Marketplace: Success of 'Slumdog' gets mixed reviews in Mumbai

THE WALL STREET JOURNAL.

VOL. XXVII NO. 17 | EUROPE | TUESDAY, FEBRUARY 24, 2009

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What's News

France's car makers are stepping up production of some models to meet rising demand reflecting government incentives to scrap old vehicles. But analysts say the gains may be temporary. Page 5

■ Advisers started lining up bankruptcy loans for GM and Chrysler, in case the firms need it, while Ford reached a tentative deal on unionized retiree health benefits. Page 4

■ Steven Rattner, co-founder of a private-equity firm, will join the U.S. Treasury as an adviser on the auto industry.

■ U.S. stocks fell sharply amid concerns about the economy. European shares also ended lower. Page 16

■ A large hedge-fund group is set to propose controversial measures in a bid to fend off a regulatory crackdown on the industry. Page 2

■ The ECB's Trichet threw his weight behind European proposals for greater global-market regulation. Page 2

■ OPEC is trying to boost the price of oil by implementing production cuts, but its efforts are being stymied by large inventories. Pages 3, 17

■ The attorney general of New York asked a judge to order former-Merrill CEO Thain to give more details about 2008 bonuses. Page 16

■ Dubai stocks rose after the emirate's government initiated a $20 billion bond program, half of which was taken up by the U.A.E. Page 20

■ Spain's justice minister resigned amid an uproar over his contacts with a judge conducting a corruption probe that has implicated the opposition.

■ France and Italy plan to sign an accord on nuclear-energy cooperation Tuesday.

■ A Taliban commander announced a unilateral cease-fire against government forces in a northwest Pakistan district.

■ Denmark seized control of Fionia Bank in a deal that will take away shareholder control and split the bank until a sale can be realized. Page 15

■ Thailand's economy contracted in the fourth quarter, joining a slump in other parts of Southeast Asia. Page 8

■ A Guantanamo prisoner who claims he was tortured at a covert CIA site returned to Britain a free man after almost seven years in captivity.

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Berlin's best bet

Germany must step up to prevent a euro-zone collapse. Page 10

Breaking news at europe.WSJ.com

The space where art and fashion meet

Agence France-Presse

HALL MONITORS: A piece is auctioned at the Grand Palais in Paris during the auction of hundreds of art treasures amassed by late fashion king Yves Saint Laurent and his companion, Pierre Berge. Page 6

Stanford link shocks buyers at U.S. resort

BY CASSELL BRYAN-LOW

In 2004, Austrian soccer player Andreas Lipa and his British wife, Sarah Adams-Lipa, plunked down a $62,000 deposit on a new luxury vacation home in an Orlando, Fla., resort called Tierra Del Sol. With the four-bedroom house still unfinished by last year, the couple filed suit in U.S. federal court to reclaim their deposit.

Now, the Lipas—and some other buyers of properties at Tierra Del Sol who are in the same situation—may have another reason to worry. A financial backer of the company developing the Florida resort is R. Allen Stanford, the Texas financier whom the Securities and Exchange Commission accused in civil charges of an $8 billion fraud. Last year, one of Mr. Stanford's companies provided a $17.5 million loan to the developer of the resort.

The SEC's allegations aren't related to Mr. Stanford's role as a backer of **American Leisure Group** Ltd., the company developing the Florida resort. But the SEC has frozen assets of three of Mr. Stanford's companies, including Stanford International Bank.

Mr. Stanford's legal problems are fueling concern that the Lipas and other property buyers at Tierra Del Sol may never win the recourse they believe is due.

"It makes me even more concerned" about not being able to recover the deposit, says Ms. Lipa, 36 years old, who teaches business English. Now, "I feel like there isn't any hope."

The SEC case against Mr. Stanford will "make it more difficult for the developer to continue the project if it were relying on funds" from investors such as Mr. Stanford, says Philip Calandrino, an Orlando attorney representing an Irish man who also is suing the resort.

Representatives for American Leisure Group didn't respond to requests for comment. Mr. Stanford has yet to respond to the SEC charges. A lawyer for Mr. Stanford couldn't be reached.

The situation shows how the alleged fraud by Mr. Stanford may have implications for people beyond the financier's individual banking customers. There are at least 10 suits similar to the Lipas's case pending against Tierra Del Sol or related entities in U.S. federal or state courts. Many of the suits are filed by British or Irish residents, to whom the properties were heavily marketed.

Kevin Burke, a U.K. lawyer

Please turn to page 27

U.S. backs banks amid Citigroup talks

By Damian Paletta and Monica Langley in Washington and David Enrich in New York

WASHINGTON—U.S. officials sought to quell fears about the viability of major banks, as the government held talks with **Citigroup** Inc. that could result in Washington substantially expanding its ownership of the struggling financial institution.

In a statement Monday, the Obama administration and U.S. bank regulators said the government "stands firmly behind the banking system during this period of financial strain to ensure it will be able to perform its key function of providing credit to households and businesses."

The statement tried to reassure the public that major "stress tests" that will be performed on roughly 20 U.S. banks will be part of an effort to shore up the companies, countering speculation that the tests could ultimately lead some of the banks to be shut down or nationalized. Regulators said the U.S. government's "capital-assistance program" comes with the "strong presumption" that "banks should remain in private hands."

U.S. share prices initially rose on the statement, but then resumed a broad market decline as investors sought more details on the govern-

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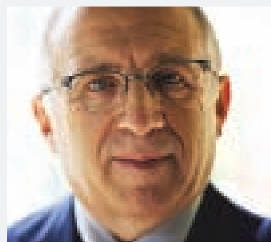

Rock the industry

Azoff's move to concentrate power in the music world.

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DJIA	7114.78	-3.41
Nasdaq	1387.72	-3.71
DJ Stoxx 600	175.29	-0.93
FTSE 100	3850.73	-0.99
DAX	3936.45	-1.95
CAC 40	2727.87	-0.82
Euro	$1.2743	+0.95
Nymex crude	$38.44	-3.97

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Trichet backs regulation

ECB chief says crisis is cause for extension of 'regulatory net'

European Central Bank President Jean-Claude Trichet threw his weight behind European proposals for greater global-market regulation, setting the stage for debate at an April meeting of world leaders in London.

*By **Joellen Perry** in Frankfurt and **Gabriele Parussini** and **Geraldine Amiel** in Paris*

Jean-Claude Trichet, at a Paris conference Monday, urged more regulation of hedge funds, credit-rating agencies and other 'systemically important' institutions.

Reuters

"The current crisis is a loud and clear call to extend regulation and oversight to all systemically important institutions—notably hedge funds and credit-rating agencies," Mr. Trichet said at a conference of European securities regulators in Paris.

The call was Mr. Trichet's strongest yet for more-stringent oversight of the lightly regulated hedge-fund industry. Previously, Mr. Trichet had supported an industry-led "code of conduct" for hedge funds.

Mr. Trichet's call followed a weekend meeting of European leaders in Berlin. There, European policy makers agreed to push for greater global financial-market regulation when leaders of the world's 20 major economies meet in London on April 2.

"The outcome of this debate should be an international agreement about the key features of the new regulatory paradigm," Mr. Trichet said. "The ultimate aim must be to extend the regulatory net to cover all instruments, institutions and markets that are either systemically important or which play a key role for the functioning of markets."

Noting a severely strained financial system is "spilling over into the real economy," Mr. Trichet highlighted signs that credit flows to the 16-nation euro zone have been falling recently as companies postpone investments and cut back on borrowing. He said the process of selling assets to reduce debt across the banking system needed to be monitored closely.

"If such behavior became widespread across the banking system, it would undermine the raison d'être of the system as a whole," Mr. Trichet said. He also continued his campaign to garner the ECB a bigger role for supervising big, cross-border banks in the euro zone.

Some European policy makers have been cool to the idea of the ECB gaining supervisory powers. A U.K. Treasury spokesman said this month that the U.K. "would not support a role for the ECB" in euro-zone banking supervision.

ING names new financial officer

By Roberta B. Cowan

AMSTERDAM—Dutch bank and insurer **ING Groep** NV on Monday named **HSBC Holdings** PLC executive Patrick Flynn as its new chief financial officer.

Mr. Flynn, finance chief of HSBC's global insurance business, will succeed John Hele, who announced his resignation in October just days after the Dutch state agreed to inject €10 billion ($12.84 billion) into the bank. Messrs. Flynn and Hele couldn't be reached for comment.

ING's supervisory board will nominate Mr. Flynn to the company's executive board at the annual general meeting April 27.

When ING announced additional state aid last month, with the Dutch government agreeing to a backup facility covering 80% of its Alt-A mortgage securities, Chief Executive Michel Tilmant also resigned. He was succeeded by Jan Hommen.

As tougher rules loom, hedge funds to offer plan

By Cassell Bryan-Low

LONDON—One of the world's largest hedge-fund organizations is set to propose measures aimed at pushing money managers to open up, in what is likely to be a controversial effort to fend off a regulatory crackdown on the industry.

The Alternative Investment Management Association, a U.K. trade group with members in many countries, including the U.S., said it plans to propose as early as Tuesday that hedge-fund managers agree to changes that many U.S. funds have resisted. The measures include registering with regulators and having regular contact with authorities about their businesses.

The move comes as policy makers around the globe are gearing up to reform financial regulation in ways that are almost certain to be more onerous for hedge funds. On Monday, European Central Bank President Jean-Claude Trichet called the crisis a "loud and clear call" to extend regulation to hedge funds and other "systemically important" institutions. Over the weekend, European leaders agreed that hedge funds must be regulated as they prepared a position for a Group of 20 summit on financial reform in London in April.

Many hedge-fund managers have been reluctant to agree to voluntary standards or provide more information, amid concerns that compliance could be costly or disclose too much about their strategies. In the U.K., an effort to set up a Hedge Fund Standards Board has attracted only a small number of the estimated 400 or so funds operating in the country.

Andrew Baker, the trade group's chief executive, said the British model of registration and oversight should be applied to the U.S.—a suggestion he acknowledges likely will be controversial among U.S. members.

In the U.K., investment professionals and others who work at hedge funds must obtain authorization from regulators by proving that they have adequate qualifications. The Financial Services Authority, the U.K. regulator, also has a group of specialists who are in regular contact with the roughly 40 largest hedge funds.

