Leading the News: Ex-UBS banker will head U.K.'s bailout agency

THE WALL STREET JOURNAL.
VOL. XXVII NO. 189 | EUROPE | THURSDAY, OCTOBER 29, 2009
DOWJONES A News Corporation Company
europe.WSJ.com

For information or to subscribe, visit www.services.wsje.com or call +44 (0) 207 309 7799 — Austria €3 - Belgium €3 - Croatia HRK 22 - Czech Republic Kc 110 - Denmark Dkr 25 - Finland €3.20 - France €3 - Germany €3
Greece €3 - Hungary Ft 650 - Ireland (Rep) €3 - Italy €3 - Lebanon L£ 6000 - Luxembourg €3 - Netherlands €3 - Norway Nkr 29 - Poland Zl 12 - Portugal €3 - Slovakia €3 32/Sk 100 - Spain €3 - Sweden kr 29
Switzerland SF 5 - Syria S£ 210 - Turkey TL 4.5 - U.S. Military (Eur) $2.20 - United Kingdom £1.50

Taliban hit both sides of border

Attacks on Pakistan market and U.N. staff in Kabul kill over 100 as Clinton arrives in region

Associated Press; Getty Images

Volunteers rush an injured child, left, to a hospital Wednesday in Peshawar, Pakistan. Right, a German man is carried from the scene of an attack on a Kabul guesthouse.

By Yaroslav Trofimov in Kabul and Matthew Rosenberg in Islamabad

Taliban groups staged deadly attacks in Pakistan and Afghanistan Wednesday, killing at least 100 people as they targeted a market in Peshawar and United Nations personnel in Kabul just as U.S. Secretary of State Hillary Clinton arrived in the region.

Both strikes were extraordinary: Pakistan's was the country's deadliest in two years; Afghanistan's showed a shift by Taliban leaders toward targeting the U.N. because of its role in the country's election process.

The attacks showed what the Taliban can still accomplish despite an expanded U.S. troop presence in Afghanistan and the Pakistani military's large-scale offensives on insurgent bases.

The biggest loss of life Wednesday occured when a car bomb ripped through Peshawar's crowded Meena Bazaar, a market selling women's clothes that Taliban zealots deem insufficiently conservative.

More than 90 people were reported dead as a fire sparked by the explosion engulfed the neighborhood, trapping many residents under the rubble of burning buildings. It was the second huge blast this month to hit a market in Peshawar, the main city in northwestern Pakistan.

The attack on the U.N. in Kabul may have more far-reaching repercussions. Five U.N. officials, including one American, were killed, and several others wounded when Taliban gunmen stormed a Kabul guesthouse housing U.N. election staff early Wednesday morning. Three attackers, two security guards and an Afghan civilian were also killed.

Insurgents also attempted to attack another guesthouse, but were repelled, and fired rockets at Kabul's main luxury hotel, causing no casualties.

The Taliban said they targeted the U.N. because of the organization's crucial role in staging the Nov. 7 runoff of the country's presidential election—an event the insurgents have threatened to disrupt by killing election workers and voters. It was the first time the Afghan Taliban leadership said they had specifically attacked the organization.

"This is a very dark day for the U.N. in Afghanistan," said Kai Eide, the organization's special representative in Kabul. Mr. Eide insisted that the attack "will not deter the U.N. from continuing all its work to reconstruct a

Please turn to page 34

Big law firms in U.S., U.K. are set to merge

By Nathan Koppel

Hogan & Hartson LLP, a powerful Washington law firm that was previously home to U.S. Supreme Court Chief Justice John Roberts, is on course to merge with Lovells LLP, one of Britain's largest and most prominent firms, according to people familiar with the matter.

If approved, the deal would create one of the world's largest law firms, with about 2,500 attorneys and $2 billion in annual revenue. It also would mark a rare combination of top-tier U.S. and British firms.

Though the merger talks could still fall apart, management committees for both firms will recommend the proposed deal to their respective partnerships, according to people familiar with the matter. Both firms would need their partners' approval for such a deal.

British firms haven't been able to become significant players in the U.S. market, industry experts say, because trans-Atlantic differences in culture and compensation practices have made it hard for them to acquire leading American firms. But the management teams at Hogan & Hartson and Lovells think they have a plan to overcome those obstacles, with Lovells likely shifting to a more-American approach to compensation.

The U.S. is "by far the larg-

Please turn to page 35

What's News

The dollar continued its comeback on economic worries, with its strongest gains against Asian and commodity-driven rivals. The rally takes the heat off several economies that were beginning to fret that dollar weakness was undermining their export competitiveness. Page 21

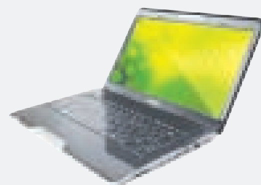
- **U.S. stocks fell** as investors continued to shy away from risk after weak readings on the economy. Shares in Europe also declined. Page 22
- **The euro-zone credit** crunch appears to be easing, an ECB survey of banks shows, but only gradually, underscoring the fragility of the region's recovery. Page 2
- **Norway became** the first European nation to raise interest rates since the financial crisis began, lifting the key borrowing rate to 1.5%. Page 2
- **Northern Rock will get** up to $20 billion more in aid and be split into so-called good and bad banks. Page 3
- **The U.S. pay czar said** he doesn't want his authority to set compensation standards to expand to a broader range of companies. Page 4
- **EU leaders were set** to meet in preparation for global climate talks but the summit was likely to focus on the Lisbon pact. Page 6
- **Audi said its sales** in China could exceed those in its home country of Germany by 2013. Page 7
- **Daimler wants** to extend its $5.9 billion cost-cutting program beyond 2009 and make it an annual target. Page 7
- **ArcelorMittal's profit fell** 76% in the third quarter amid weak steel demand. The company plans to expand in India, Brazil and the Mideast. Page 11
- **Job cuts at Versace** underscore how independent fashion houses are having a tougher time than luxury-goods conglomerates. Page 10
- **SAP posted** a rise in third-quarter profit but warned that software revenue will drop more sharply than expected this year. Page 10
- **Heineken's quarterly** revenue fell but it raised its full-year earnings forecast. Page 11
- **Climate activists dumped** 18 tons of coal in front of the Swedish government headquarters to pressure nations to shut coal-fired power plants.

Editorial & Opinion

A Royal Mess
A solution for the post office's labor woes. Page 17

Breaking news at europe.WSJ.com

Inside



Legends of the fall

Walter S. Mossberg unveils annual computer buying guide
Personal Technology, Page 32

Markets

4 p.m. ET

	CLOSE	PCT CHG
DJIA	9762.69	-1.21
Nasdaq	2059.61	-2.67
DJ Stoxx 600	237.34	-2.03
FTSE 100	5080.42	-2.32
DAX	5496.27	-2.46
CAC 40	3663.78	-2.14
Euro	$1.4762	-0.40
Nymex crude	$77.46	-2.63

Sun's SPARC Server | IBM's Fastest Server

16x Faster Response Time | 6x More Energy Consumed
25% More Throughput | 20% More Expensive
Building Smarter Computers | Building "Smarter" Planets

ORACLE®
oracle.com/sunoraclefaster

*As of 10/11/09. Source: Transaction Processing Performance Council, www.tpc.org.
12-Node SPARC Enterprise T5440 server cluster, 7,717,510 tpmC, $2.34/tpmC, available 12/14/09.
IBM Power 595 Server Model 9119-FHA, 6,085,166 tpmC, $2.81/tpmC, available 12/10/08.

Copyright © 2009, Oracle. All rights reserved.

Euro-zone credit crunch is easing

ECB survey shows slow improvement, but recovery is fragile

By Brian Blackstone

The credit crunch in the euro zone appears to be easing, a survey of banks by the European Central Bank shows, but only gradually, underscoring the fragility of the region's economic recovery.

The survey, released Wednesday, comes after separate ECB data on Tuesday showed a contraction in overall lending in September from the previous year, but some increase from August.

The new survey sheds further light on the lending trend. While banks are still being restrictive in granting loans, there are signs that their caution is starting to ease. Banks expect a small improvement in the availability of credit for businesses in the current quarter, the latest survey of lending officers shows.

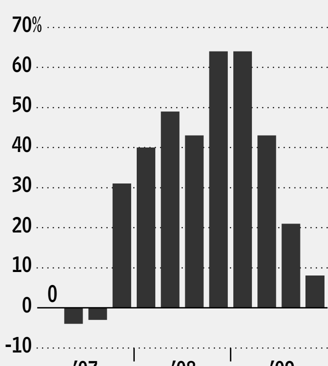
While the survey found "ongoing normalization," the ECB warned that the tightening in lending standards during the crisis "has not yet started to reverse itself and remains very substantial."

The gap between the percentage of banks reporting tighter lending standards for corporate loans and those reporting easier standards shrank to eight percentage points during the third quarter, from 21 points in the second quarter, and a peak of over 60 in late 2008, Wednesday's ECB study said. The latest result means that the tightening of lending is "close to a halt," the report said.

