Leading the News: Lisbon Treaty could be EU's last federalization bid for a while

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Powerful earthquake rocks Indonesian island

Reuters

WIDESPREAD DEVASTATION: A man sits on a motorcycle outside a collapsed shopping mall in Padang, Sumatra. At least 75 people died and thousands were trapped under rubble there, officials said. Page 3.

European markets sizzle

But weak end to quarter revives doubts about durability of shares' rally

By Sarah Turner And Annelena Lobb

European stock markets ended one of their strongest quarters in years with a whimper, raising questions about the durability of a rally that stretches back to March.

France and the U.K. led the third-quarter romp with the CAC-40 and the FTSE-100 surging nearly 21%. It was the best quarterly percentage gain in the 25-year history of the U.K. index and the best quarter for the French index since the end of 1999. Germany's DAX rose 18%, its best quarter since 2003.

The pan-European Dow Jones Stoxx 600 index gained nearly 18% for the quarter, its best performance since the fourth quarter of 1999. The Dow Jones Industrial Average rose 15% in the quarter.

Wednesday, the FTSE 100 index declined 0.5%, its fourth loss in six sessions, to 5133.90. The DAX index fell 0.7% to 5675.16, and the CAC-40 index lost 0.5% to 3795.41. For both, it was the fifth loss in the past six sessions.

During the quarter, global stock markets extended a rebound that began in early March as fears of ever-intensifying financial system problems began to abate. Since then, investors have steadily increased their appetite for risk, helping to drive stock markets higher.

Markets in Poland, Hungary and the Czech Republic had strong quarters, but many Central and Eastern European markets didn't match the huge gains made in the second quarter. Russia's RTS index, for instance, gained 27% in the third quarter compared with a 43% surge in the second quarter. Gains were more modest across Asia, and China's Shanghai Composite index

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Russia, Georgia share EU blame

By Marc Champion

BRUSSELS—Both Russia and Georgia claimed vindication Wednesday after a nine-month European Union investigation into last year's war in the Caucasus found that Tbilisi triggered the conflict, but Moscow acted illegally in the extent of its invasion of Georgia and allowed "ethnic cleansing."

The roughly 1,000-page EU report, released on Wednesday by Swiss diplomat Heidi Tagliavini, found no evidence to back Russian claims that Georgia committed genocide on the night of Aug. 7-8, 2008.

The conflict, which briefly brought the U.S. and Russia into Cold War-style confrontation, left some 850 people dead and 35,000 displaced, and severely weakened Europe's security agreements. Russian forces remain in occupation of two Georgian territories, Abkhazia and South Ossetia. Moscow has recognized them as independent states.

Ms. Tagliavini's conclusions were nervously awaited by both sides, each of which has brought lawsuits against the other in international courts. While the report attacked Russia's efforts to enforce a sphere of influence among its ex-Soviet neighbors, the finding that Georgia shot first could undermine Tbilisi's efforts to push to join Western institutions such as

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Armani executives will take new duties

By Christina Passariello

Giorgio Armani, after recovering from a months-long bout of hepatitis, slightly loosened his grip on his fashion empire Wednesday, naming one of his most-loyal executives as deputy chairman, as part of a management reorganization.

The reorganization—which includes expanding his company's board of directors and delegating more power to nonfamily members—comes as the self-described "dictatorial" designer grapples with the future of his business.

The 75-year-old Mr. Armani, who owns 100% of Giorgio Armani SpA, is a rarity in that he runs the creative and business sides of his Italian fashion house. He recently attributed his illness to the physical and mental toll of working long hours for decades. The question of whether a fashion house can outlive its designer is perhaps more urgent at Giorgio Armani than at any other family-owned fashion business. The white-haired designer is inextricably linked to the brand's image, taking the runway bow, personally dressing celebrities such as Cate Blanchett, and attending the Academy Awards.

Mr. Armani shot to fame in the 1980s for his tailored jackets, stripped of their bulky lining, and for courting Hollywood. His styles are acclaimed for their expert cut and their classic look that can

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Olympic hopefuls

As Friday's vote looms, four 2016 bid cities make pitches
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Markets

4 p.m. ET

	CLOSE	PCT CHG
DJIA	9712.28	-0.31
Nasdaq	2122.42	-0.08
DJ Stoxx 600	242.47	-0.46
FTSE 100	5133.90	-0.50
DAX	5675.16	-0.67
CAC 40	3795.41	-0.49
Euro	$1.4615	+0.52
Nymex crude	$70.61	+5.85

LEADING THE NEWS

Brown tries to keep focus on new policies

Labour plays up pledges from speech but loses a supporter

By Laurence Norman

BRIGHTON, England—U.K. Prime Minister Gordon Brown after promising a comeback to his Labour Party faithful in the climactic speech of the party's annual convention, was on the defensive on Wednesday .

Mr. Brown had on Tuesday toasted the Labour government's hefty investment in public services, unveiled a series of social policy initiatives including expanded free care for the elderly and young children, and sought to rouse Labour members for the task ahead.

A YouGov poll for Sky News taken Tuesday evening after the speech showed a poll bounce from Mr. Brown's speech. YouGov had Labour just seven percentage points behind the Conservatives—four points less than the gap on Monday and the slimmest difference for months.

On Wednesday, senior ministers sought to maintain the momentum, pushing ahead on some of the new proposals. Business Secretary Peter Mandelson announced an increase in the minimum salary and said the government would ban employers from using tips to meet that basic wage.

The Sun daily newspaper stole some of the momentum by saying it was switching its allegiance to the opposition Conservative Party. The paper's support was unlikely to have won Mr. Brown the election due by June, given how far behind in the polls Labour already is. Britain's partisan newspapers—ranging from the left-wing Guardian to the right-wing Daily Telegraph—tend to "reinforce public attitudes rather than change them," said Peter Kellner, president of polling firm YouGov.

But Mr. Kellner said the Sun's move mattered in terms of Labour Party morale and "because it's distracted attention from Gordon Brown's speech."

The Sun, the U.K.'s biggest-selling daily, had demonized the Labour Party throughout the 1980s and early 1990s and Mr. Brown's predecessor, Tony Blair, had lobbied for its support as he aimed to broaden the appeal of the Labour party. Labour won the paper's endorsement in 1997 and kept it in the next two elections.

Press Association

'People decide elections, not newspapers. And it's the people who will make up their minds,' U.K. Prime Minister Gordon Brown told Sky News Television.

"People decide elections, not newspapers. And it's the people who will make up their minds," Mr. Brown told Sky News Television on Wednesday morning. News Corp., which owns Dow Jones & Co., publisher of The Wall Street Journal, holds about a 39% stake in British Sky Broadcasting Group PLC and also publishes the Sun.

The Sun's change of heart was met with derision among Labour Party members gathered at the seaside resort of Brighton. In a conference debate Wednesday afternoon, Tony Woodley, joint general secretary of Unite, the U.K.'s largest union, stood at the podium and ripped up a copy of the tabloid to cheers from the audience.

In the interview, Mr. Brown seemed frustrated with repeated questions as to whether he would definitely lead Labour into the election. He replied he is the man to lead Labour into the next general election. "Of course," he said. "The most important thing in a recession is to keep doing the job necessary."

The recession, a parliamentary expenses scandal, a rising death toll among British troops in Afghanistan and concerns about Mr. Brown's political touch have left Labour far behind in the polls. On Tuesday, an Ipsos-Mori survey had placed Labour third—behind the centrist Liberal Democrats and the Conservatives—for the first time since the early 1980s.

Ed Balls, the secretary of state for children, schools and families, acknowledged the scale of Labour's difficulties. "It is going to be a hard fight. Yes...we are the underdogs," he told the party conference on Wednesday. "It will be the fight of our lives—let us go and win it."

U.K. banks agree to abide by tighter controls on bonuses

By Sara Schaefer Muñoz

LONDON—The U.K.'s five largest banks agreed to tighter controls on bonuses that were laid out by the G-20, after gaining assurance from the U.K. government that foreign competitors would be subject to the same rules.

Following weeks of discussions with the country's largest banks, the U.K.'s treasury announced Wednesday that **Barclays** PLC, **HSBC Holdings** PLC, **Lloyds Banking Group** PLC, the **Royal Bank of Scotland Group** PLC and **Standard Chartered** PLC would comply with measures such as bonus clawbacks following poor performance and greater disclosures about the salaries of banks' top earners.

The U.K. government, because of its role in the financial-system bailout last fall, owns 70% of RBS and 43% of Lloyds.

The Financial Services Authority, the U.K.'s financial regulator, had announced new regulations in August that would mandate essentially the same compensation restrictions.

The announcement comes as beleaguered Prime Minister Gordon Brown, facing an election no later than next spring, looks to build momentum from mixed results at his Labour party's annual conference this week. In speeches there, both the prime minister and his treasury chief, Alistair Darling, vowed to crack down on the bonus culture they say helped cause the financial crisis.

The rules go into effect next year but will affect this year's compensation. They state that banks must have an independent committee submit annual compensation reports to the FSA. In addition, they say senior executives and employees who manage risk must defer 40% to 60% of compensation over three years, and at least 50% should be in shares. There is also a requirement that poor performance should lead to a return of a person's bonus. Banks could be subject to additional capital requirements if they don't comply with the standards.

Some banks had raised concerns that signing on to new rules ahead of the banks of other nations would put them at a competitive disadvantage with both foreign rivals in the U.K. and in their operations in financial centers such as New York.

However, in the discussions that took place both before and after the G-20, U.K. authorities assured the country's banks that the rules would apply to all foreign-owned subsidiaries, and also said that the U.K.'s Financial Services Authority "will work with overseas banking regulators to ensure a consistent and timely global application of these reforms."

The U.K. is counting on other countries to quickly follow its lead. If others are slow to match the moves, the government would likely come under significant pressure to dial back measures that would risk London's prominence as a financial center.