U.S. regulators, by contrast, don't have a similar dedicated hedge-fund group. In 2006, a U.S. court stymied an effort by regulators to force hedge-fund advisers to register with the Securities and Exchange Commission. Some U.S. lawmakers are seeking to revive the registration requirement, among other measures.

A representative for the U.S. hedge-fund industry's biggest lobbying group, the Managed Funds Association, wasn't available to comment.

CORRECTIONS & AMPLIFICATIONS

Roel Jansen is senior investment manager at ING Investment Management. An International Investor article on Monday about a Chinese company's bond buyback offer incorrectly gave his title as credit analyst.

Johnson & Johnson Chief Executive William Weldon's 2008 performance bonus was $3.7 million, an increase of $200,000 from 2007. A Global Business Brief Monday incorrectly said he received a $200,000 decrease to $3.5 million. General Counsel Russell Deyo received a $1 million bonus in 2008, not $1.5 million as stated in the article.

Areva SA posted a net profit of €760 million ($975.6 million) in the first half of 2008. An article about the French nuclear-power company on Monday's leading the News page incorrectly said €760 billion.

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THE WALL STREET JOURNAL EUROPE (ISSN 0921-99)
Boulevard Brand Whitlock 87, 1200 Brussels, Belgium
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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 971428 0; 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.

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Editeur responsable: Daniel Hertzberg M-17936-2003

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LEADING THE NEWS

OPEC weighs cutting back on oil output

Member countries seek price boost as market shrinks

By Spencer Swartz

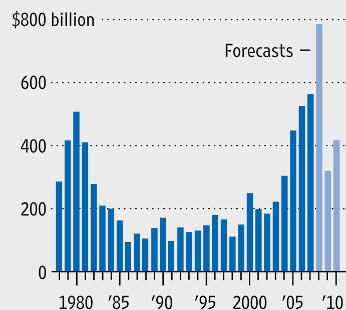
LONDON—Falling oil prices are putting pressure on the Organization of Petroleum Exporting Countries to cut production next month.

Once teeming with petrodollars from the oil boom that started in 2002 and fizzled last year, a number of OPEC members, including Angola, Ecuador, Iran and Kuwait will cut government spending this year to compensate for shrinking oil income. Nigeria narrowly avoided cutting its 2009 budget, but its president, Umaru Yar'Adua, told government workers they'll see smaller paychecks this year.

Venezuela hasn't paid hundreds of millions of dollars to a number of foreign oil-service companies, causing some firms, including Oklahoma-based **Helmerich & Payne** to halt some operations. With no work to be done in certain locations, state-run **Petroleos de Venezuela** SA has been forced to layoff an untold number of its oil workers.

Plummeting revenue

OPEC's receipts from oil exports



Notes: Adjusted for inflation; Figures before 1994 don't include Angola or Ecuador

Source: U.S. Energy Information Agency

In an attempt to boost prices, OPEC has cut production over the past two months by about 3 million barrels a day—at a nominal cost in revenue of roughly $7.4 billion. But shrinking oil demand world-wide has pushed down prices about 70% since their peak in July. And global crude demand is expected to fall 1% this year, the steepest drop in almost three decades.

The group may pledge another production cut of as much 1 million barrels a day when it meets March 15 in Vienna, according to a senior OPEC delegate.

"We will take whatever action is necessary to stabilize the market," the delegate said.

That could be a ploy just to talk up oil prices, but OPEC members' need for higher prices is real. Oil prices below $50 a barrel over the past few months threaten OPEC states' financial stability and their development projects, such as power plants, to meet the demands of their growing populations.

Ministers are girding for lean times. "In late 2008, I think OPEC expected things to get better by summer [2009], but that may not be the case. This year will be difficult for OPEC," Abdullah Bin Hamad Al Attiyah, oil minister of Qatar, said in a telephone interview.

The Iranian government, expected to shave its 2009 budget by about 3% compared with its 2008 budget, is set to raise gasoline prices again in March by several cents to make up for falling oil income and to help plug a budget deficit that may top $50 billion this year.

The increase is unlikely to sit well with Iranians used to having among the world's cheapest gas and with inflation already above 20% in the country. Some OPEC states are weathering the weaker crude prices and the financial downturn reasonably well, for now.

Saudi Arabia, the world's biggest crude exporter, has amassed foreign-exchange reserves and other assets during the oil-price boom. But economic activity is slowing rapidly in the kingdom and other Gulf states; governments are having to run budget deficits to pay for social programs and a slew of development projects has been put on hold.

James Reeve, a senior economist at Samba Financial Group, a top bank in the kingdom, says almost $8 billion in projects, such as new petrochemical and power plants, have been canceled and another $31 billion have been put on hold in Saudi Arabia alone.

For the Gulf area as a whole, just over $200 billion in development projects—sources of jobs and income for governments—have been put on hold, he says.

The International Monetary Fund recently axed its 2009 economic growth outlook for the six Gulf Arab oil-exporting nations to 3.5% from 6.8% last year.

Other problems are lurking. Production cuts at oil wells are also hurting natural-gas output, since they share production wells. This could lead to bigger problems down the road for power, plastics and fertilizer production if the number of well shut-ins grows.

There is also the question of whether any announcements for more production cuts will have credibility with oil traders. OPEC members, which pump four in 10 barrels consumed globally daily, have complied with about 75% of the 4.2 million barrels a day in cuts already announced, according to various analyst estimates.

Full compliance will be required before the market believes OPEC members will take another chop at production at the cost of more oil income.

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CORPORATE NEWS

Bankruptcy loans sought for car makers

Chapter 11 contingency financing of at least $40 billion is needed if other options don't pan out for GM, Chrysler

BY JEFFREY MCCRACKEN AND JOHN D. STOLL

Outside advisers to the U.S. Treasury have started lining up the largest bankruptcy loan ever, talking with banks and other lenders about at least $40 billion in financing for **General Motors** Corp. and **Chrysler** LLC, in case the two auto makers need it, said several people familiar with the matter.

While acknowledging the grimness of the task, administration officials involved in the auto talks said they are trying to find a way to restructure the two companies without resorting to bankruptcy proceedings. They stressed the latest efforts were "due diligence" on the part of the government advisers, and that bankruptcy financing may not be necessary.

Still, people involved in talks with senior Obama administration officials said that the administration believes that the option of Chapter 11 filings by the two auto makers needs to be seriously considered.

"Everything is on the table right now," a person involved in the matter said, adding that President Barack Obama doesn't want to see more massive job losses in the auto industry. His administration also doesn't want to anger the United Auto Workers by appearing to push for bankruptcy, this person added.

The initial discussions call for private banks to provide the financing—known as a debtor-in-possession, or DIP, loan—with the government guaranteeing or backstopping the loan. In this scenario, some of the financing would be used to pay back the $17.4 billion the government lent GM and Chrysler late last year.

Treasury advisers are handling the effort and keeping GM and Chrysler informed of the steps through back-door channels, said the people familiar with the matter. The interplay between the government, auto makers and the markets is proving to be complicated.

Lenders are reluctant to commit funding to GM or Chrysler for several reasons—mostly concern they won't get all their money back. Recently, the government advisers have begun aggressively courting big lenders **Citigroup** Inc. and **J.P. Morgan Chase** & Co.—themselves government-aid recipients—to participate in any bankruptcy financing, said people familiar with the matter.

The government advisers also are looking at ways the Treasury could "prime" other banks making DIP loans, so the government could be paid back before private creditors. Banks are deeply resistant to such steps. Both GM and Chrysler insist they can avoid bankruptcy, warning that option could cost the government as much as $125 billion in rescue financing. Bankruptcy experts say the sum isn't likely to be that high.

Even so, the estimated total of $40 billion in DIP financing GM and Chrysler would need would be five times as large as the previous record for such financing, which is used to fund day-to-day operations while companies sort out their debt. To fill such a large hole, Treasury's advisers are trying to corral as many as 70 lenders to participate in what is now informally called the "bank steering committee."

The advisers are sounding out banks about loan terms based on a government backstop, figuring out what interest rate the private market would accept and what covenants or restrictions lenders would expect.

At a news conference last Tuesday, GM Chairman and Chief Executive Rick Wagoner, once a fierce opponent of even talking about a bankruptcy filing in public, said GM could engage in talks soon with the government on how to fund a stay in bankruptcy court. "We haven't had extensive discussions yet with the government on DIP financing," he said.

DIP loans are usually viewed as among the safest loans because those lenders typically get paid before other creditors. However, that corner of the lending market froze up late last year and has only recently begun to thaw.

Rick Wagoner

Interest rates for bankruptcy financing have spiked in recent months, more than doubling from a year ago. In 2006 and 2007, the rate on the average DIP loan was the London interbank offered rate plus about 4 to 4.5 percentage points. Last year, the rate on the average DIP loan jumped to Libor plus 6.1 points, and rose throughout the year. A backstop by the federal government, however, probably would make such a loan less expensive.

Bankruptcy experts say that absent government support, lenders wouldn't step in to aid GM and Chrysler, given the proposed size of the loan and the tightness of credit markets. Most likely, the bankruptcy loan would roll up—or pay off—the $17.4 billion the government has so far lent the two auto makers. It might also pay off some other debt, including a senior bank facility.

Advising the Treasury on the GM-Chrysler situation are law firms **Cadwalader, Wickersham & Taft** LLP and **Sonnenschein Nath & Rosenthal** LLP, and the New York investment-banking firm of **Rothschild** Inc.

Cadwalader attorneys, who are in charge of advising the government on DIP lending and other matters, declined to comment. A spokeswoman for Sonnenschein declined to comment. Rothschild didn't return phone calls seeking comment.

In early January, Cadwalader bankruptcy attorney Deryck Palmer helped line up $8 billion in DIP financing for chemical company Lyondell Basell, the current record for such a loan.

So far, GM has received $13.4 billion in federal loans, The viability plan it submitted to the government last week said the company needs a total of $30 billion in aid, or $16.6 billion more than it has already gotten. GM also said it needs at least $7.7 billion in loans from the Department of Energy to develop fuel-efficient technology.

Chrysler has received $4 billion in government loans and said it needs $5 billion more. It said it would need $24 billion in financing if the company were to seek bankruptcy protection.