ECB officials have pressed banks to use the cheap money the ECB has been providing to make new loans. ECB President Jean-Claude Trichet in August sent a message of "very strong encouragement" to banks to lend.

Corporate bank lending

Euro-zone bank-lending survey, net percentage of banks, positive figures indicate tightening of credit standards



Source: J.P. Morgan

Bloomberg News

Deutsche Bank headquarters in Frankfurt

But banks face their own pressures. Loan defaults are rising, a byproduct of the severe global recession. And banks contend there is ample credit available for companies.

Deutsche Bank AG has increased lending to the *Mittelstand*, midsize German companies, despite the tough economic times, said Jürgen Fitschen, a member of the bank's management board, on Monday. "On top of that, we are holding around €10 billion [$14.8 billion] in open credit lines that our Mittelstand customers can use," he said.

There were other positive signals in the ECB survey, particularly related to demand for home loans, which accelerated during the third quarter. ECB research has found such loans tend to lead economic cycles by one or two quarters. In contrast, corporate lending can lag behind economic recoveries by many months—a trend supported by Wednesday's report that showed continued declines in demand for business loans, especially at larger firms.

"Credit strains are easing but are not yet solved," said Davide Stroppa, economist at UniCredit Group.

The quarterly survey is in line with September monthly data reported Tuesday by the ECB. They showed a continuing drop in loans to businesses and households from last year, but some improvement on a monthly basis.

The lending numbers should give some relief to ECB officials that low official interest rates and the ECB's steps to boost liquidity have unlocked credit.

The lending numbers should give some relief to ECB officials that low official interest rates, along with the ECB's unconventional steps to boost liquidity, have unlocked credit somewhat. But as J.P. Morgan economist Greg Fuzesi noted, officials still have "reason to be cautious" about withdrawing stimulus too early.

The ECB is widely expected to keep its key interest rate at 1% when it meets next week, and to offer no indication that it will unwind its other stimulus measures anytime soon.

On Wednesday, Norway became the first central bank in Europe to raise rates since the crisis. As expected, it raised its key borrowing rates by 0.25 percentage point to 1.5%. Norway has recovered more quickly than the euro zone, thanks to rising oil prices.

But in a sign of how difficult it will be for other central banks to begin their own tightening cycles, Norway said its interest rate "should not be raised too rapidly," and added that if its currency rises too much further, rate increases may be delayed.

Separately, German consumer prices nudged 0.1% higher in October from September and were flat on the year, based on preliminary data. Economists had expected fractionally weaker prices. Annual inflation in Germany and the euro zone is expected to turn positive in November, in response to higher energy and commodity prices.

However, the sluggish recovery should keep inflation well below the ECB's target rate of under, but close to, 2%.

Norway raises interest rates; first in Europe

By Elizabeth Adams

Oil-rich Norway became the first European country to raise interest rates after the financial crisis, lifting the key borrowing rate by a quarter of a percentage point to 1.5% in response to signs of renewed economic growth.

The central bank also raised its interest-rate path projections, which signaled rates will edge gradually up to 2.75% by the end of 2010.

Norway has pulled out of recession faster than the rest of Europe, helped by the strong rise in commodity prices since the start of the year, as well as significant monetary and fiscal-policy stimulus. The stimulus programs amounted to more than 4% of gross domestic product in 2009.

The rate increase by Norges Bank follows that of the Reserve Bank of Australia, which this month was the first major central bank to tighten policy after the downturn. Israel, a much smaller economy, also raised interest rates recently.

Both Norway and Australia have been helped on the road to recovery by their relatively high precrisis levels of economic activity compared with the average of countries in the Organization for Economic Cooperation and Development, and they were supported by robust demand for commodities.

In addition, the length and pace of both countries' economic contraction was less marked than elsewhere.

Norway's move is unlikely to herald tightening elsewhere in Europe, at least for now. Data released this week showed private-sector loans in the euro zone declined annually for the first time on record last month, casting fresh doubts on recovery prospects and raising pressure on the European Central Bank to maintain its easy monetary stance.

In contrast, Norges Bank pinned its rate increase on the quicker-than-anticipated pickup in Norway's economy. It said higher-than-expected inflation and considerably lower-than-forecast unemployment prompted its decision.

"The global economy is in a deep downturn but there are signs of renewed growth," it said. "Developments indicate that it is appropriate to raise the key policy rate now," Governor Svein Gjedrem said.

Norges Bank said the key rate will stay between 1.25% and 2.25% between now and March 24, with gradual increases thereafter.

—Katie Martin in London contributed to this article.

INDEX TO BUSINESSES

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

Advanced Micro Devices 23
Albertson's 19
Alcoa 22
Allied Irish Banks 22
Aluminum Corp. of China 26
AMD. 32
American Express....22
American Internationl Group 4
Apollo Group 22
Apple....32
ArcelorMittal....22
AstraZeneca 12
AT&T 22
Audi 7
BAE Systems....35
Banco Santander (Spain) 26
Bank of America 21,25
Bank of Ireland....22
BG Group....27
BHP Billiton....23
BlackRock....25,27
Blackstone Group 27
BT Group 34
Canon Inc. 26
Carphone Warehouse Group 34
Chevron....27
China Cosco Holdings .26
China International Capital 27
China Investment Corp. 27
Chuo Mitsui Trust Holdings 26
ConocoPhillips....27
Credit Suisse Group 23,27
CVS Caremark....19
Daewoo Shipbuilding ..26
Deutsche Bank....2,22
Deutsche Postbank 22
Don Quijote....4
Erste Bank 22
Exxon Mobil 27
Fanuc....32
Fast Retailing 4
Ford Motor 7
Fujitsu....32
Galleon Group 23
Genmab 12
Gianni Versace....10
GlaxoSmithKline....12
Global Infrastructure Partners 10
Globalfoundries 23
GMAC Financial Services 21
Goldman Sachs Group.23
Grupo Ferrovial 10
Hitachi....32
Hogan & Hartson....1
Honda Motor 26,36
Hopu Investment Management 27
Intel....32
Iron Mining International 27
Ivanhoe Mines 27
J.P. Morgan Chase 27
Kawasaki Kisen Kaisha 26
Lazard 23,24
Lloyds Banking Group ..3
Lovells....1
Lufthansa 22
Lukoil Holdings 27
Macquarie Group 22
McKinsey 23
Microsoft 10
Mitsubishi Electric 32
Mitsui O.S.K. Lines 26
Morgan Stanley 23
National Australia Bank 26
NEC....32
Neptune Orient Lines..26
Nordea Bank....24
Northern Rock 3
Novartis 12
Oracle 10
Prudential 24
Qwest Communications International 22
Rio Tinto 23
Rite Aid....19
Royal Bank of Scotland Group 3,36
Sal. Oppenheim Jr. 22
Samsung Electronics ..32
SAP 10,22
STX Pan Ocean....26
Sumitomo Trust & Banking....26
Svenska Handelsbanken 24
Telstra 26
Temasek Holdings....27
Tesco PLC....3
TomTom 22
Toyota Motor....36
UBS 3
U.K. Financial Investments 3
Vedanta Resources 22
Verizon Communications 22
Virgin Group 3
Walgreen....19
Wal-Mart Stores 4,19
Wienerberger....22
Xstrata 22

THE WALL STREET JOURNAL EUROPE (ISSN 0921-99)
Boulevard Brand Whitlock 87, 1200 Brussels, Belgium
Telephone: 32 2 741 1211 Fax: 32 2 741 1600
SUBSCRIPTIONS, inquiries and address changes to:
Telephone: +44 (0) 207 309 7799
Calling time from 8am to 5.30pm GMT
E-mail: WSJUK@dowjones.com Website: www.services.wsje.com
Advertising Sales worldwide through Dow Jones International. Frankfurt: 49 69 29725390; London: 44 207 842 9600; Paris: 33 1 40 17 17 01
Printed in Belgium by Concentra Media N.V. Printed in Germany by Dogan Media Group / Hürriyet A.S. Branch Germany. Printed in Switzerland by Zehnder Print AG Wil. Printed in the United Kingdom by Newsfax International Ltd., London. Printed in Italy by Telestampa Centro Italia s.r.l. Printed in Spain by Bermont S.A. Printed in Ireland by Midland Web Printing Ltd. Printed in Israel by The Jerusalem Post Group. Printed in Turkey by GLOBUS Dünya Basınevi.
Registered as a newspaper at the Post Office.
Trademarks appearing herein are used under license from Dow Jones & Co. © 2009 Dow Jones & Company All rights reserved.
Editeur responsable: Patience Wheatcroft M-17936-2003

INDEX TO PEOPLE

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

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

Ackermann, Josef 22
Apotheker, Leo 10
Barnard, Marcus 24
Bin Zayed al Nahyan, Mansour 31
Brandt, Werner 10
Budenberg, Robin 3
Carothers, Tom 13
Chapman, Frank 27
Clausen, Christian 24
Curl, Gregory 25
Eyal, Jonathan 13
Fang Fenglei 27
Farris, Ray 22
Ferguson, Niall 13
Fink, Laurence D. 25
Fitschen, Jürgen 2
Fox, Timothy 24
Fuzesi, Greg 2
Gat, Azar 13
Glazer, Malcolm 31
Golub, Steve 24
Hester, Stephen 36
Hoffman, Gary 3
Jones, Randall 4
Kato, Kazuhiko 32
Kenney, Jason 27
Kingman, John 3
Kono, Ryutaro 4
Kudrin, Alexander 25
Kumar, Anil 23
Lewis, Kenneth D. 25
Lou Jiwei 27
Matthews, Colin 10
Molina, Alvaro de 22,25
Moynihan, Brian 25
Mulva, James 27
Nishioka, Junko 4
Ong, Richard 27
Owen, Michael 31
Peterson, Peter G. 27
Ronaldo, Cristiano 31
Ruiz, Hector 23
Saenz, Alfredo 26
Schwarzman, Stephen . 27
Shinawatra, Thaksin 31
Stroppa, Davide 2
Tevez, Carlos 31
Thiam, Tidjane 24
van der Sar, Edwin 31
Walker, Chris 13
Waters, Dan 23
Weidel, Odd 24
Wittwer, Stephan 10
Witty, Andrew 12
Zhang Qi 26

LEADING THE NEWS

UKFI

Robin Budenberg was part of the team last year that structured the government's capital injection into Lloyds and Royal Bank of Scotland.