Alan Johnson, managing director of Johnson Associates, a compensation consulting firm, said banks in the U.S. and elsewhere are likely to agree to their own new rules soon.

"Banks have less flexibility to do nothing than they had six months ago," he said. But he noted that the G-20 proposals "weren't that specific" and may not have a lasting impact.

CORRECTIONS & AMPLIFICATIONS

The Organization of Petroleum Exporting Countries has 12 members, 11 of which participate in the cartel's output-quota system. A Sept. 23 Leading the News article about Saudi Arabia's oil minister incorrectly said OPEC had 11 members.

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.

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INDEX TO PEOPLE

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

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

LEADING THE NEWS

Deadly offshore earthquake hits Indonesia

Death toll uncertain; thousands trapped in rubble in Sumatra

By Tom Wright
And Yayu Yuniar

JAKARTA—A powerful earthquake struck off the coast of Indonesia's Sumatra island Wednesday afternoon, trapping thousands of people beneath flattened buildings. A complete death toll wasn't possible in the immediate aftermath. Indonesia's vice president said at least 75 people had died, but indicated the toll would rise significantly.

The earthquake had a magnitude of 7.6, according to the U.S. Geological Survey, and hit offshore about 30 miles from Padang, a city of about 750,000 on Sumatra's western coast. The quake was felt as far as Bangkok, about 1,000 miles away.

Indonesia's Vice President Jusuf Kalla, citing information from Padang's mayor, said thousands of people were likely trapped in the rubble. He said Wednesday evening that 75 people had been declared dead in hospitals in Padang.

Many more were suspected to have died in Pariaman, a rural town of about 80,000 people that was closest to the epicenter, north of Padang. Officials received reports of buildings destroyed in Pariaman, and road access to the town had been cut off by landslides.


Reuters

Students climb out of a collapsed building in Padang, on the Indonesia island of Sumatra, after an earthquake Wednesday.

Mr. Kalla said the government would send four aircraft on Thursday morning with 100 doctors, tents and medical supplies. Heavy rains and electricity blackouts in the area made it impossible to immediately send aid, he said.

Indonesian television reported that the earthquake had caused buildings and bridges to collapse in Padang, but the extent of the damage wasn't immediately clear.

The main public hospital in Padang was destroyed in the quake, local media reported.

The U.S. Pacific Tsunami Warning Center issued a tsunami advisory but later canceled it, citing sea-level readings.

International aid agencies said they were preparing to send in supplies if needed. Laura Blank, a U.S.-based spokeswoman for World Vision, said the charity was sending in a team to assess the damage early on Thursday.

Indonesia's government is sending a floating navy hospital to moor off Padang to treat the wounded, but it could take three days before it is in place, Welfare Minister Aburizal Bakrie said Wednesday, according to local media reports.

After the earthquake, thousands of people, fearing a tsunami, fled to higher ground in the hills that surround Padang, said Hendrawansyah Saputra, a 28-year-old office worker.

Mr. Saputra, who ran from his bungalow after the walls cracked apart, said there was a three-hour traffic gridlock as cars tried to leave the city. Later, many people whose houses were destroyed or were too scared to return to damaged buildings camped out in open spaces during torrential rains.

Office workers in high-rise buildings in Jakarta and Singapore reported a few minutes of shaking after the temblor, but there were no reports of damage in any of the region's business capitals.

Tremors were felt at Dumai, Indonesia's biggest export port for crude palm oil. Operations there are likely to continue as normal, industry officials said Wednesday.

Experts have long predicted the Padang area could face huge damage because it lies exposed to the massive tectonic fault line, which runs down the western edge of Sumatra. It was the same fault line that caused the December 2004 tsunami, which killed over 200,000 people across the Indian Ocean region, more than half of them inhabitants of the northwest coast of Sumatra.

Earlier in September, at least 79 people were killed on Java island after a quake along the same fault line.

In 2007, Sumatra was hit by an 8.4 magnitude earthquake off the southwest coast of the island, which killed 21 people.

— Fawziah Selamat contributed to this article.

Samoa disaster reveals flaws in tsunami alerts

By Patrick Barta

Victims of the tsunami that swept across the South Pacific Tuesday often had only minutes to escape the deadly waves and in some cases didn't receive alerts of danger, despite years of work to upgrade early-warning systems across the region.

At least 99 people were killed by the tsunami in Samoa, Tonga and the U.S. territory of American Samoa, while dozens were left missing. The tsunami inundated tourist resorts and local villages after an 8.0-magnitude earthquake struck off the coast of Samoa early Tuesday morning local time.

Authorities warned the death toll could rise significantly over the next few days as the full scale of the disaster—much of which occurred in remote areas far from large population centers—is assessed.

At least 63 people were dead in Samoa, and 30 were killed in American Samoa, according to the Associated Press, which cited local police and other officials. Authorities in Tonga confirmed at least six people were killed in that nearby island nation, the AP said.

Hundreds of people in Samoa were being treated for injuries, the Associated Press reported, with many continuing to straggle into treatment centers late in the day. The Samoa Red Cross said it had opened five temporary shelters to help with the 15,000 people who were affected. U.S. President Barack Obama declared a state of emergency for American Samoa.

The deaths in Samoa and nearby islands underscore the most vexing element of planning for tsunamis: Often the biggest challenge isn't knowing when a tsunami is coming, but getting the information out to everyone once the risk arises. Experts said the deaths may also point to deficiencies in current warning systems and training, particularly for a tsunami that strikes so close to shore, leaving only minutes to respond. The region's quake struck about 125 miles from Samoa and American Samoa

In those cases, "the propagation of warnings from official sources" can be "useless," said Sanny Ramos Jegillos, a regional crisis prevention and recovery coordinator for the United Nations Development Programme in Bangkok. What may be needed, he said, is more training at local communities to teach residents and tourists that they must evacuate to higher ground even without official warnings whenever a strong earthquake occurs.

Morison McGregor, a 47-year IT consultant who lives in Denmark, said he and his girlfriend received no official warning after they felt the earthquake while at a resort along the Samoan coast, so they assumed everything was okay. Within ten minutes, though, his girlfriend saw a wave coming and started signaling for the two of them to flee, he said.

"When you looked back you could see a three- to four-meter wall of water behind you," he said. They ran to a hill about 100 to 150 meters away and escaped without major injury.

—Rachel Pannett contributed to this article.

LEADING THE NEWS

Irish vote spells end to grand EU initiatives

While likely to pass Friday, treaty must face Czech challenge

BY CHARLES FORELLE

DUBLIN—Ireland votes Friday on whether to approve or veto a key European Union treaty, but win or lose, one thing is certain: The bloc won't try to push through any more big-bang efforts at a more federalized Europe any time soon.

Opinion polls suggest Irish voters probably will approve the so-called Lisbon Treaty, after an arduous process that included a rejection a year ago. The treaty, which Ireland alone is putting to a referendum, would give the EU a permanent president and a stronger foreign-policy chief, as well as cutting the number of areas where the bloc's 27 nations each wield a veto.

"The grand-design, big-amending treaty has probably run its course. Europe, if it wants to do things, will have to look more incrementally at specific issues," says Pat Cox, a former president of the European Parliament who is leading a pro-Lisbon group. "No more design, thank you, for a generation."

Since the 1980s, the EU has been getting wider and deeper at an extraordinary pace. It removed borders between many of its member states, gave birth to a common currency and roughly doubled its size by taking in the ex-communist bloc countries of Central Europe after the Iron Curtain fell in 1989.

Every one of those big moves came with a new treaty. Each time, resistance has grown to an EU project seen by many ordinary Europeans as elitist and undemocratic.

In 1992, Danish voters vetoed the Maastricht Treaty, which established the euro, passing it only on a second try. Irish voters needed two referendums to pass the Nice Treaty, which laid the groundwork for enlargement into Eastern Europe. In 2005, French and Dutch voters torpedoed the EU's first effort at a constitution. The Lisbon Treaty, a watered-down version of that failed constitution, has been rejected by the only country to put it to the vote.

The referendum began early on the island of Inishfree in Ireland; Barry Edgar Pilcher, left, plays his saxophone after voting Wednesday as electoral officer Hugh O'Donnell looks on.

"There is a sort of reform fatigue, really," says Marco Incerti, a research fellow at the Centre for European Policy Studies, a Brussels think tank. For now, the EU has run out of appetite for grand projects, either to take in new countries such as Turkey, or to deepen political integration.

Even if the Irish do approve the Lisbon Treaty on Friday, its travails may not be over. The euroskeptic president of the Czech Republic, Vaclav Klaus, has refused to sign his parliament's ratification of the treaty, and on Tuesday a group of Czech senators said they would challenge the treaty's validity in a Czech court—for a second time.

Mr. Klaus, in no hurry, has indicated he will wait for the court to rule. It isn't clear how long that will take, but time is short: Britain's Conservative Party, widely expected to win the next U.K. election next spring, has said it would put the Lisbon Treaty to a referendum if given the chance. Such a vote would almost certainly fail in the euroskeptic U.K., which has opted out of many of the EU's big new projects.

The Lisbon Treaty would fix a number of problems in the EU. The lack of a single strong leader has left Europe with a scattershot foreign policy. Currently, the presidency of the EU rotates every six months. So French President Nicolas Sarkozy dealt with the Russia-Georgia war, the Czechs tried to sort out Russia's cutoff of gas to Ukraine, and Sweden will take the baton in global climate-change negotiations this winter.

Who would get to be the EU's first president if Lisbon passes is up to national leaders. Former British Prime Minister Tony Blair has long been discussed for the role, and earlier this year a British minister suggested the U.K. would back him. Also discussed have been former Spanish Prime Minister Felipe González and Jean-Claude Juncker, the prime minister of Luxembourg.