GM said it might need as much as $100 billion in financing from the government if it were to go through the conventional bankruptcy process. GM's $100 billion estimate stems from the belief that it would suffer "catastrophic revenue reduction impact" in a prolonged conventional Chapter 11 process, as it would expect to sustain as much as an 80% decline in sales after a bankruptcy filing. GM would need financing not only so it could weather the storm, but also to help its suppliers and dealers survive.

Mr. Wagoner, the GM CEO, said the bankruptcy scenarios are "risky" and "costly," and would only be pursued as a last resort. "We haven't had extensive discussions yet with the government on DIP financing," he said. "They asked us to put together and address the topic. We've done that in [GM's viability plan], so I suspect we may enter into those discussions."

—Neil King Jr. contributed to this article.

Associated Press

Worker installing a tire at the GM auto assembly plant in Arlington, Texas, earlier this month.

Forks in the road | GM has presented four restructuring options to the government.

SCENARIO	Out-of-court bridge loans	Prepackaged bankruptcy	Cram-down bankruptcy	Traditional Chapter 11
	Government would pump as much as $30 billion in bridge loans into GM and enforce strict restructuring timetables, including debt-reduction and labor-concession demands	GM would agree on critical elements of restructuring, including bond exchange and labor deal, before filing for bankruptcy protection.	GM would take more aggressive action, forcing a larger conversion of debt to equity and potentially forcing unilateral labor changes	This option allows GM to take the most comprehensive action, including substantial asset dispositions and balance-sheet makeover
FINANCING U.S.	At least $27 billion	$45 billion	$46 billion–$55 billion	$71 billion–$86 billion
NON-U.S.	$6 billion	$9 billion	$11 billion–$15 billion	$15 billion–$17 billion
TIME TO COMPLETE PLAN	At least 24 months	60–65 days	90 days	18–24 months

Source: GM's recovery plan

Ford reaches deal with UAW on retiree health benefits

BY JEFF BENNETT

Ford Motor Co. said Monday it has reached a tentative deal over unionized retiree health benefits, increasing the chances that **General Motors** Corp. and **Chrysler** LLC can secure their own concessions.

United Auto Workers President Ron Gettelfinger announced the revised pact following other changes to work rules reached with the three Detroit auto makers last week.

Ford, which faces $13.6 billion in legacy health costs, said up to half of its future payments to a retiree fund could be made in stock rather than cash under the terms of the pact.

The proposed terms mirror those contained in the federal loan guarantees extended to GM and Chrysler, which the auto makers have to meet by March 31. Ford has not sought U.S. government aid.

All three U.S. auto makers reached deals in 2007 to transfer legacy health costs into trust funds known as Voluntary Employee Beneficiary Associations, or Vebas, which they have funded with cash. Those payments have added to a liquidity drain that has weakened their competitive position versus overseas auto makers.

"We will consider each payment when it is due and use our discretion in determining whether cash or stock makes sense at the time, balancing our liquidity needs and preserving shareholder value," Ford said Monday.

GM and Chrysler were not immediately available for comment.

Renegotiating the health-care obligations due to UAW members and their spouses is a key part of the restructuring plans presented by GM and Chrysler to the U.S. government last week as part of survival strategies aimed at keeping both out of bankruptcy protection.

The pact will likely set a benchmark for talks with GM — which owes $20 billion to its Veba — and Chrysler. The UAW will provide further details on the Ford plan to local leaders this week. It is also subject to member and court approval.

GM bondholders will be scrutinizing any deal reached with the UAW after some complained last week that they were being asked for an overly large sacrifice.

Associated Press

Ford has been cutting jobs around the world, including at this factory in Southampton, U.K., but the legacy health costs in the U.S. have been a major burden.

CORPORATE NEWS

Auto demand climbs in France

Analysts fear gains, fueled by incentives, will prove temporary

BY DAVID PEARSON

PARIS—In the face of the worst auto-industry downturn in decades, France's car makers are stepping up production of some models to meet rising demand reflecting government incentives to scrap old vehicles.

But while the increased demand is good news for car makers, it could prove to be little more than a short-term spike as motorists simply buy now rather than later. Also, the growing demand is for small cars, which typically have lower profit margins for manufacturers, and production remains significantly below year-ago levels.

French auto maker **PSA Peugeot-Citroën** SA has told the 6,000 employees at its plant at Poissy, outside Paris, that production of the Peugeot 207 minicar—France's hottest-selling car in January—will be raised to 900 a day by April 1 from 550 at present.

The company has abandoned plans to cut the third shift at Poissy and has to bring in some 400 assembly-line workers from two other plants to make up for the depleted head count.

French car makers slammed the brakes on production at the end of last year, when sales nose-dived as fearful consumers cut back amid reports of collapsing economic activity.

But the introduction of cash incentives of up to €2,500, or about $3,200, for car owners in France, Germany, Italy and Spain to scrap older vehicles and buy cleaner, fuel-efficient models seems to be having the desired effect of reviving demand, executives said.

Associated Press

Renault is seeing good sales of low-budget cars made by Romanian subsidiary Dacia. Cars rolled off a Dacia line Monday.

German car maker Opel, a unit of **General Motors** Corp., Monday said it is having its best sales month in Germany in the past five years. The company expects to sell more than 40,000 vehicles in the country in February, partly thanks to the government incentives.

Peugeot-Citroën's order intake from Germany is running nearly 40% above the company's sales projection drafted before the incentives were introduced in December, a spokesman said, and these orders will feed into production in coming weeks.

French rival **Renault** SA also is gearing up production to meet demand for small cars such as its Twingo, Clio and Modus models, and is seeing good sales of the Sandero and Logan low-budget cars made by Romanian subsidiary Dacia.

Orders for Renault's small cars in Germany have doubled thanks to the incentive there, while orders for Dacia's Sanderos and Logans have risen sixfold, a Renault spokesman said.

Eric Nicolas, executive vice president for finance and administration at **Nissan Motor** Co.'s European operations, said last week that the company's German subsidiary has passed on an urgent order for 2,000 Nissan Micra minicars that are made in Northeast England. Renault owns a 44% stake in Nissan.

Deutsche Bank analysts estimate that the German plan will likely increase 2009 sales by between 300,000 and 400,000 vehicles, while France's €1,000 offer will add between 100,000 and 200,000 cars. Italy's incentive of up to €700 could boost sales by 100,000.

François Roudier, spokesman for the French auto makers association, said the French incentives are generating between 700 and 1,000 car sales daily. Customers have to wait two months for Clios they have ordered.

Auto-industry executives in the U.K. are clamoring for the introduction of a similar plan to boost British car sales. Car production in the U.K. slumped 58% in January from a year earlier.

Industry analysts point out, however, that previous experience has shown that government-initiated incentives offer only short-term relief, as they simply bring forward sales that would have happened anyway.

—Erin Fines in Frankfurt contributed to this article.

Japan aspires to be tourist mecca for wealthy

BY MIHO INADA

TOKYO—Japan's newly formed tourism agency has an ambitious goal: branding the country as a premier travel destination for the world's wealthy.

Japan formed the agency in October as part of a big push to nurture its tourism industry.

ADVERTISING

A few weeks later, it invited 23 travel agencies from various countries to a conference called the Japan Luxury Travel Forum, promoting its most extravagant hotels and exclusive getaway spots, which government officials are hoping will entice the more affluent traveler.

The event featured a trip, sponsored by two dozen Japanese companies, such as Japan Airlines, that included a visit to Kanazawa, a small, historic city in northern Japan that is famous for its castle and hot springs. The group also saw a demonstration of the Japanese art of *makie*, or gold lacquer, which has been handed down from generation to generation for 1,300 years.

In another move to reach out to the affluent, the Japan Tourism Agency plans to place ads in luxury travel magazines and on high-end travel Web sites like Virtuoso.com.

The efforts are part of the nation's campaign to boost its overall number of foreign tourists. Since 2003, Japan has spent 3 billion yen ($32 million) a year to advertise Japan's wide-ranging attractions. The investment paid off until recently, with the number of foreign visitors reaching 8.4 million in 2008, up roughly 75% from 2000.

Japan's Ministry of Economy, Trade and Industry

A celebration of cracking open the lid of a sake cask during 'Japan Night' at the Luxury Travel Market in Cannes, France, in December 2007.

But the global economic downturn, combined with last year's sharp rise in the yen, which makes prices in Japan more expensive for foreigners, put a damper on the growth trend.

"We felt we should target people whose plans aren't affected by the economic situation," who are likely to be more affluent travelers, says Daisuke Idesawa, an official of the Japan Tourism Agency's division that promotes international tourism. "Up until now, we've been focusing on increasing the number."

Amid a resurgence in foreign interest in Japanese food and culture in recent years, officials bet that more-affluent travelers would visit Japan if they stepped up promotion.

But challenges remain. Takeharu Jofuku, a government official in charge of last year's travel forum, says wealthy travelers tend to be attracted not only to exclusive spots but also to "extraordinary" experiences, such as a tea ceremony by a Japanese tea master. "They find value in something that is impossible for ordinary people to do," he says.

But Japan's tourism industry, which has long been used to organizing big group tours, isn't adequately equipped to cater to such requests, he says. Language may also be a problem. Even the most upscale Japanese-style inns, called *ryokan*, rarely have English-speaking staff on hand.

Still, some in the industry say that if the effort is successful, tourism may help revive local economies that have been hit hard by Japan's recession and have few other industries to rely on. What's more, if wealthy foreigners start flocking to the country's more exclusive areas, trend-conscious Japanese, who are "poor at finding Japan's beauty on their own," may follow suit, says Fumiko Kinoshita, who specializes in promoting regional tourism at Japanese ad agency **Hakuhodo** Inc.

Honda selects company veteran as chief executive

BY JOHN MURPHY AND YOSHIO TAKAHASHI

TOKYO—**Honda Motor** Co. tapped Takanobu Ito, a senior managing director with a long career in research and development, to be president and chief executive as Japan's second-largest auto maker looks for new, younger leadership to lift it out of a global sales slump.

Mr. Ito, 55 years old, will succeed president and CEO Takeo Fukui, 64, who will step down after six years at the helm. Mr. Fukui will continue as an adviser and member of the board, Honda said Monday. The change will take effect at the company's annual meeting in June, pending approval by the board.

Mr. Ito will lead the company during a tumultuous time in the global auto industry as top car makers scramble to slash production, lay off workers and make other cost cuts as sales in the U.S., Europe, Japan and other key markets crumble.

