWE Hydraulik SE**, an engineering company based in Munich. And in the specific case of China, the exchange rate "is less of a problem" than in other markets, he said, because customers there are willing to pay a premium for technology.

The euro's steady rise hasn't scared off other German exporters, either, especially those in specialized engineering products that are less sensitive to price fluctuations than cheap, mass-produced goods.

"The product is the focus, not the currency," said Dagmar Bollin-Flade, chief executive of **Christian Bollin Armaturenfabrik** GmbH, one of Frankfurt's oldest businesses producing specialty valves for the petrochemical industry and power plants.

Last year the Bollin firm, which makes over 350,000 different kinds of shut-off valves, was able to sign deals in China despite the high euro. Demand from China has tapered off since, she said, but that is more due to changes in the structure of Chinese power plants than it is the euro.

A higher yuan and robust Chinese demand would be best, "but if I had to make a choice, demand is more important," said Gernot Nerb, head of industry research at the Ifo Institute for Economic Research. Ifo's closely watched survey of German companies has shown a rise in export expectations, thanks to demand in China and other emerging economies like Brazil, Mr. Nerb said.

EU officials say they want to make the case that a stronger yuan is good for both China and Europe. According to people within the European Commission, the three officials are preparing presentations for the Chinese that model the potential effects of a stronger yuan, including subduing domestic inflation in China.

The yuan is currently set at around 6.85 to the dollar, so when the dollar declines against other floating currencies like the euro, China's currency declines with it, making Chinese products cheaper in global markets. The euro passed the key $1.50 threshold this week, hitting a 15-month high against the dollar.

At €43 billion ($64 billion) this year through August, China still makes up only a small share of total euro-zone exports, trailing the U.K. and U.S. But unlike euro-zone exports to the U.S. and U.K., which are down 20%-plus from last year, the region's exports to China have held steady. Economists say they should resume firm growth soon. The Organization for Economic Cooperation and Development expects China's economy to expand over 10% next year, three times as fast as global GDP.

—Terence Poon and Adam Cohen contributed to this article.

China meets East Europe

By Christopher Emsden

China is beginning to poke around Southeastern Europe for business deals, taking advantage of a capital drought in the region to gain a manufacturing toehold inside the 27-member European Union.

Chinese companies have carved out niche stakes in Romania and Bulgaria, and China's government is offering a $1 billion credit line to Moldova. Investment flows are still a trickle, totaling €71 million ($106.3 million) last year, according to Eurostat. But they are poised to rise quickly, with a flurry of recent deals.

Nowhere is fresh capital more needed than in the Balkans, where economies have been pushed into recession as huge current-account deficits have proved impossible to finance since the euro-zonebanks that traditionally supplied credit have reined in lending.

While Serbia, Moldova and even Turkey make strategic sense for China, Romania and Bulgaria in particular offer cheap "back-door entry" to the whole EU market, said Margot Schuler, an economist at the German Institute of Global and Area Studies.

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Concerns over capacity

By Andrew Batson

BEIJING—The new investments funded by China's stimulus plan may swamp world markets and lead to a surge in trade conflicts, an international business group said, in a sign of the rising concerns over the side effects of the government's drive to support growth.

The European Union Chamber of Commerce in China, in a report Thursday, said a combination of easy credit and other incentives for Chinese companies to expand has led to the construction of new factories in sectors such as steel, aluminum, cement and chemicals. China's increase in industrial capacity—at a time of global economic weakness—could drive down profit margins world-wide and lead to a backlash from other countries, the chamber said.

"The Chinese stimulus package has poured credit into increasingly questionable projects and will almost certainly increase direct and indirect subsidies to investment and manufacturing," the report says. "China's growth model requires that external demand—the European Union and the United States—be able to absorb the overcapacity it produces," a prospect that is increasingly unlikely given the weak economic recovery in the developed countries. The chamber urged the U.S. and EU to encourage China to change its policies to prevent an eruption of trade disputes, which already are increasing.

The chamber of commerce represents businesses that could benefit if there were less competition from Chinese factories. But many analysts believe that China's massive expansion of industrial capacity is tied to broader economic problems, such as its persistent trade surpluses, high national savings rate and enormous foreign-exchange reserves.

China's government has also increasingly focused on the risks from the boom in bank loans and public-works projects. In recent months Beijing has announced restrictions on new investment in sectors it has identified as having excess capacity, and regulators have quietly moved to cool down the surge in bank lending.

"In many sectors the problems of excess capacity and redundant construction are still very serious, and in some areas they are even worsening," China's State Council said in a September statement. For instance, the government estimates that new steel mills capable of producing 58 million metric tons a year are now under construction—even though the industry's annual capacity, at 660 million tons last year, already exceeded domestic demand of around 500 million tons.