Budenberg named CEO of U.K.'s bailout agency

BY MARGOT PATRICK AND VIVEK AHUJA

LONDON —Former **UBS** AG banker Robin Budenberg will be the new chief executive of **U.K. Financial Investments** Ltd., putting him in charge of finding ways to repay taxpayers for the roughly £70 billion ($114.61 billion) outstanding in bailout money.

In his role leading the government agency responsible for managing stakes in state-supported banks, Mr. Budenberg will be at the crux of the U.K.'s efforts to sell down its interests in **Lloyds Banking Group** PLC and **Royal Bank of Scotland Group** PLC over the next few years.

Mr. Budenberg also will be involved in efforts to sell nationalized lender **Northern Rock** PLC. The government also will consider possibilities for Bradford & Bingley PLC's mortgage business, which it also owns.

"I am honored to have been asked to lead the strong team at UKFI, which has done an excellent job during its first year of existence," Mr. Budenberg said in a statement. "I look forward to helping the banks as they recover from the financial crisis, and ensuring taxpayers are suitably rewarded for their considerable support to the sector."

He will take over from John Kingman, the agency's chief executive since it was formed last year. Mr. Kingman is preparing to leave the government for the private sector and announced his departure in July, saying he would continue working until a successor was found. The agency said there will be an "appropriate" transition period. The agency is responsible for managing a 43% shareholding in Lloyds and a 70% stake in RBS.

Meanwhile, the government could put as much as £12 billion ($19.65 billion) of additional taxpayer money into Northern Rock under a restructuring plan approved Wednesday by the European Union. In 2007, the government injected about £25 billion into the bank.

Mr. Budenberg, who had been at UBS since 1984, was responsible for managing U.K. clients at the Swiss bank and has managed the bank's relationship with the U.K. Treasury.

UBS traditionally has enjoyed close links with the U.K. government. James Sassoon, a former vice chairman of investment banking at UBS and a former colleague of Mr. Budenberg's, last month gave up his responsibilities at the Treasury after a six-year stint.

In October last year, Mr. Budenberg was part of the team that structured the government's capital injection into Lloyds and Royal Bank of Scotland.

Mr. Budenberg also has worked for the U.K. government, advising on the replacement of Railtrack by Network Rail in 2002 and, in 2006, when UBS was hired by the government to advise on the sale of nuclear-power company British Energy.

Mr. Budenberg will receive a £155,000 annual salary and won't receive a bonus or pension, although executive directors, including the CEO, could be eligible for performance-based bonuses, according to the agency's annual report. His base salary is 8.4% higher than the £143,000 annual salary received by Mr. Kingman, who was paid through his civil-service employment contract with the U.K. Treasury.

The agency's annual report for the period since its creation in November to the end of March confirmed no board members or staff had received a bonus, but stated the agency "has a policy to recognize those staff that have performed well in their roles through the payment of bonuses."

—Laurence Norman and Matt Turner contributed to this article.

Northern Rock gets more aid

EU signs off on plan to divide the lender into good, bad banks

The U.K. government could put as much as £12 billion ($20 billion) of additional taxpayer money into nationalized lender **Northern Rock** PLC under a restructuring plan approved by the European Union.

By Carolyn Henson in Brussels and Margot Patrick in London

The European Commission, the EU's executive branch, on Wednesday cleared a series of aid measures for the bank, without imposing the draconian conditions some had feared after it forced Dutch bank ING Group NV to separate its banking and insurance businesses.

Under the plan, Northern Rock will be split into a "good" bank—which will hold the bank's deposits and some existing mortgages—and a "bad" bank holding mortgages that will be gradually wound down.

The bad bank's assets will include Northern Rock's Granite securitization vehicle, a major source of its funding before the credit crisis. Subordinated bonds issued by Northern Rock will also stay with the bad bank.

Analysts expect that the deposit-taking bank will be sold as soon as possible, but Northern Rock Chief Executive Gary Hoffman said the sale process isn't under way. If no buyer emerges, Mr. Hoffman said, it should take about 10 years for the government to get its money back as customers repay their mortgages.

The U.K. government will top up an existing loan of about £15 billion with £8 billion to fund new lending, as well as £3 billion in new capital and a working-capital liquidity facility, Mr. Hoffman said on a conference call. That would give Northern Rock about £27 billion in government aid.

While the £3 billion of new capital had been expected, the new £8 billion of funding wasn't. If fully drawn, the commitments mean taxpayers will end up being owed about as much as when Northern Rock was bailed out in September 2007.

Those borrowings had been reduced over time to the current £15 billion as mortgages in the bank's books were repaid.

To address concerns about competition, Northern Rock will only be able to lend £9 billion next year and £8 billion in 2011, while it will be limited to holding no more than £20 billion in deposits—close to its current £19 billion mark—until the end of 2011.

The commission also placed restrictions on Northern Rock's mortgage rates to prevent it from beating competitors in terms of pricing.

The U.K. Treasury said the EU state-aid decision was "an important milestone." Stephen Timms, financial secretary to the Treasury, told the British Broadcasting Corp. the government will seek to sell the bad part of the bank "in due course."

Northern Rock was nationalized in February 2008 after the U.K. government rejected bids from other companies, including **Virgin Group**, to buy it. In September 2007, the government injected about £25 billion into the bank after it ran out of funding options and became one of the first casualties of the credit crisis.

"The failure of Northern Rock would have had major detrimental effects on the U.K. mortgage market and the overall financial stability of the U.K. economy," said EU Competition Commissioner Neelie Kroes.

The commission said that it was satisfied the restructuring package would restore the good bank's viability and allow the bad bank to be liquidated in an orderly fashion. It said it believed the aid package was kept to a minimum and won't give the business an advantage over rivals.

Government guarantees for Northern Rock deposits will remain in place and would only be lifted with three months notice if a buyer emerged. Guarantees on fixed-rate bonds will continue until the bonds mature.

The government repeated comments that any sale of Northern Rock will have to promote competition in banking. Analysts have said that smaller financial-services companies including **Tesco** PLC's Tesco Bank and Virgin Group's Virgin Money are likely candidates for a bid.

—Laurence Norman contributed to this article.

BREITLING
1884
SUPER AVENGER
WWW.BREITLING.COM

Deflation threatens Japan's recovery

Little risk of a spiral, but many consumers will slow spending

By Yuka Hayashi

TOKYO—As the world resumes economic growth after the steep global downturn, a familiar problem may keep Japan from following: deflation.

Economists expect the Bank of Japan in its semiannual outlook Friday to forecast that the core consumer price index will fall for the fiscal year ending in March 2012, at a rate of at least 0.5%. That represents three years of expected deflation. The central bank has projected a decline of 1.5% for the current fiscal year and 1% for the next.

Economists see little immediate risk of Japan entering a deflationary spiral, in which price declines accelerate as demand drops and economic activity ebbs. Still, an extended period of deflation can keep consumers from spending and companies from investing as they wait for prices to fall further.

"We are very concerned about deflation being a drag on [Japan's] economic growth," says Randall Jones, an economist heading research on Japan and South Korea at the Organization for Economic Co-Operation and Development. Mr. Jones urges the BOJ to keep its policy rate close to zero and "focus on trying to stop deflation."

Japan's core CPI fell for six straight months, on a year-to-year basis, ending with a record 2.4% decline in August. A similar decline is projected for September, though the size of the declines are projected to narrow afterward, reflecting changes in energy prices. Excluding both food and energy, Japan's CPI fell 0.9% in August from a year earlier.

Fast Retailing's Uniqlo shop in the Ginza district of Tokyo

Though Japan remains expensive, signs of deflation can be found in everything from paychecks to the price of electronics. Workers' total cash earnings fell 2.7% in August from a year ago. Year-end bonuses paid by 218 large companies listed on the Tokyo Stock Exchange will fall by 13.1% this year, the largest drop at least since 1970, according to a survey by the Institute of Labor Administration, a Japanese think tank.