Mr. Ito said he is clearly aware of the challenges before him. "It's going to be tough," he said.

Still, Honda has fared better than its main rivals, **Toyota Motor** Corp. and **Nissan Motor** Co., which are projecting huge net losses for the fiscal year ending in March. Thanks to strong sales of its motorcycles in Asia and South America, Honda expects to post a modest net profit of 80 billion yen ($860 million) for the period, down 87% from last year.

Honda follows Toyota and **Mazda Motor** Corp. in handing over management responsibilities to new top executives in hopes of bold overhauls to weather the tough business environment.

Toyota last month said it appointed Akio Toyoda, grandson of the company's founder, as president. On Monday, Toyota made more management announcements, including the retirement of Mitsuo Kinoshita, an executive vice president. Mr. Kinoshita, 63, was the primary architect of Toyota's global expansion and once considered a candidate for the top job. Mazda in November tapped Takashi Yamauchi as its president and chief executive.

Mr. Fukui—who oversaw Honda's push into emerging markets, investment in the jet-airplane business and the development of the new Honda Insight hybrid car—was looking for a new, younger leader for the company as the car industry enters a slump, a Honda spokesman said. Mr. Ito long has been viewed as one of Honda's rising stars.

Asked at a news conference Monday to describe his successor, Mr. Fukui said, "I would say 'tough,' in a word."

After beginning his career as an engineer focusing on chassis design in 1978, Mr. Ito was in charge of developing the aluminum body frame of the NSX sports car and worked on several compact sedans during the 1990s. From 1998 to 2000, he was executive vice president of Honda's research-and-development operations in the U.S., where he helped develop the upscale Acura brand's first sport-utility vehicle, the MDX.

He also took charge of research-and-development operations in Japan and in 2005 became general manager of a Honda factory in Japan. In 2007, he was named Honda's chief operating officer of automobile operations.

CORPORATE NEWS

Judge clears art auction

Ruling will allow Chinese bronzes in Saint Laurent sale

Associated Press

PARIS—A French judge Monday refused to halt the sale of disputed Chinese bronze fountainheads heading for Christie's auction block as part of fashion designer Yves Saint Laurent's estate.

The judge has ordered an association that sought to prevent the sale to pay €1,000 ($1,284) in fines each to the auction house and to the firm of Pierre Berge, the longtime partner of the French fashion icon, who died of brain cancer last June at age 71.

The bronze heads of a rabbit and a rat disappeared from the summer Imperial Palace on the outskirts of Beijing when French and British forces sacked it at the close of the second Opium War in 1860.

The dispute has cast a shadow over the three-day auction of 733 works of art collected over half a century by Messrs. Saint Laurent and Berge.

Lawyers for a China-linked group, APACE, sought to block the sale of the bronzes—not the entire auction. The group acknowledges Mr. Saint Laurent acquired the bronzes legally, but says they should be returned to China or at least displayed in a museum.

Jean-Paul Chazal, a lawyer for Christie's, said he was "entirely satisfied" by the ruling.

The fountainheads date to the early Qing Dynasty, established by invading Manchu tribesmen in 1644. The Christie's catalog says they were made for the Zodiac fountain of the summer Imperial Palace. They are expected to sell for up to €10 million each, according to news reports.

Mr. Berge said Friday he had no intention of "giving these heads to the Chinese government....Rather, I would recommend that the Chinese, instead of getting worked up over the heads, worry about human rights."

Beyond the bronzes, the auction will be closely watched in the art world amid worries the financial crisis is cutting into the market. The sale is expected to gross €200 million-€300 million.

Highlights include Piet Mondrian's 1922 painting, "Composition in Blue, Red, Yellow and Black," whose squares of saturated colors inspired Mr. Saint Laurent's renowned 1965 shift dress, and a wooden sculpture by Romanian artist Constantin Brancusi expected to sell for €15 million-€20 million.

The highest price is expected to go to a 1914-1915 Picasso painting called "Instruments de musique sur un gueridon," (Musical Instruments on a Table) from his cubist period. The canvas is the last large-format painting from the period still in private hands, Christie's said. The Picasso's estimated worth is €25 million-€30 million.

Other lots include sculptures from ancient Egypt and Rome, ivory crucifixes and silver German beer steins that covered every available surface of Mr. Saint Laurent's homes. Also on sale is his Art Deco furniture and his bed.

Associated Press

A Chinese bronze rabbit head, right, and bronze rat head are part of the Yves Saint Laurent and Pierre Berge art collection being auctioned in Paris this week.

U.S. inoculates vaccine makers

By Avery Johnson

One of the little-noticed reasons **Wyeth** was attractive enough to command a $68 billion price in **Pfizer** Inc.'s planned takeover sits in a building near the White House in Washington. That is where a special "vaccines court" hears cases brought by parents who claim their children have been harmed by routine vaccinations.

The court—and the law that established it more than two decades ago—buffer Wyeth and other makers of childhood-disease vaccines from much of the litigation risk that dogs traditional pill manufacturers and is an important reason why the vaccine business has been transformed from a risky, low-profit venture in the 1970s to one of the pharmaceutical industry's most attractive product lines.

The legal shield, known as the National Childhood Vaccine Injury Compensation Program, was put into place in 1986 to encourage the development of vaccines, a mainstay of the U.S.'s public-health policy. Lawsuits against vaccine makers in the 1970s and 1980s had caused dozens of companies to get out of the low-profit business, creating a public-health scare. The strategy worked, and vaccines have driven reductions of major childhood diseases.

Vaccines have also become big business. They are poised to generate $21.5 billion in annual sales for their makers by 2012, according to France's **Sanofi-Aventis** SA, a leading producer of inoculations.

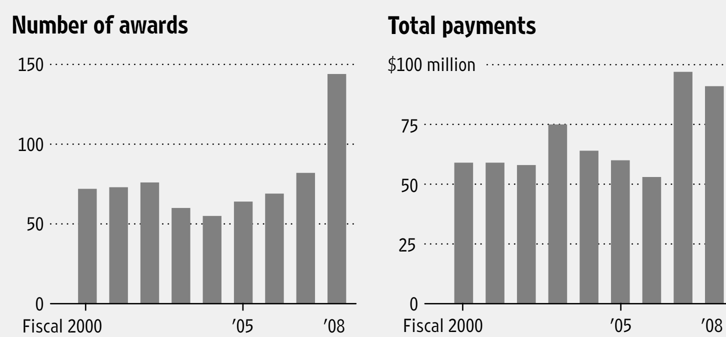
At a time when pharmaceutical companies are being battered by generic competition, vaccines offer an appealing alternative because they are biologic products that can't yet be copied. Another big draw is the partial protection from liability risk offered by the vaccines court, officially known as the Office of Special Masters at the U.S. Court of Federal Claims.

Such immunity makes a product like Wyeth's Prevnar attractive. Designed to protect children against pneumococcal disease, Prevnar had sales of $2.7 billion last year that are projected to grow to $5.5 billion in 2015, according to Sanford C. Bernstein & Co. Pfizer spokesman Ray Kerins acknowledges Wyeth's strength in vaccines was an important factor behind Pfizer's interest but says the deal made sense for other reasons.

Vaccines' transformation into a lucrative business has some observers questioning whether the shield law is still appropriate. Critics say the vaccine court's ruling this month that routine childhood immunizations aren't linked to autism underscored the limited recourse families have in claiming injury from vaccines.

Vaccine court victories

The court has paid damages on 2,260 cases in two decades



Source: Health Resources and Services Administration

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GLOBAL BUSINESS BRIEFS

Acciona SA

Endesa stake sale will cut its debt load to $7.6 billion

Spanish energy and infrastructure company **Acciona** SA said its total debt after selling its 25% stake in **Endesa** SA will fall to €5.92 billion ($7.6 billion) from €17.54 billion at the end of the third quarter. That is equivalent to 4.1 times its estimated 2009 earnings before interest, taxes, depreciation and amortization, or Ebitda, after the disposal of the Endesa stake, said Juan Muro-Lara, managing director for corporate development. At the end of the third quarter, Acciona's debt was equivalent to 6.1 times estimated 2009 Ebitda, including the Endesa assets. Acciona on Saturday announced a deal to sell its Endesa stake to Italy's **Enel** SpA for €11.11 billion in cash and assets. Acciona has no plans to further reduce its debt after the Endesa deal, he said.

Campbell Soup Co.

Campbell Soup Co. reported a 15% decline in fiscal second-quarter profit, hurt by the stronger dollar and retailers' inventory cutbacks. The maker of Pepperidge Farm cookies and V-8 juice, in addition to its namesake soups, said overall volume in the quarter ended Feb. 1 fell 3%. Consumer-staples companies like Campbell have been holding up better than the makers of more discretionary products, as budget-stressed consumers in the U.S. cook at home more often. For its latest quarter, the company reported net income of $233 million, or 64 cents a share, down from $274 million, or 71 cents a share, a year earlier. Sales dropped 4.3% to $2.12 billion.

Fresnillo PLC

Mexican silver miner **Fresnillo** PLC reported an 11% drop in 2008 net profit, hit by higher taxes. London-listed Fresnillo said net profit fell to $128 million from $143.5 million a year earlier, as income-tax expenses rose 53% to $114.6 million. Revenue increased 11% to $720.5 million, buoyed by precious-metal prices. After the earnings release, shares in the miner closed down 5.6% at 390 pence ($5.63) in London. Fresnillo said it will rein in some project and exploration costs during 2009 but would remain on the lookout for acquisitions in a distressed sector. In December, Fresnillo offered about $178.8 million to acquire the 80% of MAG Silver Corp. that it doesn't already own, but that deal stalled when MAG withdrew from a valuation process.

Actelion Ltd.

Swiss drug maker **Actelion** Ltd. said Monday it broadened its portfolio to treat pulmonary hypertension with the acquisition of a new, intravenous formulation from U.S.-based **GeneraMedix** Inc. Financial details weren't released. Actelion, which generates the bulk of its revenue with Tracleer, a pill against pulmonary hypertension, said it will be responsible for development, registration and marketing of the formulation epoprostenol sodium, starting with the U.S. market. The GeneraMedix formulation is applied intravenously and protected by patent applications. Pulmonary hypertension is a rare blood-vessel disorder of the lung. Actelion also offers the pulmonary-hypertension drug Ventavis, which patients inhale.