Should the Irish vote fail, the EU's prestige would be wounded. There is no obvious next step. The Irish prime minister on Wednesday ruled out a third try; there is no mechanism for removing Ireland from the EU; and the idea of creating a subgroup of EU countries that proceeds without Ireland and other skeptics—a "two-speed Europe"—is fraught with political and administrative difficulties, says Mr. Incerti.

Interest in Ireland's vote is strong in the rest of Europe. On Wednesday, Mr. Cox stood on a windy corner of St. Stephen's Green in Dublin, hopping from French to English as he gave interviews to foreign camera crews. A parade of EU figures has come to urge Irish voters to say yes.

Two weeks ago, European Commission President José Manuel Barroso dropped by. Not much for subtlety, he took the opportunity to announce that the EU had come up with €14.8 million ($21.7 million) in "European Globalization Adjustment Fund" money to help 2,400 Irish workers laid off when **Dell** Inc. shut a plant in Limerick in favor of new facilities in cheaper Poland.

Polls in Ireland show firm support for the treaty—55% to 27% in this week's Sunday Business Post survey, though a big group of undecided voters could make it close.

—Quentin Fottrell contributed to this article.

U.N. awaits Iran's word on nuclear inspections

BY DAVID CRAWFORD

The United Nations nuclear watchdog could dispatch inspectors to Iran's recently revealed nuclear facility within days if Tehran bows to demands from the U.S. and its allies to give investigators unfettered access to the site.

Inspection teams from the International Atomic Energy Agency are ready to leave on short notice, a person familiar with IAEA inspections said. Diplomatic realities, however, often delay so-called safeguard missions, this person said.

In March 2007, IAEA director-general Mohamed ElBaradei visited North Korea to discuss the start of IAEA monitoring. The next visit wasn't until more than two months later, when the head of the IAEA Department of Safeguards, Olli Heinonen, flew to North Korea to work out arrangements. Only in July 2007 did the actual inspectors arrive, according to a person familiar with the monitoring. In April of this year, North Korea ordered the IAEA inspectors to terminate their monitoring and leave the country.

IAEA inspectors petitioned Iran in 2003 for permission to improve the design of the agency's inspection program at Natanz, where Iran has installed more than 8,000 centrifuges. In September, the IAEA said Iran had finally approved the request, an IAEA report on Iran said. An IAEA spokesman declined to discuss the new measures the agency plans at Natanz.

Iran says its nuclear program is for peaceful purposes.

A person familiar with the IAEA inspections says the IAEA designs a specific program for each nuclear facility it monitors. The ultimate goal is to prevent the diversion of nuclear material for a nuclear weapon. Details of the strategy, known as the safeguard approach, are confidential, this person said, but many of the tools are known.

The IAEA inspectors install special cameras, neutron detectors, and heat-detection devices to detect activity or movement of sensitive equipment or fuel. To prevent tampering when inspectors are away, the IAEA inspection teams mark their equipment with special seals. Should an object be moved or altered, the seal would be damaged, the person said.

The equipment doesn't operate all the time. Cameras can be set to shoot pictures nearly continuously, or at intervals, depending on the object to be monitored. The information can be transmitted in real time or stored on memory cards until inspectors return. The person familiar with the safeguard approach said IAEA inspectors design their safeguard activity to ensure the timely detection of diversion of nuclear material.

IAEA inspectors also take dust samples to determine if nuclear enrichment has secretly occurred.

Inspectors schedule the frequency of their inspections based on an assessment of the "maximum time period I can safely leave this site unattended," the person said. A site that processes minimal amounts of low-enriched nuclear material is inspected less often than a site producing large amounts of plutonium—a possible component of nuclear weapons—the person said.

Inspection teams also vary in size. The IAEA recently dispatched just one safeguard expert to inspect a small nuclear laboratory in Central Europe, the person said. A team of more than 10 inspectors was recently needed, however, in Japan, when the agency visited a large nuclear installation, the person said. "The size of a team depends on the work that needs to be done," the person said. Usually, the IAEA will send at least two inspectors.

Before the IAEA begins inspecting Iran's new enrichment facility, the agency will purchase satellite images of the facility dating from the present and going back in time to the start of construction, the person said. These images will help the agency determine whether Iran violated an obligation to report the start of construction at a new enrichment facility.

Tax amnesty passes Italy's lower house

REUTERS NEWS SERVICE

ROME—Italy's lower house of parliament on Wednesday approved a tax amnesty on undeclared overseas funds after the conservative government called a confidence vote on the controversial bill.

The amnesty, which the state revenue agency said could collect €300 billion ($439 billion), has outraged Italy's opposition and biggest union, which said it is an incentive for tax avoidance and could allow organized crime to repatriate ill-gotten gains.

The government has defended the plan by saying it is better to have capital at work in Italy than abroad.

The amnesty allows Italians to wipe the slate clean on undeclared funds held abroad by paying a 5% penalty. Controversy flared after a senate committee Tuesday approved extending the scope to include money kept hidden abroad through accounting fraud.

LEADING THE NEWS

Kraft told to 'put up' on Cadbury

U.K. regulator says company must make formal bid or back off

By Cecilie Rohwedder

U.K. regulators have imposed a Nov. 9 deadline on **Kraft Foods** Inc. to either make a formal takeover offer for **Cadbury** PLC. or go away.

Cadbury last week asked the U.K. Panel on Takeovers and Mergers for a "Put Up or Shut Up" order. On Wednesday the agency ruled that the U.S. food maker must either launch an official bid within the next six weeks or drop its plans to buy the British sweets company for at least six months.

The U.K. company, which makes chocolate, candy and chewing gum, had received an approach from Kraft in September that was then valued at £10.2 billion, or about $16.7 billion; Cadbury immediately rejected it.

Cadbury Chairman Roger Carr said in a statement that the authority's decision creates "clarity and certainty" for the company's shareholders "at the earliest opportunity."

A Kraft spokesman said, "We've noted the decision and understand its implications."

For Kraft, Wednesday's ruling introduces an element of time pressure to the process of formalizing its bid and finding the financing for it. Kraft, the world's second-largest food maker by sales after **Nestlé** SA, now has a limited period to present an offer either to the Cadbury board or directly to its shareholders, in a hostile bid.

The Northfield, Ill., company may well make full use of the six-week window. For one, Kraft is benefiting from the weakening British pound, which is lowering the dollar amount it would have to pay for the company. If the U.K. currency drops further, that amount becomes even more favorable for Kraft.

A longer wait is also likely to increase the number of shares snapped up by short-term investors hoping for a quick profit from a takeover. Those shareholders are prone to embrace any offer that is higher than the price they paid for their shares. Less demanding shareholders will help Kraft's cause.

But the U.S. company would have to raise its offer from the 745 pence ($11.88 at current rates) in cash and shares it proposed in its informal offer letter three weeks ago. Cadbury shares quickly soared well past that price, closing at 803 pence, up 4 pence, in London on Wednesday.

As Kraft ponders its next move, another bidder could join in. A third-party offer could extend the tug-of-war for Cadbury, the maker of Dairy Milk chocolate bars and Trident gum, beyond the six-week deadline set by the British panel.

Some have pointed to Pennsylvania-based **Hershey** Co. as the most likely candidate because Cadbury's global reach would be a smooth complement to its U.S.-focused business. Cadbury has direct operations in 60 countries.

The two companies share a close familiarity because Hershey holds the license to make and sell Cadbury brands in the U.S. Hershey has hired at least four different advisers to help it consider a bid of its own for Cadbury but so far hasn't shown its cards.

One hurdle to a Hershey bid is that its management and the outside trust that controls the company would have to agree on the purchase and the right price for it.

Cadbury executives in London say they are preparing responses for different outcomes but focusing on running the company. In an interview last week, Chief Executive Officer Todd Stitzer said he was updating Cadbury staff twice a week, "asking them to stay focused and telling them our best defense is delivering on our potential."

In the interview, Mr. Stitzer also said Cadbury on its own could move from its No. 2 position to surpass Mars Inc. as the world's No. 1 candy company within three to five years, through internal growth and targeted acquisitions. He said Cadbury itself had been an active buyer of other companies.

"Consolidation is a major factor in a global industry," he said.

Market moves

Cadbury's valuation will depend on Kraft's share price and the pound-dollar exchange rate

Kraft's offer on Sept. 7:	Cadbury price on Sept. 30:
745 pence per share	803 pence per share
Value of offer: £10.2 billion	Cadbury market cap: £11.0 billion
Kraft closing price: $28.10	Kraft closing price: $26.11*
Value of the U.K. pound: $1.6349	Value of the U.K. pound: $1.6005

*as of 3 p.m. est.
Source: WSJ research

Associated Press

Kraft's next move affected by sterling, stocks

By Michael Carolan

LONDON—An early-November deadline from U.K. regulators for **Kraft Foods** Inc. to make an offer for **Cadbury** PLC leaves the U.S. food giant plenty of time to put together a bid, but its eventual valuation of the U.K. confectioner remains subject to the vagaries of equity and currency markets.

With a deadline in place for Kraft to launch a formal offer for Cadbury, the focus has returned once again to valuation, with analysts expecting a formal Kraft offer of about 850 pence a share, which would value the company at about £11.6 billion ($18.5 billion). Still, as Kraft has nearly six weeks to launch its cash-and-shares bid, the ultimate valuation could depend on gyrations in foreign-exchange markets and the performance by Kraft's shares.

The U.K. Takeover Panel on Wednesday granted Cadbury's wish and set a deadline of Nov. 9 for Kraft to make a firm bid for the U.K. confectioner or to walk away.

Nobody expects Kraft to abandon its interest. Instead, analysts expect the U.S. company will sit out the next six weeks and launch its offer just before Nov. 9.