"The continued drops in income are making households more thrifty," says Ryutaro Kono, an economist for BNP Paribas Securities in Tokyo. "Companies are responding by cutting prices, sensing they wouldn't survive otherwise."

In the fashion industry, Uniqlo, **Fast Retailing** Co.'s casual-clothing brand, ignited a price war earlier this year, introducing a new line of jeans for 990 yen ($10.80) a pair. Soon, Seiyu Ltd., a **Wal-Mart Stores** Inc. unit, cut its price to 850 yen, followed by **Don Quijote** Co., a discount chain, with a 690-yen price tag this month.

Food prices also are gradually declining, a phenomenon attributed in part to the idea that Japan's population eats less as it ages. Desperate to spur sales, supermarket and convenience chains are replacing national-brand products with cheaper private-brand options, offering smaller packages and turning their stores into shops that advertise most items at 100 yen.

"Of course, I compare prices because I am a housewife," says Shizuko Shibata, a 74-year-old pensioner who lives with her daughter in Setagaya, a Tokyo residential area. Ms. Shibata had just come out of a new 100-yen supermarket, where she bought a bag of frozen edamame, among other things. "I am not crazy about the quality at these stores, but these small packages are just the right size for us. "

Still, overall retail sales fell for the 13th straight month in September, with a 1.4% year-on-year drop, the government said Wednesday.

When prices rose in 2006, Japanese policy makers had signaled that deflation appeared to be tamed. Much of that growth is now attributed to then-rising commodities prices.

The deflation can be blamed on Japan's long-term structural problems, including an aging population and one of the lowest birth rates in the developed world. Japan's new government has proposed an ambitious program of $185 billion in spending each year to spur consumption at home, though many economists say longer-term growth initiatives and economic overhauls are needed.

The BOJ is expected to forecast near-flat growth in gross domestic product for the fiscal year ending in March 2012. Previously, it forecast a growth rate of 1.2% for fiscal 2011 after a 3.2% decline this fiscal year.

"Expectations for long deflation may be making companies more cautious about their capital-investment plans," says Junko Nishioka, a RBS Securities economist in Tokyo.

Deflation can benefit consumers and companies by making goods and services more affordable. But it also hurts people with debts—whether an individual with a home mortgage or a nation with a fiscal deficit—by inflating the value of their debts in real terms.

U.S. pay czar doesn't want added authority

By Michael R. Crittenden

WASHINGTON—The Obama administration's pay czar said Wednesday he doesn't want his authority to set pay standards, which currently covers seven U.S. firms, to expand to a broader range of companies that have received government aid.

Kenneth Feinberg, who last week slashed the total compensation for the 25 highest-paid employees at each of the seven firms by about 50%, told a House committee that additional oversight of pay practices at the hundreds of other firms that have received government aid isn't warranted.

"I believe the final compensation determinations I make and discuss in my report are a useful model to guide others in the private marketplace. But that is where my authority should end," Mr. Feinberg said in testimony before the House Committee on Oversight and Government Reform.

Rep. Darrell Issa of California, the panel's ranking Republican, assailed "corporate greed and corruption" but said he was wary of Mr. Feinberg's role of having say over any corporation's pay. "Just as government bailouts of failed firms are misguided, so too are efforts to place a cap on the rewards of true innovation and success," Mr. Issa said.

Mr. Feinberg said he too was wary of acting outside his mandate from Congress, but said the seven firms are exceptions to the government's broader reluctance to get involved in compensation issues and were covered by legislation passed earlier this year. In this case, the government is acting as a major shareholder in a firm. "These seven companies are owned by the taxpayer and the taxpayers are acting as creditors," Mr. Feinberg said.

Mr. Feinberg serves as the Treasury Department's special master for executive compensation, with oversight over the seven firms that received the most aid through the $700 billion Troubled Asset Relief Program. His staff is in the process of evaluating the pay structure for the next 75 highest-paid employees at those firms. They will then turn to the 2010 pay packages for the firms, a process he predicted will result in entirely new issues for Treasury officials.

Foremost will be what to do with roughly $200 million in scheduled bonuses to be paid out to **American International Group** Inc. executives next year. Similar payments made earlier this year caused a public firestorm, and the status of the 2010 bonuses remains an open question for Mr. Feinberg. Pushed on the issue Wednesday, he said he was "admonished" by the congressional attention on the issue and plans to sit down with company executives as soon as January to settle the issue.

Obama administration pay czar Kenneth Feinberg, testifying Wednesday before a House committee, called his compensation decisions a model to guide other firms.

"We will see what we can work out with AIG going forward in an effort to satisfy the statute, satisfy the regulations, satisfy the American people. I view that as a top priority," Mr. Feinberg said.

Rep. Edolphus Towns (D., N.Y.), the panel's chairman, said employees at firms that would have otherwise failed shouldn't be rewarded for being rescued by taxpayers. "No doubt there is howling in executive suites, but I don't think the taxpayers are going to be shedding any tears over this," Mr. Towns said.

Mr. Feinberg said his goal is to replace guaranteed compensation for high-end employees with performance-based rewards that tie individuals' compensation with the long-term success of their firms.

"Short-term profits must give way to longer-term financial stability and success," Mr. Feinberg said.

He also said the initial submissions from six of the seven firms he oversees were generally unsatisfactory and represented compensation plans that weren't in the public interest. Firms weren't tying compensation to performance benchmarks, erred on the side of giving executives excessive levels of guaranteed cash, and wanted to give stock awards to executives that vested immediately.

Another round of postal strikes at Royal Mail

By Nicholas Winning

LONDON—The union representing workers at Royal Mail, the U.K.'s state postal service, said Wednesday that a second round of nationwide strikes would go ahead this week after talks with management broke down. Both sides blame the other for the impasse.

The Communication Workers Union and Royal Mail have been in talks since Monday over pay and work conditions in an effort to avoid a repeat of last week's two-day national strike, which has delayed several million items of mail.

Dave Ward, CWU deputy general secretary, said the union made a proposal that would have enabled a "period of calm" and opened the door to further discussions at the Advisory, Conciliation and Arbitration Service, a group that helps mediate in labor disputes.

Royal Mail accused the CWU of walking away from talks. It blamed divisions within the CWU for the breakdown, and said early progress was lost when the CWU made new demands, but then continued with the strikes as these were being considered.

Both the CWU and Royal Mail declined further comment on details of the talks but said they remained open to further discussions and committed to reaching an agreement.

› You have the chance to power your own city.

How will you do it?

There are lots of ideas about how to meet a growing energy demand. Here's a chance to try out a few of your own.

Energyville is an online game that lets you choose from a wide range of energy sources to meet the demands of your very own city. Alternatives. Renewables. Oil. Gas. What should be developed? Is conservation the answer? What about safeguarding the environment? See the effect your choices have, then share those results with others.

Energyville is a lot more than just a game. It's a chance to better understand and discuss the energy challenges we all face, then find the inspiration and know-how to solve them.

Put your ideas to work at willyoujoinus.com

Energyville, from Chevron
An energy game developed by The Economist Group.

The Economist Group

CHEVRON and the CHEVRON HALLMARK are registered trademarks of Chevron Intellectual Property LLC. © 2009 Chevron Corporation. All rights reserved.

LEADING THE NEWS

Klaus's campaign opens old wounds

Hungary-Slovakia tensions increase over opt-out clause

BY LEOS ROUSEK

PRAGUE—Czech President Václav Klaus's resistance to the European Union's Lisbon Treaty for closer political unity will be under a spotlight when EU leaders gather for a summit that begins Thursday.

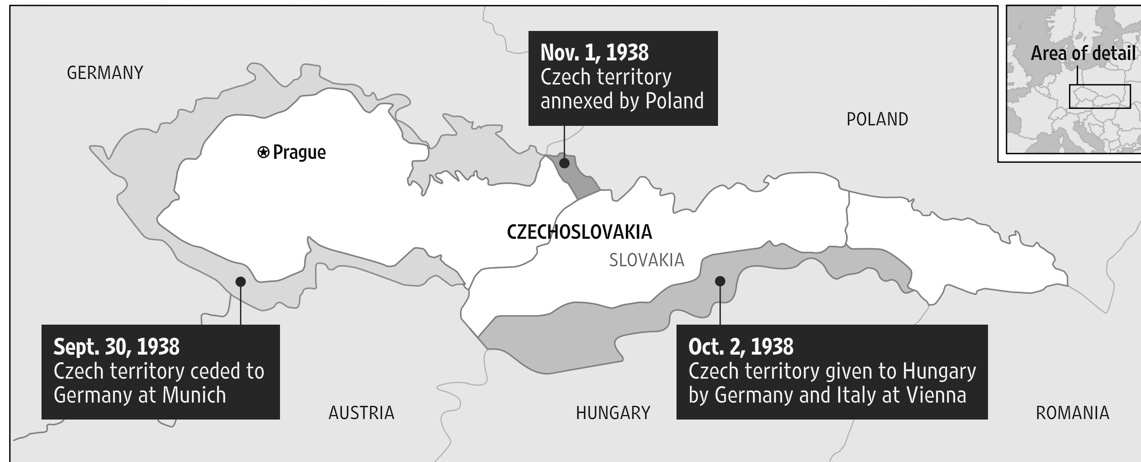
The Czech leader is all that stands between the 27-country bloc and a new political order that increases central executive powers.