Cosco Corp.

China-based shipbuilder **Cosco** Corp. said it swung to a net loss in the fourth quarter and warned of a challenging year ahead. Singapore-listed Cosco reported a net loss of 23.9 million Singapore dollars (US$15.6 million) because of provisions and delays in payments from several shipowners. The company had a year-earlier profit of S$116.5 million. Revenue fell 15% to S$723.5 million from S$846.6 million a year earlier. A slowing economy and the financial crisis have forced many Cosco customers to cancel shipbuilding contracts or to delay delivery. The company said it made provisions of S$61.3 million for impairments.

Anheuser-Busch InBev

Private-equity firm **KPS Capital Partners** LP agreed to buy Labatt USA, a unit of brewing giant **Anheuser-Busch InBev**, as part of a foray into the beer industry. New York-based KPS also said it has acquired **High Falls Brewing** Co. and formed a new company, North American Breweries Inc., to serve as a platform for investments. Labatt USA, which imports Labatt Blue and other brands made in Canada by Anheuser-Busch InBev, has been on the block because the U.S. Justice Department required InBev to sell the Buffalo, N.Y., division to complete its purchase of Anheuser-Busch last year. Financial terms of the deals weren't disclosed.

Fairfax Media Ltd.

Fairfax Media Ltd. booked a fiscal first-half net loss of 365.3 million Australian dollars (US$234.2 million) as the Australian publishing and broadcasting company joined many of its international peers to write down assets. The result for the six months ended Dec. 28, which compares with a net profit of A$196.0 million a year earlier, includes a non-cash impairment charge of A$447.5 million as the group wrote down the carrying values of its mastheads, licenses and goodwill across all its businesses. The result also included A$62.4 million in restructuring and redundancy charges after it laid off workers. Earnings were also weighed down by a slump in advertising. Revenue was flat at A$1.44 billion.

Virgin Blue Holdings Ltd.

Australian airline **Virgin Blue Holdings** Ltd. fell into the red in the fiscal first half due to losses from derivatives and hedging instruments, as well as startup costs from its new international long-haul airline. The Brisbane-based airline posted a net loss of 101.4 million Australian dollars (US$65 million) in the six months ended Dec. 31, compared with a net profit of A$113.3 million a year ago. Virgin Blue lost A$81 million after tax on its fuel-price hedging. While jet fuel prices fell sharply, the company's fuel bill rose 44% to A$400 million in the first half largely due to hedging at higher prices and a weaker Australian dollar. The carrier said interim revenue rose 12% to A$1.35 billion as the airline carried 13% more passengers.

Citigroup Inc.

Citigroup Inc. said Monday it appointed Farhan Faruqui as its head of global banking, Asia Pacific, the bank's most senior Asian appointment since it merged corporate and investment-banking operations in the region. Mr. Faruqui was formerly head of Citigroup's Asia Pacific Corporate & Commercial Bank. He will remain in Hong Kong and will report to the co-heads of global banking, Alberto Verme and Raymond McGuire, as well as to Ajay Banga, Citigroup's Asia Pacific chief executive.

—Compiled from staff and wire service reports.

U.S. wrestles with federal role in economy

Nation isn't any closer to deciding how big a part the government should play, even after last year's election

By Gerald F. Seib

CAPITAL JOURNAL

When U.S. President Barack Obama delivers his inaugural speech to Congress Tuesday night, a giant and unresolved question will hang over the proceedings: What's the proper role for the U.S. government in today's troubled economy?

In fact, this is the megaquestion of our time. Yet it is increasingly clear that neither the lawmakers the president will be addressing, nor the nation beyond them, has come close to consensus on an answer. You might have expected the election of 2008 to resolve this conundrum, but it really didn't.

Look up and down Pennsylvania Avenue this week and you can see how the issue is dividing not just the two political parties, but factions within them as well:

■ The Treasury Department is confronting a once-unthinkable decision over whether to nationalize big American banks. It's clear the Obama administration doesn't want to take that step, even though the British government is heading in precisely that direction, and some analysts think some form of nationalization in the U.S. is inevitable. The administration's effort to increase the government's stake in **Citigroup** without actually taking it over represents a stab at compromise.

■ Republican governors are splintering over the big federal stimulus package that is supposed to spur economic activity in their states. The Republican chief executives of the biggest and fourth-biggest states, California and Florida, are in favor of the package just passed by Congress, arguing that government spending can, in fact, give their states a boost. Meanwhile, the Republican chief of the nation's second-largest state, Texas, along with colleagues from smaller states, is leading the charge against it, arguing that the stimulus programs' expansion of government will hurt them in the long run.

■ The budget plan Mr. Obama will outline Tuesday, and then deliver to Congress Thursday, will reflect the struggle over government's role. It will, for example, envision a wider reach in health care by seeking to draw more citizens into the Medicare program. But it also will put off for later any real effort to address liberals' desire for a broader government-guaranteed plan for universal health coverage.

In reality, of course, the economic crisis already is expanding government's role in the economy. The feds now hold a controlling interest in insurance giant AIG and could hold a stake as big as 40% in Citigroup before the week is out.

The government also holds the fate of **General Motors** and **Chrysler** in its hands. Thanks to the financial-industry bailout and fiscal stimulus, government spending will account for about a quarter of the country's gross domestic product this year, a post-World War II high. And it isn't over; in their private moments, most officials acknowledge the administration within the year may seek more funds to stabilize the financial industry, and perhaps more stimulus money.

So the real issue isn't whether the government's role in the economy should be growing—it is and will continue—but rather how big and long-lasting that growth should be.

This question brings to the surface the most basic philosophical divides between the parties, and within the nation. One might have expected last fall's vote to put to rest, at least temporarily, the dispute over the government's role. But it didn't really do so. The 2008 presidential campaign, though momentous, wasn't a particularly ideological one. Moreover, today's problems are so deep that they challenge the previously held economic philosophies of both parties anyway.

So the debate is going on now, in real time, and with live ammunition. Former House Speaker Newt Gingrich, emerging as a leader of the Republican attack against Democrats' economic strategy, argues that "the left is making an extraordinary gamble that they can actually make government-led economic growth happen," and predicts "a raw power struggle" over how government and the economy should interact.

That's why the argument over the recently passed economic stimulus was so pointed and divisive. Many of us in the fourth estate wrote loosely of "solid" Republican opposition to the stimulus plan, and "solid" Democratic support for it.

Yet the picture is far more complicated than that. Not only are Republican governors proving to be deeply divided about the value of the stimulus package, so too are core Republican constituencies. The U.S. Chamber of Commerce and the National Association of Manufacturers—basic components of the Republican coalition—both were vocal advocates of stimulus. Chamber President Thomas Donohue declared that "the government is the only game in town capable of jump-starting the economy."

At the same time, a small group of House Democrats opposed the stimulus plan. Most came from the so-called Blue Dog coalition within the House, made up of Democrats fixated on fighting federal deficits.

This week, the Obama budget plan will call for reinstituting and making stricter "pay-as-you-go" budget rules, which require future spending to be offset by either mandatory spending cuts elsewhere or tax increases. Liberals will hate the rules because they clip favored domestic programs. Conservatives will hate them because they can compel tax increases. Meanwhile, the great debate—what should the government's footprint in today's American economy really be?—will roll on.

Agence France-Presse

U.S. President Barack Obama, right, and Vice President Joe Biden at the National Governors Association meeting Monday.

Jobs elude some former Bush administration officials

By Joann S. Lublin

The jobless rate is hanging high—for many of the roughly 3,000 political appointees who served U.S. President George W. Bush. Finding work has proved a far tougher task than those appointees expected.

"This is not a great time for anyone to be job hunting, including numerous former political appointees," said Carlos M. Gutierrez, Mr. Bush's commerce secretary. Previously chief executive of cereal maker Kellogg Co., he hopes to run a company again because "I have a lot of energy."

Only 25% to 30% of ex-Bush officials seeking full-time jobs have succeeded, estimated Eric Vautour, a Washington recruiter at Russell Reynolds Associates Inc. That "is much, much worse" than when Ronald Reagan, George H.W. Bush and Bill Clinton left the White House, he said. At least half those presidents' senior staffers landed employment within a month after the administration ended, Mr. Vautour recalled.

A handful of Bush cabinet officers have accepted academic appointments. Former Treasury Secretary Henry Paulson joined Johns Hopkins University's Paul H. Nitze School of Advanced International Studies as a fellow. Condoleezza Rice, previously secretary of state, resumed her Stanford University roles as a political-science professor and senior fellow at its Hoover Institution think tank.

Mike McConnell, the ex-director of national intelligence, also rejoined a prior employer. He resumed work last week as a senior vice president of Booz Allen Hamilton, the title he held when he left the management consultancy to become U.S. spy chief. Last week, Fidelity Investments named Anthony Ryan, a former acting Treasury undersecretary, to head its asset-management strategy.

Some high-level Bush appointees say they are in no rush to be reemployed. Michael Leavitt, previously secretary of Health and Human Services, said he will spend a few months trying to align his interests with opportunities. Meanwhile, the former Utah governor continued, "I'm writing some about the past [and] I'm giving speeches about the future."

Mr. Gutierrez is keeping equally busy during his job hunt. He said he recently signed up for a speakers' bureau and collects $25,000 to $50,000 per lecture about issues such as global business. Earlier this month, United Technologies Corp. named him a director.

Mr. Gutierrez would like to stay in Washington, which he acknowledges could impede his search for a corporate CEO role. "I don't want to go anywhere" because "public policy makes a difference," Mr. Gutierrez explained. He said he may ultimately consider businesses based elsewhere.

Senior Bush aides keen to work again "have to look broader than Washington," said Nels B. Olson, a recruiter for Korn/Ferry International. Mr. Vautour agrees. A number of former officials are now saying, " 'I'll look anywhere' " because they realize the Washington job market "is very tough," he said.

Washington think tanks, charities and trade associations long provided fertile ground for ex-political appointees. But many lack interest in hiring high-profile Republicans when Democrats control the White House and Congress. Mr. Bush's low approval ratings at the end of his term don't help, said Leonard Pfeiffer IV, a Washington recruiter for nonprofits.