"Kraft will see no benefit in delivering an offer before the deadline," said industry consultant James Amoroso. "It will wait and see if any other bidders appear.

Shore Capital analyst Darren Shirley agreed. "It wouldn't surprise me if Kraft used the whole six weeks," he said.

When Kraft makes a formal bid, it is unlikely to be at its initial proposal of 745 pence a share, which has received a lukewarm response from the market and a flat-out rejection from the Cadbury board. Instead, analysts say they are expecting a bid of between 800 pence and 900 pence a share.

Evolution Securities analyst Warren Ackerman said the market will also expect cash to account for 50% of the new offer, up from the current level of 40%.

Kraft's original proposal was to pay 300 pence in cash and 0.2589 new Kraft Foods shares for each Cadbury share. The bid was originally valued at 745 pence per Cadbury share, or £10.2 billion, but a fall in Kraft's share price since the announcement means that valuation is now closer to 720 pence.

The valuation would be even lower if the U.K. currency hadn't fallen in value against the dollar during the past week.

The pound has suffered on fears U.K. interest rates are going to stay low in the long term and that the Bank of England is happy with the weakness of sterling as it will drive up exports.

Any further weakness in the pound over the next six weeks is likely to play further into Kraft's hands, as it makes the proportion of Kraft stock in the deal much more attractive to Cadbury's shareholders.

The share element of the deal also means that Kraft's share-price movements over the next six weeks will influence any eventual takeover price. Kraft shares have dropped more than 6% since it first approached Cadbury on Sept. 7. As Kraft is proposing to pay part of the consideration in its own stock, this fall lowered the value of the bid.

Kraft's management will hope that the negative sentiment related to its offer for Cadbury is already priced into the company's shares. Any further downward drift in the shares will hurt Kraft's eventual offer.

"Crucial will be the reaction of the Kraft share price upon the new offer announcement," Mr. Amoroso said. "If it sinks again, it may eradicate the increase in the cash offer."

Cadbury itself has its own opportunity to influence proceedings with its third-quarter trading update on Oct. 21. In July, Cadbury beat expectations with a 4% rise in first-half sales and increased its margin target for the full year, after a strong performance in emerging markets and its chocolate division more than offset slow sales in North America and Europe.

If its performance has weakened since the half year, Cadbury's claim that it can generate more value as a standalone company will look hollow and Kraft's offer may not need to be so full.

Any new offer from Kraft is expected to prompt counterbidders to show their hand.

"If there is a counterbidder, I think they'll emerge quite quickly after Kraft makes its bid," Mr. Ackerman said.

Nestlé SA and **Hershey** Co. are seen as the two most likely counterbidders, possibly in combination.

While Nestlé's comments so far have suggested it is cool on the idea, Hershey might make the Swiss company a proposal too good to refuse.

"I wouldn't underestimate how much Hershey needs to do something," said Mr. Ackerman. "If it doesn't, it will be left as a peripheral player."

Mr. Amoroso, however, views a counterbid as unlikely. "I continue to expect this to be a one-horse race, but the question is whether the one horse has the stamina to finish it," he said.

U.S. loosens its control over Internet body

By Christopher Rhoads

The U.S. government said Wednesday it had ended its 11-year contract with the nonprofit body that oversees key aspects of the Internet's architecture, after demands from other countries for more say in how the Web works.

The move addresses mounting criticism in recent years that no one country should have sole control over important underpinnings of the Internet, such as determining domain name suffixes like ".com." The criticism has intensified as Internet usage has soared around the world and become critical to economies and governments. Some countries, including China, have suggested they would build their own version of the Internet if the matter wasn't resolved.

"This reflects the globalization of the Internet," said Rod Beckstrom, chief executive of the body, called the Internet Corporation for Assigned Names and Numbers, or Icann. "By America relaxing some control and inviting other countries to have an active hand, that increases the possibility that the global Internet will remain unified," Mr. Beckstrom said in an interview

Instead of reporting to the U.S., Icann now will go under regular review by a series of panels, including representatives from other countries and fields. But management of the domain-name system, also known as the root, won't change, at least for now. The Commerce Department has a separate contract with Icann, which expires in 2011, to manage the technical aspects of the root.

The changes announced Wednesday, the day the main contract expired, relate to addressing policies and guidelines.

Icann, which is based in Marina del Rey, Calif., was established in 1998 by the Clinton administration as a way to ensure that important Internet governance decisions, primarily addressing, were coordinated by a single body. The plan was for the Department of Commerce to oversee the body, with veto power over important decisions, until Icann became strong enough to operate on its own as a private-sector organization.

It was considered essential that one body make such decisions to ensure that all users of the Internet were operating with the same address book, known as the domain-name system. The power of the Internet lies in part in this universality. Typing in www.ibm.com allows a user, whether in Paris or Pittsburgh, to reach the same Web site.

As the Internet became increasingly important to global commerce, communication and government, other countries argued the arrangement was no longer proper.

While the Internet was started in the U.S., today just 15% of the world's estimated 1.7 billion Internet users reside in North America, according to internetworldstats.com.

France, China, Libya, Brazil and others argued that such decisions should be placed under the United Nations, or perhaps under a newly created multinational body.

For the average Internet user, the changes will have no discernible effect, since they relate to how the decisions about the Internet's unseen plumbing are made, and by whom.

CORPORATE NEWS

Danone ends troubled Wahaha venture

China partnership was plagued by disputes over drinks business; cash payout will settle legal cases

By James T. Areddy

SHANGHAI—France's **Groupe Danone** SA will accept a cash settlement to relinquish claims to the name Wahaha, one of China's best-known brands, in a decision to exit a valuable consumer-products business after a rare public battle for control of it.

In a joint statement Wednesday, Danone announced a settlement with China's **Hangzhou Wahaha Group** Co. by saying its 51% share in existing joint ventures that make soft drinks and related products will be sold to the businesses' Chinese partners. "The completion of this settlement will put an end to all legal proceedings related to the disputes between the two parties," the statement said.

No financial terms were disclosed. A person familiar with the matter said the settlement amount is "slightly below" the figure Danone has cited in previously published financial accounts as the value of its Wahaha holdings: €381 million, or about $555 million.

The public feud over control of the Wahaha empire offered a rare peek into the breakup of a major Sino-foreign joint venture. Danone's strategy to publicly confront its partner, and Wahaha's to respond with its own accusations, marked a distinct break with prevailing business practice in China, where problems have usually been settled with face-saving, private negotiations.

Analysts said the case served to reinforce how difficult it is to operate a partnership in China. "That's a key lesson: To build a [brand] business in China you need to build from the ground up," said Jonathan Chajet, China managing director for consultancy Interbrand.

Foreign firms have reported billions of dollars in sales through their Chinese partnerships. International giants such as Procter & Gamble, Starbucks, General Motors, Ford, Citigroup and Prudential have operated wholly or in part through joint ventures in China.

Agence France-Presse/Getty Images

After ending its Wahaha venture, Danone will sell its Bio brand yogurts in China, seen above in a Shanghai supermarket.

But executives involved say the expectations of foreign and local parties can conflict in a JV, for instance when an international company is striving for efficiencies and profits that match its global goals while the local partner—sometimes an arm of the Chinese government—strives to maximize employment or improve technology. At other times partners have stolen corporate secrets, cheated and otherwise sabotaged a venture, while legal avenues have had little effect on day-to-day operations.

In past years foreign companies were required to have joint ventures, or found it was the only practical way to get into the Chinese market quickly. But in recent years China has opened up more sectors for wholly owned foreign ventures, especially after it joined the World Trade Organization in 2001.

The Wahaha brand is among the most famous in China, with soft drinks and juices. It ranked No. 16 among domestic brands and is worth $2.2 billion, according to a recent report by Shanghai research firm Hurun Report, which uses qualitative and quantitative measures to arrive at brand values. Wahaha doesn't publicly disclose financial figures.

In 2007, Danone, which had virtually no involvement in the day-to-day management of Wahaha operations, went public with allegations against its partner of more than a decade, Zong Qinghou, Wahaha's founder and a Chinese folk hero entrepreneur.

The French company charged that Mr. Zong had for years produced and sold Wahaha-branded drinks using an outside network of operations that he owned in parallel to the joint ventures. Danone said that cut it out of the 51% in earnings from anything carrying the Wahaha name that it was entitled to under contracts signed in 1996.

Moreover, Danone said Mr. Zong reneged on a late 2006 agreement that would have settled the matter amicably.

For his part, Mr. Zong never denied he established Wahaha-branded businesses outside the ventures but said it was done with the blessing of Danone. A colorful figure, brilliant marketer and active blogger, Mr. Zong argued the original agreements were outdated and unfair, written when he was a regional player and Danone was one of the world's largest companies.

In rabble-rousing speeches, he claimed to represent China's national interests, while dismissing Danone as a foreign company hungry for short-term profits.

"One of the most successful alliances in China" degenerated into a case study of a relationship that "was not sustainable in the long run," according to Teng Bingsheng, a professor of Cheung Kong Graduate School of Business in Beijing.

Deep distrust and loss of face on both sides, Mr. Teng said, made Danone's eventual exit likely. "For the simple reason Mr. Zong is the one who runs the show," he said.

Mr. Zong founded the Wahaha group in the late 1980s, pricing soft drinks cheaply and pushing them with widespread distribution, some of China's first television advertisements and a catchy name that roughly translates as "laughing baby." In 1996, he and Danone began establishing joint ventures to sell drinks under the Wahaha name.

Eventually Danone owned 51% of around 40 joint ventures, but left Mr. Zong to run them with virtually no oversight.

Over the past two years, the companies traded accusations through the press and filed dueling lawsuits in courts around the world, some of them directed at individuals at the center of the ventures. At one point, Danone estimated its losses from Mr. Zong's ventures at $100 million, while Mr. Zong responded that "the French" had no claim on a business he built into a multibillion dollar empire.