But he has linked his ratification to a sensitive slice of Czech history. About three million Germans and about 80,000 Hungarians were expelled from Czechoslovakia in 1945 to 1947. They accounted for almost one-fifth of Czechoslovakia's prewar population, and most of them—or their surviving descendants—say that their family assets were expropriated after the war out of revenge for the German and Hungarian invasion, and view what happened as ethnic cleansing.

As a condition for ratifying the bloc's treaty, Mr. Klaus has demanded an opt-out clause for the Czech Republic from the EU's Charter of Fundamental Rights, which allows the European Court of Justice to review rulings by national courts.

Home ground

The ownership status of assets in Czech and Slovak regions. The issue isn't just the status of regions themselves but the ownership status of assets left behind by expelled Germans and Hungarians.



Once that exemption is negotiated, Mr. Klaus has said he will ratify the agreement, Czech Prime Minister Jan Fischer said Wednesday.

Slovakia has also asked for the same opt-out clause, which would mean the postwar expulsion orders issued by then Czechoslovak President Edvard Benes, known as Benes Decrees, can't be overturned by EU courts or legislation.

The Lisbon Treaty would allow "ownership claims by individuals expelled after the Second World War [to be lodged] directly to the court of the European Union," Mr. Klaus said on Oct. 9. He added that such rulings would violate ownership rights of many Czechs.

An area known as the Sudetenland is at the heart of the dispute. Once an ethnically mixed area inhabited by Germans, Jews and Czechs, Mr. Benes expelled the German population after World War II. He also managed to get the four Allied powers—the U.S., the Soviet Union, Britain and France—to agree to his decree on reclaiming the Sudetenland for Czechoslovakia, making it part of the postwar restructuring of European borders.

Mr. Klaus has been supported in his objections by a group of 17 Czech lawmakers, led by Senator Jiri Obelfazer, who filed a complaint against the Lisbon Treaty to the Czech Constitutional Court. The complaint said that that the treaty violates the Czech Constitution by abolishing the veto power of the EU member states in several policy areas.

But so far, Czech and Slovak courts have dismissed all legal attempts to seek property compensations from Czech and Slovak governments, filed mostly by descendants of Sudeten Germans and Slovak Hungarians.

There also is legal precedent for EU-level courts to dismiss restitution claims lodged by descendants of Germans expelled from Poland in 1945.

The Czech parliament's lower house approved the Lisbon Treaty in February and the Senate approved it in May. But the furor over sovereignty and the Sudetenland history have since split the population.

In two surveys published this month, Czechs gave mixed views of Mr. Klaus's campaign, their level of support varying according to the questions asked. When asked in a poll by the Median polling agency, 65% of 500 adults said they agreed with Mr. Klaus's effort to get a clause supporting the Benes Decrees.

A poll taken by the Sanep polling agency found that 58% of 2,800 adults questioned said that Mr. Klaus's delaying tactics damaged the Czech Republic's reputation in the EU.

The debate also has opened old wounds among the former Czechoslovakia's neighbors.

Hungary, already feuding with Slovakia over language rights of the remaining ethnic Hungarian minority in Slovakia, has objected against mentioning Benes Decrees in the Lisbon Treaty or any of its accompanying documents.

"For Hungary this is a line that mustn't be crossed," Hungarian Foreign Affairs Minister Peter Balazs said this week. "The EU Lisbon Treaty is about the future rather than the past."

—Adam Cohen in Brussels and Veronika Gulyas in Budapest contributed to this article.

EU leaders' goals hampered by Lisbon pact's murky status

BY ADAM COHEN

BRUSSELS—European Union leaders, meeting in Brussels this week to prepare for global climate talks and to discuss the bloc's economic recovery, are finding other unfinished business keeps creeping to the top of their agenda.

The EU's Lisbon Treaty, first negotiated more than two years ago, still hasn't been ratified by all 27 EU states. Ireland had to hold two national votes before passing the pact this month, and Czech President Václav Klaus refuses to ratify it. With that issue unresolved, global warming talks, economic issues and the distribution of key EU policy jobs will be secondary matters, according to diplomats from several EU countries.

Sweden, which currently holds the EU's rotating presidency, in recent weeks has been negotiating with Mr. Klaus, who wants his country to be exempt from the so-called Charter of Fundamental Rights included in the Lisbon Treaty. Mr. Klaus fears the charter—the EU parallel to the U.S. Bill of Rights—will diminish his country's sovereignty.

Swedish Prime Minister Fredrik Reinfeldt, in a letter inviting other EU leaders to this week's two-day summit, said he wants leaders to "review the situation and map out the way forward."

The Lisbon pact, which is designed to streamline the way the EU works, will create a new EU president and a new foreign-policy chief. The summit was supposed to fill these positions and shape the new leadership of the European Commission, the EU's executive arm. Diplomats say EU leaders are likely to discuss those positions but, with the treaty's status uncertain, in an informal, behind-the-scenes way.

The EU leaders are slated to devote some time to discussing climate change, preparing for the December global summit in Copenhagen on this issue. The bloc is divided about how to finance emissions cuts and other measures, particularly in developing countries.

In a draft statement prepared for their meeting, the EU leaders said "the overall level of the international public support required could lie in the range of €22 billion ($32.5 billion) to €50 billion a year by 2020."

Associated Press

The U.K.'s Tony Blair, left, and Luxembourg's Jean-Claude Juncker attend a 2005 EU Council meeting.

"The EU is ready to take on its resulting fair share of total international public finance," the draft said. This document will be debated and could be changed during the leaders' Brussels meeting. Eastern European countries think they shouldn't have to pay as much as their wealthier neighbors to the West. Germany and Italy don't want the EU to set a funding target, saying that could limit the the bloc's negotiating powers at the Copenhagen summit.

The United Kingdom is expected to push former Prime Minister Tony Blair for the EU presidency. Other potential candidates include Luxembourg's Prime Minister Jean-Claude Juncker, former Spanish Prime Minister Felipe González and Dutch Prime Minister Jan Peter Balkenende.

On the economic front, the leaders are expected to endorse a recent statement from the Group of 20 nations, calling for more international economic coordination.

U.K. Prime Minister Gordon Brown, in a letter sent Tuesday to Mr. Reinfeldt, said the EU must ensure that "our banks follow new standards for responsible remuneration, and taking further action to clean up bank balance sheets to maintain stability and ensure a resumption of lending."

Lagarde says France and China both want the dollar to be strong

BY TERENCE POON

BEIJING—France and China are both extremely keen for the U.S. dollar to be strong, French Finance Minister Christine Lagarde said Wednesday.

Ms. Lagarde, speaking to reporters during a visit to the Chinese capital, also said France and China intend to support the recoveries in their economies until they become sustainable.

She said French gross domestic product is likely to have grown in the third quarter, continuing the trend of the second quarter. The economy resumed growth in the second quarter, with GDP gaining 0.3% in the three months to the end of June from the previous period.

Ms. Lagarde said China will send a procurement delegation led by Chinese Commerce Minister Chen Deming to France next month, and that French Prime Minister François Fillon will visit China in December.

She said the Chinese procurement delegation is expected to include 100 or more companies in many industries, while Mr. Fillon's visit to China will cover cooperation in areas such as aerospace, energy and transport.

She added that China Development Bank and France's Caisse des Dépôts et Consignations signed a memorandum of understanding to create a fund to help financing of small and midsize businesses. The French Embassy's press counselor in Beijing, François Legue, said the hope is that Caisse des Dépôts et Consignations will contribute €300 million ($444 million) to the fund and that China Development Bank will match the amount, though details still need to be finalized.

Ms. Lagarde met with Chinese Vice Premier Li Keqiang, People's Bank of China Gov. Zhou Xiaochuan, and Finance Minister Xie Xuren during her visit.

CORPORATE NEWS

Audi's China sales outpace target

German car maker to add hatchback, SUV to offerings in fast-growing market

BY CHRISTOPH RAUWALD

FRANKFURT—**Audi** AG will significantly exceed its sales target in China this year and expects the country to outpace its German home turf as its largest single market in 2012 or 2013 at the latest.

The projection underscores a broader geographic shift among auto makers toward Asian growth markets.

"Today we're at 118,000 car sales already. We're on track to significantly surpass our initial target in China this year" of selling 130,000 cars, said Peter Schwarzenbauer, Audi's executive board member responsible for sales and marketing, in an interview.

He said the Ingolstadt-based company will launch its A3 hatchback in China next year as part of a wider move to attract a broader customer base there, in addition to the new Q5 small sport-utility vehicle, which is being rolled out globally.