U.S. to propose new rules to regulate carbon dioxide

By Ian Talley

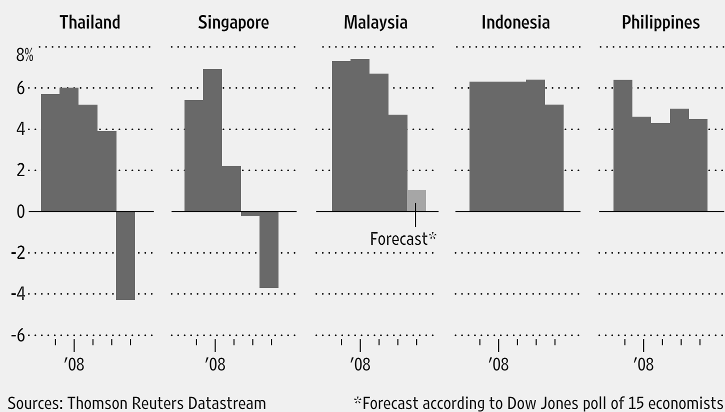
WASHINGTON—U.S. President Barack Obama's climate czar said the Environmental Protection Agency will soon determine that carbon-dioxide emissions represent a danger to the public and propose new rules to regulate emissions of the greenhouse gas from a range of industries.

Carol Browner, special adviser to the president on climate change and energy, said in an interview Sunday that the EPA is looking at a 2007 Supreme Court ruling that requires the agency to determine whether carbon dioxide endangers public health or welfare. And the agency "will make an endangerment finding," she said.

Officially recognizing that carbon dioxide is a danger to the public would require the government to draw up regulations governing greenhouse-gas emissions from coal-fired power plants, refineries, chemical plants, cement firms, vehicles and any other emitting sectors.

Legal experts say designating carbon dioxide a public danger could open up any emitters to legal challenge. The U.S. Chamber of Commerce and the National Association of Manufacturers have been lobbying the EPA against trying to regulate greenhouse gases, warning that such action would lead to costly new regulations affecting not only coal plants and large manufacturers but also schools, apartment buildings and hospitals.

Speaking to governors and reporters later Sunday, Ms. Browner said the administration also is seeking to establish a national policy for auto emissions.



Idle cranes are seen at Singapore's Tanjong Pagar container terminal last week

Reuters

Thailand GDP contracts

Bangkok joins slump in Southeast Asia as exports plummet

By Tom Wright And Patrick Barta

A contraction in Thailand's quarterly economic growth confirmed fears that much of Southeast Asia—once a relative bright spot in the world economy—is sinking into a potentially deep recession.

Growth was already nosediving in Singapore, the region's financial capital, and Malaysia is expected to see deceleration in economic activity when it reports its most recent quarterly data this week. Layoffs are thinning textile factories and semiconductor plants, and economists warn the region's planned stimulus packages won't be enough to offset declines in exports to the U.S. and elsewhere.

Thailand's data out Monday underscored the fears. The country's economy—Southeast Asia's second-largest behind Indonesia—contracted 4.3% in the fourth quarter compared with the year-earlier period, considerably worse than analysts expected. The government slashed its forecast for 2009 to between 0% and a minus 1% contraction, from earlier projections of 3% to 4% growth, meaning Thailand will almost certainly enter a recession this year.

The Thai economy "will be likely to get worse" before it gets better as exports stay weak, said Sriyan Pietersz, an analyst at J.P. Morgan in Bangkok.

Southeast Asia had until recently looked somewhat stronger than the rest of Asia and many other emerging markets, thanks in part to the reserves its governments built up after the 1997-98 Asian financial crisis. Many local companies and consumers, burned by currency devaluations in the late 1990s, avoided the excessive foreign borrowing and other risks now weighing on Eastern Europe and elsewhere.

Within the region, Indonesia and the Philippines are still performing better than most emerging nations, mostly because their large consumer markets are offsetting declines in export revenue. Both countries posted growth of more than 4% in the fourth quarter.

Indonesia faces further fallout from swooning prices for copper, palm oil and other commodity exports, and the Philippines is counting on remittances from foreign-based workers to maintain domestic spending, even though a weaker global economy could trim those funds.

The area's other big players are starting to look like Taiwan and Korea, where the economies have been sent into tailspins by excessive reliance on exports.

In Malaysia, a hub of electronics manufacturing, growth was at 6.7% as recently as the second quarter of 2008. Analysts now are forecasting only slight growth for the fourth quarter of 2008 and a contraction of minus 0.5% or worse for 2009. Auto sales fell 17.5% in January from a year earlier.

In Singapore, the government said last week that nonoil exports fell 35% in January from the previous year to $6.6 billion, its worst performance since records began 30 years ago.

The city-state is bracing for a contraction of between 2% and 5% in 2009, according to the government. The economy fared this badly once before, in 2001, when the U.S. tech slump led to a 2.4% fall in Singapore's gross domestic product.

At Singapore's port—one of the world's largest—hundreds of ships linger offshore with no cargo to transport. Guy Lamb, managing director of Singapore-based Island Shipbrokers, which charters oil tankers, says the company has maintained its volumes but rates have fallen 75% since a peak at the beginning of 2008.

Property prices, fueled in recent years by foreign demand, also are in free fall. A report by Credit Suisse last month said 200,000 foreigners could leave Singapore over the next two years due to job losses in services and manufacturing. Property prices, down 8% from their peak in 2008, could fall by as much as 40% this year, Credit Suisse warned.

Singapore-based **Chartered Semiconductor Manufacturing**, one of the world's largest chip makers, said last month it was shedding 600 workers amid forecasts of a record loss in the first quarter.

Tapping its official reserves for the first time, Singapore in January announced a $13.6 billion stimulus package that cut corporate taxes and included measures to spur bank lending and help households. Other Southeast Asian nations have announced stimulus plans.

Without a turnaround in global demand to restore export growth, such measures are likely to have only limited impact, economists say.

In Thailand, some analysts noted that the recent contraction reflected one-time losses from November and December, when antigovernment protesters shut down the country's main airport and blocked tourist arrivals. But Mr. Pietersz at J.P. Morgan said the key culprit was a nearly 9% drop in exports in the quarter.

That problem accelerated in January, when exports tumbled 26.5% from a year earlier. Thai officials have said manufacturers could cut as many as 100,000 jobs this year as exports fade.

—Wilawan Watcharasakwet contributed to this article.

China forecasts further downturn

By J.R. Wu

BEIJING—China's central bank warned there is growing likelihood of a further downturn in China's economy, and that "relatively large" deflationary pressures loom.

In its annual monetary policy report published Monday, the People's Bank of China reiterated that it remains committed to keeping its yuan exchange rate at a balanced level. The report said the central bank also plans to use interest rates and banks' reserve requirement ratio to manage liquidity in the banking system.

Given "the contraction in external demand, excess capacity in some industries, management difficulties at corporations, [and the] increase in urban unemployment, the downward pressure on [China's] economic growth has clearly increased," the report said.

There could be global inflationary pressures in the medium-to-long term, but in the short term, deflation is the greater danger, the bank said.

"The risk of deflation is relatively large" due to falling raw-material prices in the international market and weak external demand causing overcapacity within China, the bank said.

The report didn't appear to signal any policy change was imminent in terms of the central bank's moderately loose monetary policy, but it did say that pushing forward reform of the country's electricity-pricing mechanism is among its tasks for 2009.

The central bank already set out in its December executive summary that it will target a growth rate of about 17% for broad money supply, M2, this year. *—Victoria Ruan contributed to this article.*

Aso travels to the U.S. to stress cooperation

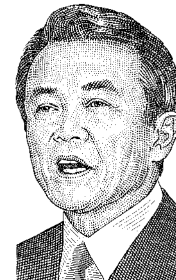
By Yuka Hayashi

TOKYO—Taro Aso, Japan's embattled prime minister, is betting his future on one of the few options he has left: diplomacy.

On the eve of becoming the first foreign leader to meet President Barack Obama in the White House, the 68-year-old Mr. Aso faces mounting problems at home.

Japan's economy contracted at its fastest pace in 35 years during the October-December quarter as exports plunged.

But the nation doesn't have much room for policy maneuvering, as the government faces a huge fiscal deficit and interest rates are already close to zero. Furthermore, the government is unpopular among voters, in part because of Mr. Aso's policy flip-flops and gaffes.


Taro Aso

A poll released Monday by the Nikkei newspaper showed only 15% of respondents approved of Mr. Aso's cabinet. In response to another question, 70% of those polled said a general election should be held within the next few months, well ahead of the October deadline.

Such a vote could force Mr. Aso's Liberal Democratic Party out of power—triggering a headache for Washington, which has counted on the LDP as an ally. The LDP has been Japan's ruling party for five decades, except for a brief period in the early 1990s.

The Democratic Party is the main opposition that could take power if the LDP is defeated.

The Democratic Party advocates a "more equal partnership" with the U.S. in its bilateral security alliance and has clashed with the LDP on legislation authorizing Japan's military cooperation with Washington, including refueling of U.S. ships operating in the Indian Ocean.

Mr. Aso may be hoping his meeting with Mr. Obama on Tuesday is an opportunity to show off his achievements. While a deadlock in the parliament has delayed passage of his domestic economic measures, Mr. Aso has focused in recent weeks on meeting world leaders and pitching Japan's role in the global effort to contain the financial crisis.

Atop the agenda for Tuesday's meeting is the reconstruction of Afghanistan and support for Pakistan. Mr. Aso also will highlight Japan's recent $100 billion loan to the International Monetary Fund to ensure help to countries affected by the crisis.

"We'd like to share the conclusion with the U.S. that the two nations will join hands to respond fully to these problems that are global and long-term in nature," Mr. Aso said in a televised news conference before his departure from Tokyo.

The visit to Washington follows a busy week for Mr. Aso. He welcomed U.S. Secretary of State Hillary Clinton in Tokyo and flew to Sakhalin Island in the Russian Far East to meet with President Dmitry Medvedev to discuss bilateral territorial issues.

However, Mr. Aso is visiting Mr. Obama without the news he had hoped to bring: that along with other major nations, Japan is implementing steps to stimulate its domestic economy.

Since October, Mr. Aso has announced three economic packages with a combined value of 75 trillion yen, or $840 billion, including 12 trillion yen in fiscal spending. But of the three, only the first package, valued at 11.5 trillion yen, has been cleared for implementation because of a parliamentary stalemate.