In some of the legal actions, Mr. Zong appeared to prevail, particularly in Chinese courts, while Danone chalked up successes on foreign soil.

The settlement signed Wednesday in Beijing is subject to approval by Chinese authorities. It is expected to be completed before year end.

Danone, which reported the Wahaha business generated about 10% of its global revenue in 2006 but has since adjusted how it accounted for Wahaha, said it expects no impact on its income statement from the Wahaha settlement.

In China, it will be left with a much smaller footprint and is essentially starting over, pushing its Bio-brand yogurt through a recently launched, wholly owned business that lacks the distribution might that Wahaha controls.

"We are keen to accelerate the success of our Chinese activities," Franck Riboud, chief executive officer and chairman of Danone said in the statement. He said he is confident Wahaha will "continue to be highly successful."

The closely held Wahaha, meanwhile, is faced with following through on plans to extend its reach overseas without a sizable international partner, analysts said.

Chevron CEO to retire, paving the way for his lieutenant

By Ben Casselman

Chevron Corp. Vice Chairman John S. Watson will take over at year-end from longtime Chairman and Chief Executive David J. O'Reilly, putting a seasoned strategist and deal maker at the helm of one of the world's largest energy concerns.

The selection of Mr. Watson, a longtime lieutenant of the CEO, suggests directors don't want a radical shift in direction as Mr. O'Reilly steps down after a decade running the San Ramon, Calif., oil company.

"Chevron has a 130-year history, and I take it very seriously," Mr. Watson, 52 years old, said in an interview Wednesday. "You'll see a great deal of continuity going forward."

That board also decided to promote Chevron executive George Kirkland to vice chairman. A 35-year Chevron veteran, Mr. Kirkland oversees oil-and-gas exploration and production for the company.

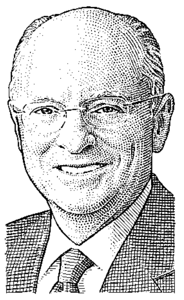
Mr. Watson, who began his Chevron career in 1980 as a financial analyst, rose to prominence leading the company's integration with Texaco Inc. early this decade. He has since held a variety of senior posts, including chief financial officer, head of international exploration and production and head of strategy.

Mr. Watson's selection wasn't a surprise. His promotion to vice chairman earlier this year was widely interpreted as a sign that he would take over when Mr. O'Reilly stepped down.

The timing of Mr. O'Reilly's departure, after exactly 10 years in the job, was somewhat less expected. At 62, he is three years short of Chevron's mandatory retirement age for senior executives, though past CEOs also have left before turning 65. Chevron has recently achieved several significant milestones, including the completion of major offshore projects in Brazil, Angola and the Gulf of Mexico and a decision to move forward with the company's long-delayed Gorgon liquefied-natural-gas project in Australia.

"The company is performing well, executing well," Mr. O'Reilly said. "It's time to pass the baton."

Mr. Watson will take over at a time of uncertainty for the company and the broader oil industry. After years of record profits amid rapidly rising oil prices, companies have seen their earnings fall sharply in the past year with the price of oil. Chevron's second-quarter profit fell 71% from a year earlier to $1.75 billion, and the company has suspended its share-buyback program to conserve cash.



David J. O'Reilly

Meanwhile, falling U.S. demand for gasoline because of the recession, improved fuel efficiency and increased competition from biofuels has hurt the profits of U.S. refiners, including Chevron.

The industry also is facing longer-term questions about supply and demand. Companies are struggling to find new sources of oil and gas as old fields begin to dry up and governments restrict access to many of the most attractive new fields. At the same time, concerns about global climate change are leading governments in the U.S. and elsewhere to consider policies that could damp demand of traditional fuels by favoring renewable sources of energy.

Chevron so far has met those challenges better than many of its competitors. The company amassed a war chest of more than $7 billion when oil prices were rising that has allowed it to keep its capital spending steady, even as other big producers, such as **Royal Dutch Shell** and **ConocoPhillips**, have cut their budgets. Chevron found more oil than it produced last year, while global oil reserves fell for the first time in a decade. And the company expects to increase oil and gas production by 5% this year, the fastest projected growth of the major publicly traded producers.

"If you look out five or ten years, it's one of the few, if not the only, integrated [oil company] that most people agree has the possibility to maintain or even grow production," said Philip Weiss, an analyst with Argus Research Group in New York.

Mr. Weiss said Mr. Watson's major challenge will be executing on the long list of projects on which Chevron has embarked in recent years. But he said Mr. Watson's finance background positions him well to keep those projects on time and on budget.

Mr. O'Reilly will step down after more than 40 year's with the company. Born in Ireland, he began his career at Chevron as a chemical engineer and rose through the ranks to run Chevron's chemical business and its refining unit.

One of Big Oil's longest-serving chief executives, Mr. O'Reilly made his most lasting mark on the company early in his tenure, orchestrating Chevron's $35 billion acquisition of Texaco less than a year after taking over in 2000.

CORPORATE NEWS

Michelin is doubtful about upturn

Tire executive says recent demand is due mainly to restocking

BY SEBASTIAN MOFFETT

PARIS—The recent world economic recovery is shaky and could soon fade, the chief financial officer of Michelin said Wednesday.

Despite "the euphoria we have seen in the past weeks...we never had these signals [of recovery] and we still don't have them," Jean-Dominique Senard said in an interview. "The prospects in the coming weeks are not good."

Cie. **Générale des Établissements Michelin**, as Michelin is formally known, is one of the world's biggest tire makers and is exposed to all kinds of economic forces: Trade volume affects demand for truck tires, and the consumer mood influences the number of car and airplane tires sold. For that reason, the company's fortunes "amplify the moves of GDP," Mr. Senard said.

Most of the world's big economies fell into recession at the end of last year, but many have since improved. France and Germany moved out of recession in the second quarter. But some measures of economic growth remain negative. The Baltic Dry Index, a measure of international trade volume, rose until July, but has since fallen—albeit not to the lows it reached late last year. European unemployment is still rising.

Much of the upturn has been due to China's continuing economic boom, plus the rebuilding of inventories, Mr. Senard said. After using up stockpiles of goods during the worst of the downturn, companies have started buying again.

Tire-industry sales have improved as truck fleets rebuilt their tire inventories, and Michelin's production is up to around 70% of capacity, from a low of 30% earlier this year.

Even so, Mr. Senard said there was no reason to expect continued improvement. "We do not see any pickup in activity in the truck business," he said. "When you look at the infrastructure business—construction, quarries, things that would trigger new freight—[stronger demand] is simply not in sight today."

One of Michelin's challenges is to produce more in fast-growing markets. Though it has three factories in China, for example, 70% of its production takes place in mature economies, such as in Europe and North America. Some of that output has to be exported to emerging markets, such as China, India and Brazil.

To tap the new source of growth, Michelin wants partly to grow organically, gradually expanding its operations. But it would also look for possible acquisitions to speed its moves into emerging markets.

"We are certainly watching with great attention the different opportunities that could come," he said. But, "it's getting more and more difficult to find partners who are willing."

Associated Press

'When you look at the infrastructure business—construction, quarries, things that would trigger new freight—[stronger demand] is simply not in sight,' said Michelin finance chief Jean-Dominique Senard, pictured at a July earnings presentation.

Infineon says chip demand on the mend

BY ARCHIBALD PREUSCHAT

MUNICH—The semiconductor sector has passed the worst of the slump, but it will take years to return to sales levels reached before the financial crisis, said Marco Schröter, chief financial officer of German chip maker **Infineon Technologies** AG.

"In the last four to six weeks the situation has changed," Mr. Schröter, who is also a member of Infineon's management board, said in a recent interview, echoing more positive recent comments from companies across the sector.

Earlier this month, Dutch semiconductor-equipment maker **ASML Holding** NV raised its sales expectations, as did industry heavyweight **Texas Instruments** Inc.

Demand, especially from industrial and automotive customers, has increased, Mr. Schröter said. Moreover, "we now have visibility into the next two quarters and it looks better than six weeks ago," he said. "However, quarterly growth rates could flatten in the second quarter," he cautioned, though he added the company won't see a decline as sharp as it recorded in its first fiscal quarter, ending Dec. 31.

Infineon supplies logic chips used in the communications, automotive and industrial sectors. Its products are also used for passports and chips used on mobile-phone SIM cards and credit cards.

It could take three years until Infineon reaches the sales level prior to the crisis, Mr. Schröter said, but the signs are encouraging. Infineon's book-to-bill ratio now stands at above 1, up from a floor of 0.6 in the December quarter of last year, Mr. Schröter said.

As a result of the improved conditions, Infineon has scrapped the shorter working hours it introduced to mitigate the effects of the slump, and factory utilization has recovered to almost full levels from the 40%-to-60% levels seen in recent months, he said.

Referring to Infineon's fourth-quarter results for the period ending Sept. 30, Mr. Schröter said: "We won't disappoint market expectations," without elaborating.

After a recent capital increase in which Infineon raised €725 million ($1.06 billion), the Neubiberg, Germany-based company will be able to refinance its debt and has built up a solid cash position.

Meanwhile, Mr. Schröter poured cold water on recent market speculation that Russian conglomerate **AFK Sistema** might take a major stake in Infineon.

Mercedes should hit profit goal, chief says

BY CHRISTOPH RAUWALD AND KATHARINA BECKER

STUTTGART, Germany—Sales at **Daimler** AG's core Mercedes-Benz unit appeared to turn a corner in September after months of poor performance, and Dieter Zetsche, who runs the car unit, said the company was increasingly confident the division would post an operating profit in the second half.

"We're more confident than before that we can keep our promise of achieving a positive operating result at Mercedes-Benz in the second half," Mr. Zetsche said in an interview at the company's headquarters Wednesday.