Audi ranks third in global luxury-car sales behind BMW AG and Daimler AG's Mercedes-Benz. But it keeps a firm grip on the top position in China, which it gained thanks partly to the early market entry of its parent company, Volkswagen AG.

Mr. Schwarzenbauer said annual sales in China might soar to 250,000 cars by 2012 or 2013 as Audi is preparing to launch several new or revamped models, ramping up local production and expanding its dealership network.

He said Audi also plans to establish a broader leasing and financing business in China to tap rising customer demand. Most Chinese buyers tend to pay cash for their vehicles.

China has proved to be one of the few bright spots for luxury-car makers after sales collapsed in other major geographies amid the economic downturn. Demand has been backed by a government stimulus package and tax break.

A move to halve the purchase tax on autos with 1.6-liter engines or less to 5% has fostered demand, particularly for smaller cars.

In the January-August period, passenger-vehicle sales in China rose 37% to 6.23 million, according to the China Association of Automobile Manufacturers, while total vehicle sales rose 29% on the year to 8.33 million.

Some analysts have voiced concern that the tax break advanced future demand and sales may collapse when it expires. Mr. Schwarzenbauer said Audi "sees no signs" of an imminent market slump.

He noted that the premium segment in China still accounts for only 5% of the overall market, but is expected to grow to around 8% by 2015, with the overall market rising to between 12 million and 14 million annual vehicle sales by then.

He said he regards BMW as the company's main competitor looking forward, due to a similar positioning of the brand, with Toyota Motor Corp.'s Lexus brand competing more directly with Mercedes-Benz.

Audi steered through the industry gloom better than its peers and narrowed the gap with its larger rivals BMW and Mercedes-Benz, mainly due to new products, its large footprint in China and a relatively small exposure to the troubled U.S. market.

Mr. Schwarzenbauer confirmed that Audi will slightly exceed its global sales target of 900,000 cars this year, possibly by around 20,000 vehicles. He said Audi's global sales are poised to rise again in 2010, including growth in Europe and the U.S., but said it might take "two to three years" before reaching the one million level of last year again.

Mr. Schwarzenbauer said Audi has no plans to bring its new small A1 model, due to be launched early 2010, to the U.S. and China. But the company might launch the second generation of the A1 in these two markets, possibly including electric or hybrid versions.

He said Audi's U.S. sales are expected to come in at around 80,000 vehicles in 2009 after 86,000 last year, slightly better than the initially anticipated decline of 10% on the year.

Mr. Schwarzenbauer said he sees significant sales growth in the U.S. next year, driven, for example, by the small Q5 SUV, as the country's economy is expected to rebound faster than other major markets. But he said he doesn't believe the U.S. market will return to levels of between 16 million and 17 million vehicles again.

These levels were fueled by "extreme incentives" granted by Detroit's Big Three at the time, he said.

Racing ahead

Audi dominates the Chinese luxury-car market. September vehicle sales, change from a year earlier

	Sales	Change
Audi	15,000	+37%
BMW	8,131	+34
Mercedes	6,800	+56

Source: the companies

Reuters

Audi hopes that its small sports-utility vehicle Q5—shown here at the Beijing auto show in April, 2008—will attract a wider customer base in China.

Ford taps Geely as lead bidder in Volvo talks

BY NORIHIKO SHIROUZU

BEIJING—**Ford Motor** Co. has selected a group led by China's Geely Holding Group Co. as the preferred bidder for the U.S. company's Volvo unit, marking an important step forward for what would be the most ambitious international expansion so far by a Chinese car maker.

Wednesday's announcement means that Ford and Geely, one of China's biggest privately owned auto makers, are in exclusive negotiations over Volvo, but it doesn't ensure that the companies will reach a deal. A senior Geely executive said it isn't clear how much longer negotiations might last.

Still, Ford's decision is the strongest sign of progress in Geely's years-long pursuit of Volvo. Ford acquired Volvo in 1999 for $6.4 billion and which it decided to sell last year amid losses at the Swedish car maker.

Amid concerns in Sweden about the potential fate of Volvo under Geely ownership, Geely on Wednesday stressed that it is committed to maintaining Volvo's existing production and research facilities, as well as union agreements and dealer networks. It said the company would remain headquartered in Gothenburg, Sweden, and be led by independent management. Geely, which said its bid is supported by Chinese banks, also promised to "enhance Volvo's access to sales networks and sourcing opportunities" in China's fast-growing market.

Volvo welcomed Ford's decision. "It's good for us to have a clear indication of where the process is going so we can move forward," said Volvo Cars spokeswoman Maria Bohlin.

Daimler to extend cost-cut program

BY CHRISTOPH RAUWALD AND KATHARINA BECKER

Daimler AG Chief Financial Officer Bodo Uebber wants to extend the German auto maker's €4 billion ($5.9 billion) cost-cutting program beyond 2009 and make it an annual target, as part of a wider initiative to streamline the company.

"We can't and we won't abate, because next year won't be an easy one," Mr. Uebber said in an interview at Daimler's headquarters in Stuttgart, Germany.

Mr. Uebber said he wanted the annual cost reductions, which were initially targeted just for this year in the face of the auto industry's steep downturn, to be extended to coming years as well.

"In the midterm, we want to save this amount permanently," Mr. Uebber said. "The crisis showed us where we had cost positions in our budgets, which we can take out long-term as well," he said, pointing to consulting and travel expenses as examples.

Daimler has been cutting costs with measures such as reduced hours for a large part of its work force in Germany. It has 167,000 workers in Germany and it employs 273,000 in total world-wide. It has said on numerous occasions that it expects savings in 2009 to exceed the €4 billion goal.

The company generated revenue of €95.9 billion in 2008, but that is expected to drop sharply this year as a result of the downturn.

Mr. Uebber said Daimler's core Mercedes-Benz Cars unit is set to become more efficient with every new model thanks to the gradual roll-out of a modular system to develop and produce cars, which reduces costs between the different model lines.

On Tuesday, Daimler confirmed that after posting steep first-half losses it returned to net profit of €41 million in the third quarter as sales at Mercedes-Benz, the company's former cash cow, picked up.

Car sales in the fourth quarter are expected to be higher than in the third quarter, driven mainly by the new generation of the Mercedes-Benz E-Class, an important model both in terms of earnings and revenue per vehicle.

Associated Press

Daimler CFO Bodo Uebber (left) talks with CEO Dieter Zetsche, last February.

Premier Cercle
In association with THE WALL STREET JOURNAL. EUROPE
The leader's fight
Lessons from the bullring
Confrontation | Commitment | Triumph
THURSDAY OCTOBER 29th, 2009
PARIS
Programme and registration:
www.premiercercle.com/tauromachie
With the support of
Arsene Taxand
UNIQUE&DIFFERENT
The Wall Street Journal Europe is a registered trademark of Dow Jones Company

Special Advertising Section

INVESTING IN GERMANY

REUTERS/Christian Charisius

Germany's car scrappage plan has provided a bigger stimulus to the economy than expected. These cars stored near the Volkswagen plant in Wolfsburg are ready for collection by their new owners.

Outlook brightens for Europe's largest economy

$50 billion stimulus brings country out of its recession; more market-oriented reforms seen under new coalition

Even the German government was taken aback by the runaway success of its "cash for clunkers" car scrappage plan — in which consumers trade in their old cars for new ones and receive a €2,500 bonus. German car dealers reported a storm of interest in the deals after they were initiated in January, leading the government to raise its budget for the program from €1.5 billion to €5 billion to fund an expected two million car sales through 2010, rather than the 600,000 cars originally targeted.

Critics — mainly from environmental groups — of the so-called "Abwrackprämie," or wreckage premium, have said the plan was of dubious environmental value and simply drew revenues away from other places consumers would have put their money. But even the critics had to concede that the measure stimulated the economy, if only temporarily.

The car scrappage measure was part of a huge €50 billion stimulus approved by the German government in January. That included around €17 billion in public investment for renovating schools, institutes of higher education, roads and other public buildings, €10 billion for municipal investments and €4 billion in project finance. It also established a credit and guarantee fund to give loans to struggling industries, with special write-downs extended to small and medium enterprises and €3 billion for building renovations aimed at cutting CO2 emissions.

Stimulus spending

Economists believe the stimulus spending has helped move the country out of its worst recession since the 1930s, and that similar measures enacted by other governments have also aided the export-oriented German economy. At least in the short term.

"Germany left recession territory in the second quarter of this year and we expect a continuation," says Stefan Bielmeier, head of economic research and asset allocation at Deutsche Bank in Frankfurt. "The country benefited from both foreign and domestic stimulus, from car scrappage schemes, to subsidies for industrial sectors and short-term labor measures that kept unemployment down."

Analysts agree that the German economy has shown a greater robustness than previously expected. And the government recently revised its predictions for the economy. Earlier this month, Chancellor Angela Merkel said she expected the economy to shrink between 4% and 5% this year, compared with an earlier projection of 6%.

The International Monetary Fund also recently revised its outlook for Germany, saying the economy would grow 0.3% in 2010, rather than shrink 0.4% as it had previously predicted. Officials said the export-based economy stands to benefit from more optimistic global growth forecasts.