Mr. Aso wanted to secure parliamentary approval for the budget for the fiscal year starting April 1, which includes a stimulus package valued at 37 trillion yen.

He had to give up the plan after the opposition party became fired up by the resignation of Finance Minister Shoichiro Nakagawa.

Mr. Nakagawa came under criticism after videos of his odd demeanor at a Group of Seven meeting went public on the Internet last week. Mr. Nakagawa blamed his conduct on the effect of cold medicine.

With a majority in one of the two chambers of the parliament, the opposition Democratic Party has used its clout to delay the passage of stimulus steps—a blow to Mr. Aso, who started his tenure five months ago by declaring the economy his No. 1 priority.

China blast may hurt coal supply

SHANGHAI—Sunday's deadly blast at a modernized China coal mine could lead Beijing to order stringent safety checks at all mines.

Analysts say China has been facing a coal surplus of more than 50 million metric tons this year, but this could change if some mines are forced to close temporarily or permanently.

The explosion in a state-owned mine in northern Shanxi province killed at least 74 miners. On Monday, the Associated Press said relatives of miners killed and injured at Tunlan mine expressed frustration over scant information on their loved ones' fate and the causes of China's deadliest mine disaster in a year.

Beijing has long pledged to improve safety at its coal mines, and last year shut more than 1,000 shafts that it considered unsafe. But a death toll of 3,200 people last year, while representing a 15% decline from 2007, means the country's coal mines remain the world's deadliest.

"What sets this accident apart is that it happened at a state-owned coal mine of relatively large size," said Li Chaolin, a market watcher with the China Coal Transportation and Distribution Association. "So it is possible that stringent safety checks will be carried out not only in small coal mines but also in large ones with good safety records," he said.

Tunlan coal mine, under the state-owned Shanxi Coking Coal Group, has an annual coal production capacity of five million tons, according to the official Xinhua news agency. The group's major products include high-quality coking coal, a raw material used in steel production.

Shanxi province produces a quarter of China's coal output, which last year totaled 2.62 billion tons.

Xinhua said Beijing has ordered an investigation into the blast, and three officials at the mine have been dismissed.

—Jing Yang

REVIEW & OUTLOOK

Governors v. Congress

Debt-laden state governments were supposed to be the big winners from the $787 billion U.S. economic stimulus bill. But at least five Republican Governors are saying thanks but no thanks to some of the $150 billion of "free" money doled out to states, because it could make their budget headaches much worse down the line. And they're right.

These Governors—Haley Barbour of Mississippi, Bobby Jindal of Louisiana, Butch Otter of Idaho, Rick Perry of Texas and Mark Sanford of South Carolina—all have the same objection: The tens of billions of dollars of aid for health care, welfare and education will disappear in two years and leave states with no way to finance the expanded programs. Mr. Perry sent a letter to President Barack Obama last week warning that Texas may refuse certain stimulus funds. "If this money expands entitlements, we will not accept it. This is exactly how addicts get hooked on drugs," he says.

Consider South Carolina. Its annual budget is roughly $7 billion and the stimulus will send about $2.8 billion to the state over two years. But to spend the hundreds of millions of dollars allocated to the likes of child-care subsidies and special education, the state will have to enroll thousands of new families into the programs. "There's no way politically we're going to be able to push people out of the program in two years when the federal money runs out," Mr. Sanford says.

The Medicaid money for states is also a fiscal time bomb. The stimulus bill temporarily increases the share of state Medicaid bills reimbursed by the federal government by two or three percentage points. High-income states now pay about half the Medicaid costs, and in low-income states the feds pay about 70%. Much of the stimulus money will cover health-care costs for unemployed workers and single workers without kids. But in 2011 almost all the $80 billion of extra federal Medicaid money vanishes. Does Congress really expect states to dump one million people or more from Medicaid at that stage?

The stimulus sets a long-term budget trap for the states.

The alternative, as we've warned, is that Congress will simply extend these transfer payments indefinitely. Pete Stark, David Obey and Nancy Pelosi no doubt intend exactly this, which could triple the stimulus price tag to as much as $3 trillion in additional spending and debt service over 10 years. But the states would still have to pick up their share of this tab for these new entitlements in perpetuity. Thanks, Washington.

Governors are protesting loudest over the $7 billion for unemployment insurance (UI) expansions. Under the law, states will increase UI benefits by $25 a week. The law also encourages states to cover part-time workers for the first time. The UI program is partly paid for by state payroll taxes imposed on employers of between 0.5% and 1% of each worker's pay. Mr. Barbour says that in Mississippi "we will absolutely have to raise our payroll tax on employers to keep benefits running after the federal dollars run out. This will cost our state jobs, so we'd rather not have these dollars in the first place."

The problem for these Governors is that they may be forced to spend the federal money whether they want it or not. Representative James Clyburn of South Carolina slipped a little-noticed provision into the stimulus bill giving state legislatures the power to overrule Governors and spend the money "by means of the adoption of a concurrent resolution." Most state legislatures are versions of Congress; they can't say no to new spending.

These five Governors deserve credit for blowing the whistle on the federal trap that Washington has set for their budgets. They stand in contrast to most of the other Governors, who are praising the stimulus as a way to paper over their fiscal holes through 2010. But money from Congress is never as free as it looks, as the banks can attest. Don't be surprised if two years from now states are still facing mountainous deficits. They will have their Uncle Sam to thank.

Hillary on Human Rights

Before heading to Beijing on Friday, Hillary Clinton told reporters that pressing China on human rights "can't interfere" with cooperation between the U.S. and China on "the global economic crisis, the global climate change crisis and the security crisis." Oh really?

Beijing's bad rights record already interferes with U.S.-China ties. The same nontransparent judicial system that jails dissidents can hurt U.S. businesses and businessmen. Witness the case of Jude Shao, an American who was jailed for 10 years on tax-evasion and fraud charges despite the lack of credible evidence. More than 50 Americans are currently imprisoned in China, many for similar alleged economic crimes.

Or consider the media restrictions that have exacerbated food- and product-safety problems by preventing Chinese reporters from breaking news of safety problems before they spread. The results have been greater fears from U.S. consumers over the safety of imported goods and greater calls for trade barriers from some in Congress. China's stifling of domestic investigative reporters and foreign journalists also makes it hard to tell if or when Beijing is concealing public health problems of global import, like avian influenza, SARS or AIDS.

At best, Mrs. Clinton's comment is a serious rookie mistake. At worst, it's a slap to dissidents in China, including at least 12 who were placed under house arrest during her visit. The new Secretary of State has ceded rhetorical ground to Beijing just as authorities may intensify a crackdown on dissent—this year is the 50th anniversary of the Tibetan uprising, the 20th anniversary of the Tiananmen Massacre and the first anniversary of the Llasa uprising.

Her statement also could mark a troubling change in U.S. policy. Previous Administrations of both parties viewed human rights as an important issue, even if rights weren't always front and center in bilateral talks. First Lady Clinton herself publicly condemned China's one-child policy at a United Nations summit in Beijing in 1995. President George W. Bush met with the Dalai Lama in the White House, and discussed religious freedom with Chinese President Hu Jintao.

Beijing then had no choice but to listen, because those Administrations had consistently said they cared about China's rights record. But Mrs. Clinton's latest pronouncement signals to Beijing that leaders can ignore rights with relative impunity, even as she herself met with activists on this trip. If Mrs. Clinton's comment was a mistake, now's the time to say so. If it is a change in policy, now's the time to reconsider.

The New Sultans of Swat

Last year, Pakistanis in the northern Malakand district voted overwhelmingly for the country's secular parties, including the Pakistan People's Party of President Asif Ali Zardari. Last week, Mr. Zardari repaid the favor by agreeing to the imposition of Shariah law in the area and suspending military operations against an encroaching Taliban.

Pakistan cuts a dangerous deal with the Taliban.

We would call this terrifying, but that may understate matters for the people of the region. For several years, the Taliban and its allies have sought to gain control of the district, particularly its scenic Swat valley, once a popular tourist destination. Gaining control, Taliban-style, meant fighting the Pakistani military to a standstill. It also meant blowing up 180 girls schools and publicly beheading locals who offended them, including barbers who dared trim customer beards.

The deal was struck with longtime insurgent leader Sufi Mohammed, who has been fighting to impose Shariah law for 40 years. Sufi Mohammed is said to be at loggerheads with his even more radical son-in-law, the Taliban-connected Maulana Fazlullah, and the government hopes that the concession of Shariah law could marginalize Fazlullah while the Pakistan Army girds for more fighting in the spring. The Pakistan government portrays the deal as little more than a tactical concession and, according to Information Minister Sherry Rehman, is "in no way a sign of the state's weakness."

Yet no sooner was the deal signed than a Pakistani journalist was murdered while covering a "peace march" organized by Sufi Mohammed—the 20th journalist killed around Swat in two years. Fazlullah has also refused to honor the government's cease-fire beyond a 10-day period that expires later this week. Local residents who reluctantly acquiesced in hopes of gaining peace may soon find themselves living with Shariah, without peace.

This cease-fire smacks of a similar deal the previous government of Pervez Musharraf arranged in Pakistan's tribal areas in 2006. That deal created a Taliban sanctuary and led to sharp increases in terrorist attacks, both in Afghanistan and the Pakistan heartland. Sufi Mohammed has signed three previous pacts with various Pakistani governments extending the writ of Islamic law. Each invited the next round of violent demands.

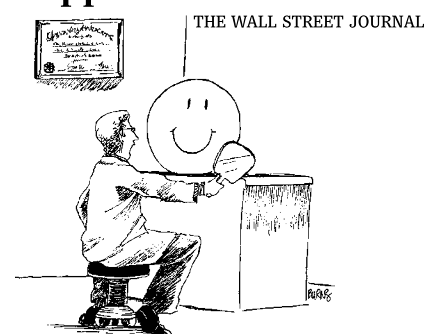
"Now that the Taliban have pressured the Frontier's provincial government and Islamabad into acquiescence in one part of the country, what is to stop them from replicating their designs elsewhere?" asks Murtaza Razvi, an editor with the Dawn newspaper. Good question. It doesn't induce confidence that the government capitulated even when it was fielding 10,000 troops against a Taliban force estimated at 2,000. If Pakistan's military can't defeat a militia 100 miles from Islamabad, its reputation as the country's one competent institution and guarantor of security will fast evaporate.