Mr. Zetsche said Daimler's target hadn't been set, in anticipation that the division would "only earn one euro," suggesting a solid positive result.

That is encouraging for Daimler and other luxury-car makers that have endured leaner times during the recession than mass-market rivals, whose sales have been propped up by government-backed incentives in numerous markets world-wide. Those initiatives typically encourage car owners to trade in aging gas guzzlers and buy new, fuel-efficient vehicles, and benefited companies that produce smaller, cheaper cars.

Mr. Zetsche, 56 years old, joined the former Daimler-Benz in 1976 and has worked in operations ranging from engineering to sales. He now has day-to-day control of the Mercedes-Benz car business.

Mercedes-Benz sales in September came in at around last year's level, he said. Mercedes-Benz is the world's second best-selling luxury-car maker, after German rival **BMW** AG, and its truck division is the world's largest maker of commercial vehicles by sales.

The Mercedes-Benz Cars unit, which comprises the Mercedes-Benz nameplate, Smart minicars and the ultraluxury Maybach brand, is expected to return to profitability mainly because of revamped versions of its E-Class and flagship S-Class models.

Sales at the Mercedes-Benz unit were down 17% year-over-year in the January-to-August period at 711,300 cars. The Mercedes-Benz brand suffered an 18% sales decline in the first eight months of the year to 632,700 cars as demand for luxury cars contracted sharply.

Audi, **Volkswagen** AG's premium brand, has been narrowing the gap with Mercedes-Benz amid the recession, partly because of a strong presence in China and limited exposure to the troubled U.S. market.

"We acknowledge that they steered through the crisis very well. But there is no reason to fear Audi," Mr. Zetsche said, adding he was confident Mercedes-Benz was on the right track for growth. He played down Audi's benefits through economies of scale within the Volkswagen group.

He said the U.S. market would maintain an important one for premium auto makers, mainly for demographic reasons, but said the Chinese market harbors the biggest potential for growth in coming years.

Mercedes-Benz could ramp up production in China by gaining access to the entire capacity of its former alliance partner there, **Chrysler Group** LLC, he said. The Chinese joint venture had annual production capacity of 25,000 Mercedes-Benz cars and about 75,000 Chryslers.

Daimler has the scale and technological expertise to steer through the recession as a stand-alone company, he said, but added that, especially in the field of small and compact cars such as the Smart brand, it was looking at projects with other companies to benefit from synergies. Mr. Zetsche was optimistic Daimler would announce details on cooperation agreements "within the next months."

Reacting to the steep fall in demand for cars and trucks, Daimler initiated an initiative to trim costs by €4 billion, or roughly $6 billion, this year and streamline the organization.

Mr. Zetsche reiterated that Daimler was poised to exceed that target and expects earnings to gradually improve in coming quarters, adding that he regarded the company's net liquidity level of €4.6 billion as of June 30 as sufficient. He said Daimler had no plans to revive its share-buyback program.

Adding to hopes that auto markets are finally stabilizing, Mr. Zetsche said several major commercial-vehicle markets had started to bottom out. He said the European truck market was stabilizing at around 50% lower than last year, while the U.S. market showed the first signs of recovery.

Agence France-Presse/Getty Images

Mercedes head Dieter Zetsche, seen at a September auto show, is optimistic Daimler will announce details on cooperation agreements within months.

CORPORATE NEWS

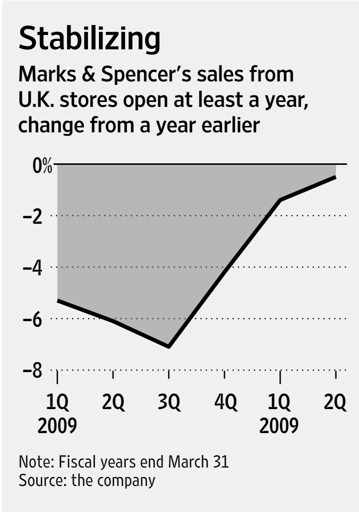
Marks & Spencer sales rise 2.7%

Online gains bolster quarterly results, but retailer is wary

By Lilly Vitorovich

Reuters

A shopper passes a Marks & Spencer store in central London.



LONDON—**Marks & Spencer Group** PLC on Wednesday reported better-than-expected fiscal-second-quarter sales, driven by the introduction of less expensive food and revamped clothing and housewares ranges, but the U.K. retailer cautioned that business will remain difficult well into next year because of the economic downturn.

Marks & Spencer, the U.K.'s largest clothing retailer and a bellwether for the nation's consumer sentiment, joins a growing list of retailers, including **John Lewis Partnership** PLC, **Next** PLC and **Debenhams** PLC to warn of difficult conditions ahead due to rising unemployment and likely higher taxes in the U.K.

Second-quarter group sales rose 2.7%, largely thanks to a 9.6% rise in international sales and a 30% jump in online sales. The company also raised its outlook on annual profit margin thanks to better stock control, sourcing and supply chain management.

"Whilst there is more visibility in the marketplace and consumers appear more confident, we continue to be cautious about the outlook," Stuart Rose, executive chairman and chief executive, said in a statement. "We expect 2010 to be a tough year and we will continue to run the business accordingly."

The U.K. retail market is "tough and volatile," Sir Stuart said. While the market has "bottomed out," rising unemployment and taxes are a major concern, he told reporters in a conference call.

Marks & Spencer has been hit hard over the past 18 months by the economic downturn as shoppers either cut back spending on non-essential items or sought less expensive food and clothing elsewhere. As a result, the company has revamped its food offer and availability, and introduced a budget range of grocery products. It has also cut capital spending, laid off 1,230 staff and closed some stores.

As well as facing tough competition in its traditional stores, Marks & Spencer is also facing strong competitors on the internet. Online fashion retailer **Asos** PLC Wednesday booked a 47% jump in sales for the six months to Sept. 30 as shoppers snapped up its range of clothing, shoes and bags.

Marks & Spencer said it expects gross margin in fiscal 2010 to narrow by between 0.5 percentage point and one percentage point compared with a year earlier—although that's an improvement from its previous guidance for a fall of between 1.25 points and 1.75 points. The improved outlook comes despite an expected increase of up to 1% in annual operating costs due to higher logistic, marketing and staffing costs.

The uncertain outlook hit Marks & Spencer's shares, and by midday in London, the stock was down 1.8%.

In the U.K., sales from stores open at a least a year were down 0.5% in the 13 weeks ended Sept. 26 from a year earlier, better than analysts' expectations for a 1.4% fall. That compares with a 1.4% fall in the first quarter of fiscal 2010. Marks & Spencer's high-end-food business reported flat same-store sales, slightly better than the 0.5% fall in the first quarter. Analysts had expected a 0.3% fall.

Within the company's U.K. general-merchandise unit, same-store sales fell 0.8%, much better than the 2.4% fall in the previous quarter. Analysts had expected a 2.7% drop.

Clothing sales rose 2.7% in the second quarter following the launch of its new womenswear casual range "Indigo" as well as a new designer collaboration with Jsen Wintle in "Autograph" for men. Its clothing market share was broadly flat.

Marks & Spencer said it will hire approximately 20,000 temporary staff to work in its 600 stores in the U.K. and Ireland at Christmas. Other retailers, including **J Sainsbury** PLC, have also announced recruitment drives for the holiday period.

Marks & Spencer will report results for the six months ended Sept. 26 on Nov. 4.

France plans cuts in car-buying incentives

By David Pearson

PARIS—The French government's draft budget reduces supports for the automobile industry that have underpinned car sales in the past 21 months.

The government is trimming a €1,000 ($1,460) car-scrapping incentive that was introduced at the beginning of this year to get old, fuel-thirsty cars off the road, to cushion the drop in demand for automobiles because of the recession and to prevent massive layoffs in the industry.

The incentive is paid when owners of cars that are at least 10 years old scrap their vehicles and buy new ones emitting less than 160 grams of carbon dioxide per kilometer. If lawmakers approve the draft budget, the incentive will be reduced to €700 on Jan. 1 and to €500 on July 1, before being phased out altogether at the end of next year.

The government has budgeted €240 million to cover the cost of these payments next year.

The initial budget for 2009 was €220 million, but the plan has been so successful that 380,000 car owners have taken advantage of it so far, resulting in a €380 million tab for taxpayers.

In its draft budget for 2010, the government said it plans to increase overall spending to €388 billion next year from €364.7 billion in 2009 in an effort to strengthen the country's incipient economic recovery, though it said it still plans to trim its budget deficit. The 2010 projected deficit amounts to 8.5% of gross domestic product, slightly broader than the 8.2% seen for 2009 and more than double the 3.4% deficit recorded in 2008.

At the same time, the government is toughening a system of bonuses and penalties introduced at the start of 2008 aimed at encouraging new-car buyers to opt for less-polluting vehicles. The plan involves a sliding scale with gradually increasing penalties—from €200 to €2,600—for cars emitting more than 160 grams of carbon dioxide per kilometer.

The initial plan will reduce the threshold by five grams of CO_2 every two years, so that the lower threshold would come down to 155 grams on Jan. 1. The government has decided to bring forward the threshold reduction for 2012 to Jan. 1, 2011.

Meanwhile, the Italian government is ready to renew its car incentive plan once it expires on Dec. 31, Prime Minister Silvio Berlusconi said Wednesday.

Over the first eight months of this year, sales of new cars in France rose 1.7% from a year earlier, adjusted for an equivalent number of working days. In contrast, new-car registrations in Europe fell 8% from a year earlier.

—A.H. Mooradian and Jennifer Clark contributed to this article.

Novartis multiple-sclerosis pill does well in study

By Jeanne Whalen And Anita Greil

Novartis AG said its experimental pill for multiple sclerosis performed well in a large clinical trial, marking a possible advance in the push to develop oral drugs for MS.