Analysts agree that the German economy has shown a greater robustness than previously expected.

German unemployment has also fallen more sharply than expected. In September it was 3,346,000, 125,000 fewer than the previous month, pushing the jobless rate to 8% from 8.3%. The Federal Labor Agency attributed that partly to seasonal fluctuations. But economists also say that government-subsidized short-term labor programs — in which workers reduce their hours by a third, but still draw a higher proportion of their wages — have had a clear impact.

"Half a million workers, or more than 1% of the work force, were saved from unemployment," says Peter Tergeist, labor specialist with the Organization for Economic Cooperation and Development in Paris. He believes Germany's fiscal stimulus package will continue to have a positive effect in stemming job losses.

In spite of these signs of life for the economy, experts are more cautious over the medium term. Deutsche Bundesbank President Axel Weber recently expressed concern that the economy could stall when the impact of the short-term stimulus measures recedes, dampening consumer spending.

Expectations were also dashed somewhat recently when it emerged that exports in August fell for the first time in four months, dipping 1.8% from the previous month, according to the Federal Statistics Office in Wiesbaden.

Another obstacle is that company inventories are low, as is investment in machinery and equipment. "Over the medium term it's a problem for the economy," says Rolf Schneider, head of macro research at Munich-based financial services company Allianz SE. Although the firm is predicting a "sizable recovery" of the German economy in the second half of this year, it doesn't expect industrial output to reach precrisis levels through 2011.

And with global demand generally expected to be muted, it is unlikely that Germany will soon experience an export boom as it did ahead of the crisis. "We still have overcapacity world-wide, which could put a long-term lid on investment spending. As long as we have that, don't expect to see huge GDP growth," adds Mr. Bielmeier of Deutsche Bank.

Still there are reasons for optimism that over the long-term, Germany is well-positioned. In spite of the financial crisis, private consumption has remained relatively stable.

Robust consumption

"There was no debt or real estate bubble in Germany among consumers. Robust private consumption is what differentiates Germany from many other countries," says Mr. Bielmeier. Consumers actually reduced debt over the past five to seven years, he notes, and debt relative to GDP has not increased.

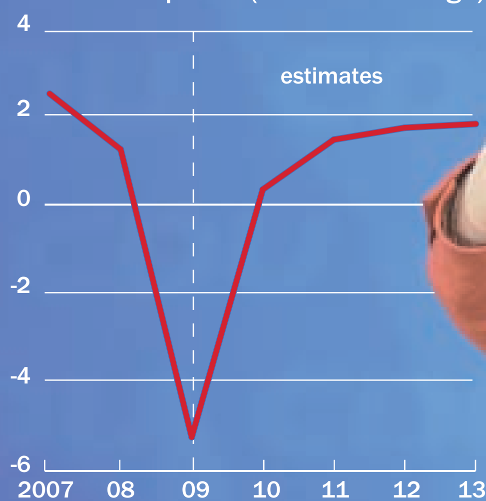
Some pockets of the German economy have also come through the crisis pretty well, he adds. "We see rising employment in health, education and even the construction business. Service sectors that are not linked to exports are not in recession."

Finally, the recent election of a new center-right coalition government, consisting of the Christian Democratic Union/Christian Social Union under Chancellor Merkel and the Free Democratic Party — should lead to more market-oriented reforms than were possible under the previous "grand coalition" with the more left-leaning Social Democrats.

That's good news for economic reforms such as the proposal to offer companies which conduct research and development a tax credit, says Dietmar Harhoff, director of the Institute for Innovation Research, Technology Management and Entrepreneurship at the Ludwig-Maximilians-University in Munich.

"There are good signs that the R&D tax credit will be implemented," under the new government, says Dr. Harhoff, who is also chairman of the Expert Forum on Research and Innovation (EFRI), an independent commission established in 2007 to advise the German government on its innovation policy. The tax credit has been a cornerstone of the program advocated by EFRI to help Germany become more competitive.

Of course, what the government decides is up in the air until the new coalition hammers out its common agenda over the next few weeks. But, besides the R&D credit, the new government is expected to push through some tax cuts as well as rejecting a proposal that was on the table for a financial transaction tax, that critics say could drive business away from Germany.



Source: IMF, World Economic Outlook Database, October 2009

German Chancellor Angela Merkel

Photo: REUTERS/Johannes Eisele

Special Advertising Section

Strong fundamentals continue to draw foreign investors

The financial woes of once-storied companies such as Porsche, Opel, or retail chain Arcandor (formerly Karstadt-Quelle) may dominate the German headlines, but international investors have remained surprisingly bullish on the country. In a survey conducted by the Boston Consulting Group and the American Chamber of Commerce in Germany in February, for example, 61 U.S. companies based in Germany said the country was their top business location in Europe.

Just over a quarter of the companies polled expected a decline in revenues in Germany this year, compared with 9% last year. But in spite of that, about a third polled said they felt the effects of the financial crisis less in Germany than in the rest of Europe, pointing to the relatively stable real estate market, strong consumer purchasing power and low levels of personal debt.

"U.S. companies appreciate the highly qualified and innovative work force in Germany and are attracted to the emphasis on product and process quality," says Dr. Robert Hermann, managing director investor consulting of Germany Trade and Invest (GTAI), Germany's Berlin-based foreign trade and inward investment agency. U.S. investors make up Germany's single largest investor group (accounting for roughly one-third of foreign direct investment), he notes. And while skilled workers may be cheaper in Romania or Poland, Germany can boast expertise in highly specialized areas such as automobile engineering, fuel cells, nanotechnology, solar energy and wind power.

> *"Germany is historically an outperformer when the world economy rises."*

Subsidized solar

With 60% of demand world-wide for solar energy, Germany is the largest market for the photovoltaic industry, Dr. Hermann says. That is a result of the Renewable Energy Act (put in place in 2000 but updated this year), which subsidizes consumers' purchases of solar panels. The solar industry also employs 60,000 people, according to GTAI. In 2007, Phoenix-based First Solar set up its first international facility in Frankfurt-Oder, near the border with Poland, to make solar modules, citing the qualified work force, good infrastructure and support from the state and federal government.

And while the biotech industry in Germany has taken some hits since the downturn, it is still drawing companies such as U.S. cancer drug maker ImClone Systems, a subsidiary of Indianapolis-based Eli Lilly & Co., that chose Heidelberg as its international base last October.

REUTERS/Hannibal Hanschke

Germany is the largest market for the photovoltaic industry.

Sovereign wealth funds have also shown strong interest in Germany. Aabar Investments of Abu Dhabi this year took a 9% stake valued at €1.95 billion in automotive company Daimler, and the Qatar Investment Authority in July acquired 6.78% of Volkswagen valued at €7 billion, as well as 10% of Porsche, which is being acquired by VW.

Munich was named the most attractive city for real estate investors among 98 cities in Europe, according to the European Regional Economic Growth Index released last month by U.K.-based LaSalle Investment Management. La Salle said the Bavarian city's diversified mix of global companies and small and medium size enterprises, healthy research and development base and high levels of personal wealth have helped shield the city from the worst of the economic crisis.

Renewed enthusiasm

Domestic and international investors have shown renewed enthusiasm in recent months for the country's equity markets. Since the German blue-chip DAX index hit a low of 3,588 in March, it has climbed 63% to 5,869 in mid-October. Analysts say this reflects the conviction that the global recession is ending, and, more recently, approval of the new center-right government elected last month. "Germany is historically an outperformer when the world economy rises," says Andreas Hürkamp, equity strategist at Commerzbank in Frankfurt.

The German industrial sector still offers investors long-term value, particularly if the government carries through on plans to help companies invest more in R&D, says Stefan Bielmeier, head of economic research and asset allocation at Deutsche Bank in Frankfurt. In particular, he sees good long-term chances in investing in companies related to renewable energies and tools. Investors are also showing renewed interest in real estate and property management companies such as Gagfah, Colonia Real Estate and Deutsche Wohnen, which stand to benefit if the economy picks up.

The text of this Special Advertising Section was written by Mary Lisbeth D'Amico.

CORPORATE & INVESTMENT BANKING I ASSET MANAGEMENT I PRIVATE WEALTH MANAGEMENT I PRIVATE & BUSINESS CLIENTS

Setting the stage for our clients' success.

www.db.com

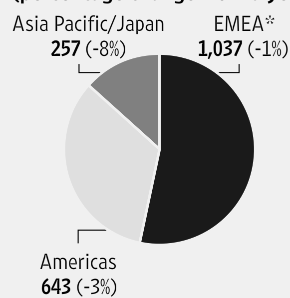
A Passion to Perform. Deutsche Bank

This advertisement has been approved and/or communicated by Deutsche Bank AG London. The services described in this advertisement are provided by Deutsche Bank AG or by its subsidiaries and/or affiliates in accordance with appropriate local legislation and regulation. © Copyright Deutsche Bank 2009.