Mr. Zardari's government has heretofore shown a willingness to fight the Taliban and has taken an openly pro-U.S. line since gaining power last year. It has also allowed the CIA's Predator strikes, which have reportedly killed 11 top al Qaeda leaders. Pakistanis have also consistently repudiated Islamists at the ballot box.

This makes it all the more crucial that Mr. Zardari not squander this public support by backing down against Islamist terrorism. The longer the Swat cease-fire lasts, the more likely the region will become another safe haven for extremists inside Pakistan—and an existential threat to Mr. Zardari's government and moderate Pakistani Muslims.

Pepper . . . and Salt

THE WALL STREET JOURNAL



"I think you're a wonderful candidate for cosmetic surgery. I'd like to see some definition to your cheeks, maybe a nose . . ."

State of the Union / *By Simon Tilford*

How to Avoid a Euro-Zone Debt Crisis

Twelve months ago it seemed inconceivable that any European Union member could face a sovereign debt crisis. It would have been the stuff of fantasy to argue that Ireland or Austria could be among those at risk. Yet such an outcome is now within the realm of possibility. And if one country suffered a crisis, it would almost certainly trigger a wave of crises, plunging the EU, and especially the euro zone, into turmoil.

There is nothing inevitable about this. But a way out requires Germany to show more vision.

Some euro-zone members—Italy and Spain—are vulnerable because they have lost competitiveness over the years and investors are skeptical that they will be able to regain it. Others—Austria and Belgium—have disproportionately large banking sectors and/or banks with huge exposures to crisis-hit regions such as Eastern Europe. Ireland and Greece have lost competitiveness and have very exposed banking sectors.

One way forward might be for governments to collectively issue euro-zone bonds, rather than their own national bonds. This would help address the problem of poor liquidity that has bedevilled many of the smaller euro-zone financial markets. And it would reduce borrowing costs for most euro-zone countries.

There are, however, obstacles. German borrowing costs would rise, as it shared its fiscal credibility with the rest of the euro zone. It might be hard for Berlin to convince taxpayers that they should help pay for other countries' mistakes.

Also, such a move would arguably let profligate countries off the hook. It might then be difficult to ensure budgetary discipline in the fiscally weaker countries. The issuance of euro-zone bonds would require a far greater degree of political integration in the euro zone in order to curb the budgetary autonomy of member states.

These concerns highlight what many economists have always believed to be the inherent contradiction in economic and monetary union: the absence of a political union. However, the German government's objection to the pooling of bond issuance—that it would cost Germany too much money—is parochial. The alternative, failing to help its neighbors, would be much more costly for Germany and Europe.

> Euro zone bonds would be in Germany's interests.

Berlin is slowly realizing this. German Finance Minister Peer Steinbrück last week indicated that there may be a case to support hard-hit members of the euro zone. But he is mistaken if he thinks a fiscal crisis in one member state would be a cleansing experience, with the chastened country receiving a highly conditional, IMF-type bailout, and the others learning the lesson of their errant ways. Moreover, pre-emption is a better strategy than dealing with a crisis once it occurs.

First, one sovereign crisis would almost certainly lead to others as investors rapidly turned their attention to the next weakest link. There will be no shortage of euro-zone economies experiencing severe fiscal pressures.The direct costs of a bailout could be surmountable in the case of Ireland or Greece, but would pose a much bigger challenge in the case of larger member states, such as Spain or Italy.

Second, there would be indirect costs from a fiscal crisis in neighboring countries to the German economy, which depends on exports to the rest of the euro zone. The last thing Berlin needs is a further collapse in external demand.

David Klein

Third, there is a worst-case scenario. If Italy or Spain were to default on its sovereign debt—perhaps as a result of the rest of the euro zone's failing to agree on a bailout or attaching excessively onerous terms to one—the repercussions for the euro zone could be dramatic and could well lead to its breakup.

For large, inflexible economies, it is far from clear that default within the currency union is more plausible than a default and a move to leave it. A member state could decide that having defaulted—and thus having cut itself off, at least temporarily, from most sources of capital—it may as well exit the euro zone and devalue. This would at least help to restore competitiveness and get the economy growing again, while in the longer term importing inflation of course. If one country were to leave, pressure on others to follow suit would be intense.

Germany can't afford to be sanguine about such an outcome. German companies have spent years holding down costs. The result has been improved competitiveness versus the rest of the euro zone, but at the expense of weak domestic demand. If the euro zone were to unravel, Germany would experience a huge real appreciation, reversing almost overnight the competitiveness gains it has painfully ground out.

A move to issue euro-zone bonds may help prevent such a worst-case scenario. And it would not mean Germany sacrificing its own interests for the good of Europe. A country as export-dependent and politically reliant on the EU as Germany is cannot afford to be blasé about economic crises in neighboring countries.

Germany is going to have to show solidarity one way or another, so it should do so in a way that imposes the fewest costs on itself and maximizes its political capital.

Mr. Tilford is chief economist at the Center for European Reform.

How California Became France

By Matthew Kaminski

SACRAMENTO, Calif.—As California goes, says an old cliché, so goes America. Oh my.

These days, the Golden State leads America on economic and fiscal dysfunction, from the empty homes spread across the Central Valley to the highest state budget shortfall in U.S. history. Meanwhile, its political class pioneers denial in the face of catastrophe.

The spark for the immediate political crisis was a familiar Californian discovery, a fiscal hole of $41 billion. Gov. Arnold Schwarzenegger declared an "emergency" in November and took legislative leaders behind closed doors to hammer out a compromise. The budget adopted in a marathon session last week splits the baby, closing the deficit with spending cuts (hated by the left) and tax hikes (ditto the right), all the while largely failing to tackle the state's built-in structural defects.

Some parts of the deal, such as borrowing from future lottery receipts, may yet collapse at the ballot in May, and California could soon be back in line to mark another first—state bankruptcy. In anticipation, Standard & Poor's this month downgraded its bond rating a notch below Louisiana's.

Even discounting for the impact of global recession, the most populous state's ills are unique and self-inflicted—and avoidable. In the last three decades, California expanded the public sector and regulation to Europe-like dimensions. Schools, state employees, health care, even dog kennels, benefited from largesse in flush times. Government workers got 16 official holidays, everyone else six. The state dabbled with universal health care and adopted strict environmental standards. In short, California went where the new U.S. president and Nancy Pelosi of San Francisco want America to go.

> Unable to afford a welfare state and unable to reform it.

Now there's much to recommend the Old World. California brings to mind my last home, France—blessed with fertile soil for wines, sunblanched beaches, and a well-educated populace. Amusingly, both states are led by blingbling immigrants married to glamorous women and elected to shake up the status quo. In both departments, the governator got a head start on Nicolas Sarkozy in Paris.

The parallels are also disquieting. The French have long experienced the unintended consequences of a large public sector. Ask them about it. As the number of people who get money from government grows, so does the power of constituencies dedicated to keep this honey dripping. Even when voters recognize the model carries drawbacks, such as subpar growth, high taxes, an uncompetitive business climate and above-average unemployment, their elected leaders find it near impossible to tweak the system. This has been the story of France for decades, and lately of California.

Six years ago, Mr. Schwarzenegger arrived in Sacramento to "cut up the credit card" and give the girlie men at the State Capitol a testosterone shot. California languished then in a fiscal crisis whose causes were pretty much the same as today. The hapless Gray Davis had been recalled, and the Austrian-born actor made a promising start to break the pattern.

In 2005, the governor pushed an ambitious ballot initiative to impose a hard state spending cap, limit the unions' political buying power, tighten requirements for teacher tenure, and overhaul a gerrymandered state political map. Arnold lost.

After that setback, Mr. Schwarzenegger shifted his attention to green jobs and energy, winning fans in Europe and among Democrats. "He's recognized that California's a pretty moderate place," says Darrell Steinberg, the Democratic president pro tem of the Senate. "You've got to govern from the middle."

People closer to the governor offer a different take. "Once he got beat, he reverted back to, 'I want to be liked,'" says a former Schwarzenegger aide. "It's classic narcissism." (The governor declined requests for an interview, but I did walk away with three custom-made Daniel Marshall cigars from his office.)

In the Arnold era, the overall cost base has stayed the same as in the Davis era. That isn't entirely his fault. California's constitution locks in higher spending in good years, paving the way for huge deficits in the down. A dependence on a highly progressive tax code leaves it particularly vulnerable to boom and bust cycles. Democrats run the legislature. Across the street from the Capitol, the offices of unions and lobbyists are arguably the real locus of power in Sacramento.

In this budget debacle, Mr. Schwarzenegger found himself back where his remarkable political journey began in 2003. Only now with him in the Davis role. The pill is bitterer still since the budget he signed Friday will raise the vehicle tax—the same Davis tax increase he campaigned against and terminated in his first act in office.

Neither side won with this deal, to which the one good alternative would be a time machine to take Sacramento's political class back five years and do it right then. In the event, Republicans split, and signed off on $12.8 billion in new taxes and a less than airtight spending cap. State personnel reductions are minimal, further infuriating their base. The Democrats swallowed $15 billion in spending cuts, which unions vow to fight.

California is in a French-like bind: unable to afford a welfare-type state, and unable to overhaul it. "The people say they want all these programs, then there's nothing they want to pay for," says Hector De La Torre, a Democratic assemblyman. "The schizophrenia in the legislature reflects the peoples'."

Last week's deal likely won't keep the state in balance beyond 18 months, perhaps even fewer. "This budget will take us through 2010," says Karen Bass, the Assembly speaker, a Democrat from Los Angeles. "I don't know if it will hold."

Some Democrats and Republicans privately say the best option may be failure. The rough scenario is fiscal insolvency, followed perhaps by federal receivership. No precedent or legal avenue exists for a state to reorganize its affairs under a form of Chapter 11 protection, but that striking suggestion sounds better by the day.

The expectations for Mr. Schwarzenegger's two remaining years in office are low, leaving many of his supporters to ponder the might-have-been. "No one has the political incentives to cut government," says a Republican strategist. "It takes tremendous political capital, which Arnold had. It's a tragedy to have this rare moment when you can try to change and waste it."

For America, California is the what-might-be.

Mr. Kaminski is a member of the Journal's editorial board.

THE WALL STREET JOURNAL.
EUROPE
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