Analysts said the results look promising, but can't be thoroughly reviewed until Novartis publishes the full set of data next year.

Current drugs for MS—in which the immune system attacks nerve cells in the brain, leading to tingling, numbness and eventual paralysis—are injections or infusions. But several companies—including **Biogen Idec** Inc. and Germany's **Merck KGaA**—are competing to develop pills that could be taken orally. Such drugs would be easier for patients to use and could take sales from injectables sold by Biogen, **Pfizer** Inc. and **Teva Pharmaceuticals** Inc.

The Novartis-funded, two-year study tested the company's drug, FTY720, against a placebo pill in 1,300 patients with the relapsing-remitting form of multiple sclerosis. In patients taking a high dose of FTY720, the rate of suffering a relapse was 60% lower than in the placebo group, Novartis said. In patients taking a lower dose of the drug, the relapse rate was 54% lower than in the placebo group.

Patients taking Novartis's drug also experienced a slower progression in their level of physical disability, Novartis said.

Previous studies of FTY720 raised concerns that the drug could be linked to side effects including melanoma, a form of skin cancer; macular edema, which can lead to blindness; increased blood pressure; and liver trouble.

In this study, rates of malignant melanoma were no higher on FTY720 than in the placebo group, Novartis said. There were three cases of macular edema at the high dose compared with none at the low dose or in the placebo group. Raised liver enzymes and lung infections were found more often in patients taking FTY720 than in the placebo group, Novartis said.

Because the drug showed similar efficacy but fewer side effects at the lower dose, Novartis plans to file the lower dose for regulatory approval. Novartis said it will file for U.S. and European regulatory approval by the end of the year.

Novartis, based in Basel, Switzerland, says the drug has the potential to generate at least $1 billion in annual revenue.

Merck KGaA is ahead in the race to market. Merck filed its oral MS drug, cladribine, for European regulatory approval in July, and said Wednesday it also has filed it with the U.S. Food and Drug Administration.

Fiat's chief won't renew Magna deal

By Gilles Castonguay

LA SPEZIA, Italy—**Fiat** SpA's chief executive said he won't renew a **Magna International** Inc. contract to build **Chrysler Group** LLC vehicles in Europe, and will move their production to a site in Italy that Fiat bought at auction in August.

Fiat CEO Sergio Marchionne said Chrysler vehicles will be assembled at a former Carrozzeria Bertone plant in which Fiat plans to invest €150 million ($218.3 million) during the next three years to convert for Chrysler assembly. The plant has a production capacity of 70,000 cars a year.

Magna assembles the Chrysler 300C sedan and Jeep Grand Cherokee for European markets. Magna declined to comment on the decision and when its existing contract with Chrysler expires.

The move would be a continuation of Fiat's strategy to take control of Chrysler's manufacturing. Fiat has pulled Chrysler out of a number of partnerships, including with Nissan Motor Co. and Mitsubishi Motors Corp., as it sets about restructuring the third-biggest U.S. car maker, in which it owns a 20% stake.

It is unclear whether Fiat's decision was influenced by Magna's agreement earlier this month to acquire a majority stake in General Motors Co.'s European operations, which produce the Opel and Vauxhall brands. The deal has raised fears among customers of the Canadian auto-parts maker. Germany auto makers Volkswagen AG and BMW AG have expressed concern about sharing technical secrets with a supplier that now stands to become a direct competitor in making cars.

Chrysler's total sales in 2008 were 2.01 million units. In Europe, its biggest market outside North America, Chrysler sold just 37,295 vehicles in the first eight months of the year, industry figures show. That is down 46.9% from a year earlier, the worst drop for any maker.

A decision to allow Chrysler's production agreement with Magna to lapse will be one of the biggest steps taken so far by Fiat Chief Executive Sergio Marchionne to take control of Chrysler's product development. Mr. Marchionne took control of Chrysler's assets in June as part of the auto maker's bankruptcy process. In exchange for the assets, he promised to share Fiat's small-car technology and expand Chrysler's international presence.

Last Friday, Mr. Marchionne presented his strategy for Chrysler to its board of directors.

Mr. Marchionne first told reporters of his plans for the former Bertone plant at the Frankfurt motor show earlier this month, saying it would play a role in Chrysler's future. "There will be some Chrysler cars (manufactured there)," he said.

Bertone made its name in the 1960s working on cars like the Alfa Romeo Giulietta. Although its manufacturing arm went into special administration in April, 2008, its design facilities are still in business. The last model to roll out of its facilities, in September 2006, was BMW's Mini Cooper, for which it did the paintwork.

—Milena Vercellino and Jeff Bennett contributed to this article.

ECONOMY & POLITICS

Villepin testifies in slander case

Former French prime minister denies orchestrating plot to discredit President Sarkozy

Associated Press

PARIS—Former French Prime Minister Dominique de Villepin denied orchestrating a plot to discredit President Nicolas Sarkozy, in much-awaited testimony Wednesday that is central to a slander trial pitting the two political rivals against each other.

Mr. Villepin, known for a 2003 speech at the United Nations arguing against the U.S.-led invasion of Iraq—calmly and alertly laid out his defense in what the French have dubbed the Clearstream trial.

It was Mr. Villepin's big day in the monthlong trial, his first and main chance to try to fend off charges of complicity in slander and forgery that could jeopardize his political career.

The trial centers on mysterious lists circulating in 2004 that claimed to show clients with secret accounts at the Luxembourg clearing house Clearstream, including Mr. Sarkozy and other leading political and business figures. The accounts purportedly had been created to store kickbacks from the sale of warships to Taiwan, among other shady income.

The lists were leaked to the media before investigators determined they had been faked.

Mr. Sarkozy says it was all a smear campaign to thwart his bid to be elected president in 2007—and filed suit saying he believed Mr. Villepin was "the primary instigator" behind it. At the time, both men were leading conservative contenders to succeed then-President Jacques Chirac.

A key question in the trial is what Mr. Villepin knew about the lists and when. The presiding judge asked him on Wednesday if he was aware that someone had sent the lists to judges to investigate them in April 2004.

"No," replied Mr. Villepin.

Associated Press

Former French Prime Minister Dominique de Villepin arrives at a courthouse in Paris on Wednesday. In long-awaited court testimony, Mr. de Villepin denied orchestrating a plot to discredit President Nicolas Sarkozy.

He has said he never saw the lists himself, and said Wednesday he didn't know where they came from.

Mr. Villepin said he wasn't behind any plot targeting Mr. Sarkozy. Mr. Villepin says he first heard Mr. Sarkozy's name was on the lists from a July 2004 magazine report.

Mr. Villepin's detached poise cracked briefly when he was questioned by Mr. Sarkozy's lawyer. Mr. Villepin accused Mr. Sarkozy of intervening with the Justice Ministry during the investigation and quipped that the whole case had been built up to feed Mr. Sarkozy's "determination to destroy a political adversary."

Mr. Sarkozy hasn't hid his feelings about the trial. Last week, he referred on national television to the five defendants as "guilty"—prompting Mr. Villepin's lawyers to take legal action against the president for allegedly violating the presumption of innocence.

In Wednesday's testimony, Mr. Villepin denied suggestions that his mentor and ally Mr. Chirac was involved in the Clearstream affair, testifying that he "never had any presidential instructions from Jacques Chirac in this case." Mr. Chirac has denied wrongdoing and refused to testify.

Two leading defendants have already testified. Jean-Louis Gergorin, a former vice president at Airbus parent company European Aeronautic Defence & Space Co., has said he sent the lists to the investigating judge. Mr. Gergorin told the court he was unaware the lists were bogus at the time, and that he was duped by a well-connected computer expert alleged to be the one who falsified the lists.

Mr. Gergorin told the court he remains "convinced of the total good faith of Mr. de Villepin."

About 20 witnesses are testifying in the trial, which began Sept. 21 and is scheduled to run through Oct. 23.

Israel, Palestinians reach deal on prisoners

By Charles Levinson

JERUSALEM—Israel said Wednesday it will free 20 female Palestinian prisoners in exchange for a proof-of-life videotape of captured Israeli soldier Cpl. Gilad Shalit, the most promising sign of progress in negotiations for his release since Palestinian militants nabbed him more than three years ago.

The breakthrough comes as rival Palestinian factions Hamas and Fatah appear to be narrowing differences over an Egyptian-brokered reconciliation agreement that would reunite the Fatah-controlled West Bank with Hamas-controlled Gaza.

Hamas leader Khaled Meshaal said on Monday in Cairo that Hamas had agreed "in principle" to the Egyptian proposal to reunite the rival factions and end a two-year split in Palestinian politics. Hamas officials said Wednesday that they would return to Cairo at the end of October for a signing ceremony. Senior Fatah officials, however, said significant differences still need to be worked out.

The accord would call for Palestinian elections in mid-2010 and restructuring of the security services to meld the Hamas-controlled forces in Gaza with the Fatah-controlled units in the West Bank, according to Ahmed Yussuf, a senior Hamas official in Gaza.

Cpl. Shalit's continuing captivity and the Fatah-Hamas gulf are critical obstacles to U.S. peace efforts. As long as the Palestinian government remains divided between a Hamas-ruled enclave in the Gaza Strip and the Fatah-controlled West Bank, any Israeli-Palestinian agreement will lack popular legitimacy in the eyes of many Palestinians.

Associated Press

Relatives of Fatima Al Zaq, who is on a list of prisoners scheduled to be released by Israel, celebrate outside the family home in Gaza City on Wednesday.

But Israel is unlikely to relax its siege on Gaza or slacken its conditions for dealing with a Palestinian government that includes Hamas, as long as Cpl. Shalit remains captive.