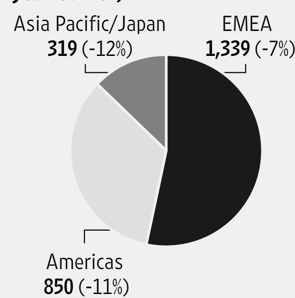
Not out of the woods yet

SAP lowered its 2009 software-revenue forecast, citing falling demand in emerging markets and Japan in the third quarter

Software and software-related service revenue, in millions of euros (percentage change from a year earlier)



Total revenue, in millions of euros (percentage change from a year earlier)



*Europe, Middle East and Africa
Source: the company

Leo Apotheker, CEO of SAP AG

SAP cuts sales outlook

Software giant says environment remains difficult

By Hilde Arends

FRANKFURT—**SAP** AG posted a 12% rise in third-quarter profit, but warned that software revenue will drop more sharply than expected this year because of weakness in Japan and emerging markets.

The business-software giant, whose customers include Kraft Foods Inc. and Bank of America Corp., saw its American depositary shares tumble 10% in afternoon trading on the New York Stock Exchange.

Chief Financial Officer Werner Brandt said SAP is "seeing signs of stabilization in the general environment" but "the market remains difficult."

SAP, like rivals **Microsoft** Corp. and **Oracle** Corp., has faced falling demand for its business-software products as companies have cut investment and technology spending.

Oracle last month reported lower-than-expected sales of new software during its latest quarter, blaming SAP's weakness as a reseller of its products.

Stephan Wittwer, an analyst at Landesbank Baden-Württemberg, said "many companies are looking for new software projects," but "there is a difference between what IT departments want and what the operating situation of many customers allows."

Despite the tough environment, SAP Chief Executive Leo Apotheker said the company is making progress in shifting its business away from a reliance on big-ticket deals to smaller and multi-year agreements, where customers buy and use software over many quarters.

The Walldorf, Germany-based company said profit in the three months ended Sept. 30 rose to €435 million ($643.5 million) from €388 million a year earlier.

SAP said profit rose as its tax rate fell to 21% in the third quarter from 31.9% a year earlier due to acquisitions. It also said cost-cutting helped protect margins.

Revenue fell 9.2% to €2.51 billion.

The company now expects software and software-related services revenue to drop between 6% and 8% this year from the €8.62 billion posted for 2008. In July, SAP had forecast a 4% to 6% decline.

—Philipp Grontzki contributed to this article.

BAA aims to repay its debt

By Jonathan Buck

LONDON—U.K. airports operator BAA Ltd. said it will use the bulk of its proceeds from the sale of London's Gatwick Airport to repay £1 billion ($1.64 billion) in debt, but signaled it plans to raise more cash.

The unit of Spanish infrastructure giant **Grupo Ferrovial** SA said in a statement detailing its third-quarter results that, subject to market conditions, it plans to tap debt capital markets in coming months to take advantage of strong demand for highly rated regulated utilities.

BAA said its external net debt as of Sept. 30 edged up 3.7% to £9.77 billion from a year earlier and that it was operating comfortably within financial ratios. The cost of debt after all hedging including the real cost of index-linked hedges was 5.67%.

The company said it generated more than £375 million of surplus cash after payment of interest in the nine months ended Sept. 30.

Applying the net proceeds from the sale of Gatwick toward debt repayments was expected to have a neutral impact on its overall debt-to-equity ratio.

Heathrow continued to be a bright spot for BAA. Passenger traffic at the airport was relatively stable, slipping 2.3% to 49.9 million.

BAA last week announced the sale of Gatwick Airport to **Global Infrastructure Partners** for £1.51 billion. It expects net proceeds from the sale of Gatwick of about £1.2 billion.

After it repays debt that will mature in March 2010, BAA said it will have no significant debt maturities until 2011.

BAA posted total pretax exceptional items and impairment charges of £537.1 million, largely due to Gatwick, and £267.1 million in increased pension liabilities. The airport operator disclosed a £225 million impairment charge reflecting Gatwick's sale price relative to its carrying value.

Regulators earlier this year demanded the sale of three of BAA's seven U.K. airports, including Gatwick and Stansted, because of competition concerns. BAA, which also owns London's Heathrow Airport, is appealing the decision.

Including Gatwick, BAA reported that its pretax loss for the nine months ended Sept. 30 widened to £784.7 million from a loss of £519.5 million a year earlier, even though revenue climbed 7.6% to £1.85 billion.

Adjusted earnings before interest, tax, depreciation and amortization and exceptional items jumped 17% to £804.6 million. The company didn't report net-profit figures.

Traffic fell 5.5% to 90.7 million passengers, but net retail income per passenger rose 6.1%.

Heathrow continued to be a bright spot for BAA. Passenger traffic at the airport was relatively stable, slipping 2.3% to 49.9 million, benefiting from its position as a major global hub airport for long-distance flights.

"We have delivered a good performance in line with expectations for the first nine months of the year, helped by Heathrow's continued resilience, higher retail spending by passengers and tight cost control," Chief Executive Colin Matthews said in a prepared statement.

"Our London airports are strongly cash generative and our debt and underlying interest costs are stable," he said.

THE WALL STREET JOURNAL.
EUROPE
Executive Travel Program
Guests and clients of 320 leading hotels receive The Wall Street Journal Europe daily, courtesy of
THINK MEDIA
OUTDOOR
www.thinkmediaoutdoor.be

For high-end designers, deep pockets become key

By Stacy Meichtry And Christina Passariello

ROME—Newly announced job cuts at **Gianni Versace** SpA show how the economic downturn is forcing independent fashion labels to cut costs and stem losses in order to survive in an industry dominated by conglomerates that can better absorb downturns in demand.

Versace, the Milan-based fashion house, said it was cutting a quarter of its work force, or 350 jobs, as part of a two-year restructuring plan that will also include a review of the company's store network around the world. Versace has gone through struggles since the fashion house's celebrated founder Gianni Versace was shot to death in 1997, and every few years the company has changed management and announced plans to try to improve performance.

Still, the latest cost-cutting plan is a clear sign that the global cutback in spending on luxury goods is hitting small family-owned companies the hardest. Last week, Prada SpA began calling employees back to full-time work after cutting some work days for 210 of its 3,000 Italian workers, according to a spokesman.

Chanel, the French luxury firm owned by the Wertheimer family, slashed 200 jobs, or 10% of its factory work force, last December.

Bigger multi-brand players in the industry, such as LVMH Moet Hennessy Louis Vuitton SA and PPR SA's Gucci Group, are weathering the slump better—partly because their different brands can lower fixed costs by pooling resources such as materials purchasing or ad buying.

For example, Yves Saint Laurent, Stella McCartney and Alexander McQueen—which are all part of PPR's Gucci Group—have closed boutiques within the past year in crucial luxury markets such as Japan and Russia. But operating profit at Gucci Group inched up in the first half.

At LVMH, small brands such as Celine are living off the riches of the group's profitable labels such as Louis Vuitton. Celine has avoided the deep restructuring of independent brands such as Versace.

In an interview, Chief Executive Gian Giacomo Ferraris —who joined Versace this past spring —said the company doesn't plan to rein in spending on designs. Rather, the cuts will focus on production, distribution and logistics, which he said could be outsourced to third parties.

"We are attacking our infrastructure, our rent situation and our duplications of functions world-wide," he said.

Mr. Ferraris said the company expects to post a pre-tax loss of €30 million ($44.4 million) on revenue of €273 million. In 2008, Versace had a net loss of €7.5 million on sales of €336 million. In March, Versace reported a €9 million net profit for 2008. A spokesman, however, said the company had changed the way it reports results; the previously reported profit figure included income booked with the fashion house's holding company.

"A responsible manager, a responsible board, a responsible shareholder cannot permit this situation to go on, because then we would face other kinds of problems like insolvency," Mr. Ferraris said. Mr Ferraris added that the company isn't at risk of insolvency.

Mr. Ferraris said the decline in revenue this year stemmed from a 30% downturn in sales in the company's wholesale business. The financial collapse of IT Holding SpA, which produced clothing for Versace under brand licensing agreements, also deprived the company of royalty payments, he said.

The Versace family tapped Mr. Ferraris earlier this year after Ms. Versace clashed with the label's former CEO over spending on new designs. The label recently closed its last stores in Japan, one of the world's biggest luxury markets.

Reuters

Pedestrians walk past the Versace store on Fifth Avenue in New York.

Lufthansa casts doubt on target

By Jan Hromadko

FRANKFURT—Deutsche Lufthansa AG swung to a net loss in the first nine months of the year and cast doubt on its full-year profit target amid falling passenger numbers and rising oil prices.

Germany's flagship airline also said results will be hit by losses from newly acquired airlines British Midland Airways, or bmi, and Austrian Airlines AG. Austrian Airlines was included in its results from the beginning of September, while bmi was consolidated from July.

For the nine months ended Sept. 30, the company posted a net loss of €32 million ($47.3 million), compared with a year-earlier net profit of €529 million. Sales fell 13% to €16.2 billion. The company's closely watched operating profit plunged 76% to €226 million.

The airline said its target of an operating profit in 2009 will depend on developments in the fourth quarter. Analysts said the wording of Lufthansa's outlook was more cautious than previous guidance.