Palestinian militant groups including Hamas captured the corporal, now 23 years old, from a guard post just outside Gaza in 2006. Hamas released an audiotape of him in 2007 and later delivered two letters in the soldier's handwriting to the Shalit family.

In Israeli society, where army service is mandatory, political and military leaders face massive public pressure to bring home captured soldiers and even the missing corpses of dead soldiers. But talks to bring home Cpl. Shalit have repeatedly stalled, dashing past hopes for a deal. Israel has refused Hamas demands that it release 1,000 or more prisoners, including some responsible for killing Israelis.

The release of the 20 prisoners is part of a "confidence-building measure in the framework of the indirect negotiations," Israeli Prime Minister Benjamin Netanyahu's office said. All have less than two years left to serve, according to a list published by Israeli prison officials.

Unemployment edges down in Germany

By Geoffrey T. Smith And Ilona Billington

German unemployment dropped for a third consecutive month in September, helped by a seasonal decline usually seen at the end of the summer holidays, but the country's Federal Labor Office warned that the labor market remained under pressure.

Other European economic figures released Wednesday showed consumer prices across the 16 countries that use the euro fell more steeply than predicted in August. Data from France and Italy showed producer prices in the euro zone's second- and third-biggest economies after Germany rose more than expected in August, but were significantly lower on an annual basis.

Germany's Federal Labor Office said that, after seasonal adjustments, the number of jobless people fell by 12,000 in September, resulting in an unemployment rate of 8.2%. Economists polled by Dow Jones Newswires had predicted a rise of 25,000 and a jobless rate of 8.3%.

"However, this is not a change in the trend," Labor Office Chairman Frank-Jürgen Weise said. "Overall, the effects of the economic crisis on the labor market remain palpable."

Without the support of the reclassification of people enrolled with independent job agencies and other government measures, the number of unemployed people would have risen by 10,000 in September and 13,000 in August, he said.

Economists are concerned about what will happen when government-subsidized short-term work initiatives end.

A preliminary reading from Eurostat, the European Union's statistics agency, showed euro-zone consumer prices fell 0.3% from last September. "Data details are not available yet, but we suspect that the inflation rate dipped further into negative territory mostly due to developments in energy and food prices," said Marco Valli, an economist at UniCredit Research.

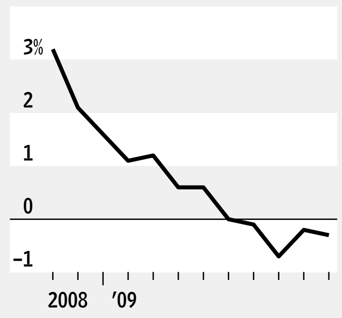
Figures from France showed producer prices there rose 0.5% in August from July, but were 7.5% weaker than in August last year.

In Italy, factory-gate prices rose 0.6% on a monthly basis in August, but were 6.7% lower on the year—above expectations of a 0.5% monthly gain and 7.3% annual drop.

In the U.K., official data showed the decline in output in the services sector slowed further in the three months to July, a fresh signal that the worst of the recession has passed.

Deflation deepens

Change from a year earlier in the euro zone's consumer price index



Source: Eurostat

U.S. Fed weighs timing

Central bank officials describe conditions for ending rescues

By Maya Jackson Randall And Emily Barrett

The U.S. Federal Reserve will carefully evaluate economic forecasts to judge exactly when and how to exit from its extraordinary rescue programs, and the withdrawal will happen "well before" inflation has a chance to rise out of control, the Fed's vice chairman said Wednesday.

Bloomberg News

Donald Kohn, vice chairman of the U.S. Federal Reserve, testifies at a House Financial Services subcommittee hearing in Washington in July.

"We must begin to withdraw accommodation well before aggregate spending threatens to press against potential supply, and well before inflation as well as inflation expectations rise above levels consistent with price stability," Fed Vice Chairman Donald Kohn said in a speech to the Cato Institute in Washington.

In a separate speech, the president of the Federal Reserve Bank of Atlanta said the Fed probably has a while longer to wait before it needs to start withdrawing its market support programs in earnest. "I think it may well be some time before comprehensive exit need be under way," Dennis Lockhart said in prepared remarks for a speech at an event hosted by the University of South Alabama's Mitchell College of Business.

Mr. Kohn said there wasn't necessarily a list of variables that would trigger an exit. Instead, he pointed out that the Fed would base its decisions on economic forecasts, not current conditions. He added that he couldn't predict the pace of rate increases.

"That, too, depends on how the economy seems to be recovering and the outlook for inflation," Mr. Kohn said. Mr. Kohn went on to outline the tools the Fed has on hand to withdraw from its extraordinary programs and tighten monetary policy.

Though the U.S. economy is "unquestionably" improving, the Atlanta Fed's Mr. Lockhart recommended only "measured optimism" on the recovery in the economy and financial markets. Unemployment is likely to rise above the current 9.7% before it falls; the residential-housing market remains weak; and the commercial sector still poses a real threat, he said. The progress made so far has been achieved with considerable government and central-bank stimulus, most of which remains in place.

His comments reinforced the view that the central bank would hold its target interest rate close to zero—where it has been for the past nine months—well into next year.

"I would like to see more evidence of private activity in the economy before advocating change in the Fed's overall monetary policy stance," Mr. Lockhart said.

"The flow of credit through the U.S. banking system is not yet approaching anyone's notion of normal," he said. Though banks have been repairing their balance sheets, "a return to robust bank lending is unlikely, at least in the near term."

Mr. Lockhart singled out the continued deterioration of the commercial real-estate market as a "developing risk that could set back the progress being made by banks."

He said commercial real-estate professionals at a recent Atlanta Fed conference believe that the worst may still be ahead for the sector.

Even the recuperation of the long-suffering residential property markets is fragile, and still depends heavily on the support of public programs, Mr. Lockhart said.

"There is too much uncertainty at the moment to project happy days almost here again."

Mr. Lockhart is a voter this year on the Fed's Open Market Committee, which last month opted to continue holding its target interest rate at the historic low of zero to 0.25% it hit in December.

CAPITAL ▪ David Wessel

After binge, Americans cut debt, but the economy pays the price

The story of the past few years in a few sentences: U.S. financial firms, other businesses and families went on a borrowing binge. It was fun. Lenders and investors lent too freely and didn't charge enough to cover risks they were taking. When borrowers couldn't pay the loans and the collateral they pledged wasn't sufficient to cover the loans, a lot of lenders lost money. That wasn't fun.

Now, it's harder to get a loan. And many Americans, most banks and some other businesses are reluctant to borrow. They are trying to lighten their debt loads, to "deleverage."

There is more to come. "Deleveraging in the household sector has barely begun because it's hard for households to lower debt burdens, other than declaring bankruptcy," says Martin Barnes, who has been monitoring the credit cycle for years for the Bank Credit Analyst, a forecasting journal.

He notes that government is giving consumers a mixed message: preaching the virtues of saving more and borrowing less while dangling "cash for clunkers" and urging consumers to take a loan to buy a car.

Household debt now amounts to about 125% of after-tax income, down slightly from the peak but well above the 80% levels of the mid-1990s. A lot turns on whether Americans will keep saving at current rates as the economy perks up, or will they save more or less.

The U.S. government is doing the opposite of deleveraging. By the Fed's tally, federal debt increased at a 28.2% annual rate in the second quarter.

This prudent reaction to a borrowing binge that proved unwise hurts the economy. Financial institutions, which basically borrow from some to lend to others, are borrowing less and, thus, lending less. Consumers are skimping to pay down debt, and, thus, spending less. The result is an economy growing too sluggishly to reduce unemployment. The U.S. government can't stop this deleveraging, but it's trying to ease the pain by borrowing more while everyone else tries to borrow less.

Deleveraging is in its early stages. Big finance has done a lot. Especially after the Lehman Brothers calamity a year ago, highly leveraged firms pulled back. Many had no choice. The latest Federal Reserve data show the domestic financial sector reduced borrowing at a 12.2% annual rate in the second quarter after cutting it at a 10.4% pace in the first quarter.

But banks remain skittish. "Even though bank earnings are recovering," the International Monetary Fund said this week, "they are not expected to be big enough to offset fully the anticipated write downs over the next 18 months."

The combination of "insufficient earnings" and "continuing deleveraging pressure" means "banks are not yet in a strong position to lend support to the economic recovery," the IMF said.

American families, who account for about 40% of all borrowing in the U.S., aren't nearly as far along the deleveraging road as big finance. Either because they want to or because they can't get credit, households began reducing debt a year ago, the Fed says. In the second quarter, which ended in June, household debt shrank at a 1.7% annual rate—a far cry from 10%-plus pace of increase in the mid-2000s.

The thriftier they are, the less they'll spend at stores, car dealers, airlines and restaurants. "What is the level of debt that household want to hold?" asks Rebecca Wilder, a financial analyst who writes for the Angry Bear blog. "Nobody can tell you—just something less than 125%."

The U.S. government is doing the opposite of deleveraging. By the Fed's tally, federal debt increased at a 28.2% annual rate in the second quarter. This is not a long-run solution.

"The hope is that the government borrows like crazy while the private sector gets its financial house in order," says Mr. Barnes. "By the time the government is forced to deal with its debt problem, and retrench massively, the private sector will have its act together and can start leveraging again." That's the hope.

In this space in December 2007, I wrote, "Economists dub recent decades in which recessions were scarce and inflation calm the Great Moderation. That seems to be giving way to the Great Deleveraging. At best, the economy has a hangover, and will feel better in a couple of months. But this may be more like a case of mono, an ailment in which the patient doesn't return to normal vigor for a lot longer."

The medical metaphor was wrong. The patient had a massive heart attack. He's out of intensive care, but far from healthy. It's going to take a lot of time on the treadmill of deleveraging before he feels anything close to normal.

Write to me at capital@wsj.com. Discuss at wsj.com/capital