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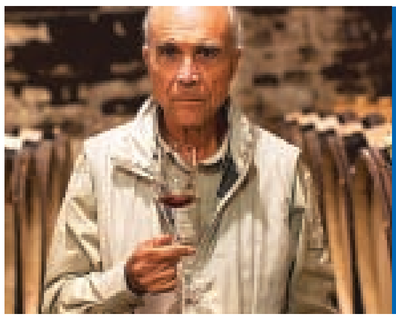

WEEKEND JOURNAL.

Inside the world of Romanée-Conti

PLUS: TINA GAUDOIN ON THE ART OF WEARING BLACK


# THE WALL STREET JOURNAL.

VOL. XXVIII NO. 171 — EUROPE — Friday - Sunday, October 1 - 3, 2010

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£1.50 Bahrain BD 1.50 - Egypt $1.75 (C/V) Jordan JD 2 - Kuwait KD 1 - Oman OR 2 Qatar QR14 - Saudi Arabia SR 14


# Ireland seeks to shore up ailing banks

By Neil Shah And Quentin Fottrell

DUBLIN—Ireland on Thursday scrambled to draw a line under its financial crisis—and convince investors it won't need an emergency bailout by the European Union—by promising to pump billions more into its hardest-hit lenders.

The move, coming after efforts two years ago to rescue the troubled banks, underscores the country's new and unwanted status as the next hot spot in Europe's continuing financial turmoil. The government said on Thursday that the total cost of fixing its banks, battered by the aftermath of an epic housing bust, could now total as much as €50 billion ($68 billion)—or about a third of the country's economic output last year. As a result of its bank rescues, Ireland's budget deficit will rise to 32% of its economic output this year, roughly 10 times the EU limit and the biggest in the euro-zone's 11-year history.

Ireland is betting it can show that it has fully absorbed the pain of its banks' problems and that the worst is over. But more trouble may loom ahead, as the government, which has already mounted one of the toughest budget-cutting programs in Europe, will now likely make even deeper cuts in its new budget this November.

If the new cuts further stifle the economy, concern will build that Ireland—like Greece before it—will one day need to seek financial assistance from the EU. Similar fears are building in Spain and Portugal, where there is also mounting concern about government debt.

Most European officials and analysts say that for now it remains unlikely that Ireland will need assistance, as Ireland has financed its budget until next summer and has roughly €20 billion of reserves. But the prospect of deeper cuts and further economic uncertainty inevitably means the question will be raised regularly in coming months.

Ireland's central bank said the final bill for bailing out **Anglo Irish Bank** Corp., the country's weakest bank, could climb as high as €34 billion—meaning it could need €11 billion more over time to meet regulatory requirements. The Irish government also prepared to take effective control of its second-biggest

*Please turn to page 5*

## Tiger on the Ryder Cup trail

Associated Press

Tiger Woods signs autographs for golf fans Thursday during the U.S. team's final practice on the eve of the Ryder Cup against Europe at the Celtic Manor course in Wales. The players expected a tough weekend with strong winds and rain forecast. **Article on Page 28 and updates at WSJ.com/Sport.**

# AIG reaches a deal to speed exit by U.S.

**American International Group** Inc. and its U.S. government overseers announced they have agreed in principle on a plan that would speed up repayment of the giant insurer's debt to taxpayers and pave the way for the U.S. to end its ownership of the bailed-out company.

As part of the plan, the Treasury Department would convert $49.1 billion of preferred shares it holds in AIG into common shares, increasing the government's ownership stake in the company to 92.1% from 79.8% currently. The conversion would position the government to sell off its stake in AIG over time.

Before the conversion of the Treasury's shares can occur, AIG would have to repay a $20 billion secured credit facility from the Federal Reserve Bank of New York in full.

About $5 billion of AIG shares are held by private investors, who would be given as many as 75 million warrants that let them benefit from gains in the stock alongside the government.

AIG Chief Executive Robert Benmosche said he hopes to complete a $2.5 billion equity offering and a small debt sale by March to test investor confidence in its plan.


■ AIG's Benmosche says deal simplifies U.S. support ........ 9

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# North Korea offers a glimpse of Kim son, likely new leader

A North Korean newspaper on Thursday published a front-page photo of Kim Jong Eun, the son and heir apparent of dictator Kim Jong Il, in what is believed to be the first public photo of the young man as an adult.

Previous photos of him were more than a decade old, from his childhood in Pyongyang or teenage years as a student at a school in Switzerland.

South Korean media rushed to compare the image of Kim Jong Eun to old photos of his father, Kim Jong Il, and grandfather Kim Il Sung, the founder of North Korea and its leader for four decades.

Not much is known about Kim Jong Eun. Even his precise age remains a mystery—he is believed to have been born in 1983 or 1984.

Agence France-Presse/Getty Images

Kim Jong Eun

Earlier this week, Kim Jong Il announced Kim Jong Eun's appointment as a four-star general in the Korean People's Army and to the military commission of the Workers' Party, moves marking the first public acknowledgment that the Kim family will attempt another generational transition of power in North Korea.

The new image was transmitted by the state news agency and available internationally. Because it shows a group of dozens of people and its resolution isn't high, tightening the photo on the younger Mr. Kim results in a poor image.

■ Full article, plus another photo of the heir apparent 11

## PAGE TWO

# This looks like a rather damp squib

**[ Agenda ]**

By Simon Nixon

What are the chances the U.K.'s Independent Commission on Banking (ICB) will prove genuinely radical and successfully bring about the breakup of U.K. banks, whether on financial stability or competition grounds? Surely, close to zero. The ICB has always looked like an attempt to kick a tricky political problem into the long grass, while the serious business of banking reform was resolved internationally.

The five commissioners—Sir John Vickers, Martin Taylor, Clare Spottiswoode, Bill Winters and Martin Wolf—all have reputations for analytical rigor and independent thinking. No doubt they have been told to think the unthinkable and have received clear assurances their proposals will be seriously considered. But it's hard to see it being anything but a damp squib.

There are no right or wrong answers to the questions they are asking. The options they have identified are well-known and have been widely discussed in the U.K. and globally for at least two years. The choice is entirely a political one. It's possible to design a fail-safe banking system, but the costs to the economy would be ruinous. The issue is how much risk a society is willing to accept by agreeing to underwrite the risk of bank failures relative to the likely rewards in terms of a lower cost of capital. Fomer **Barclays** boss Martin Taylor has noted that, with hindsight, the U.K. might have accepted a higher precrisis cost of capital—and therefore lower precrisis growth—to mitigate the impact of the recession. But unless the ICB can show convincingly that its proposals will provide a positive net present value for the U.K., it won't be taken seriously.

Bloomberg News

Chairman John Vickers with other members of the Independent Commission of Banking in London last week.

To build a case for radical reform, the ICB needs to base its case on quantitative evidence. It needs to show what impact its proposals would have on the cost of capital to the U.K. economy. And it needs to balance this against its judgment of the probability of a future banking crisis occurring, the likely cost of that crisis, and the appropriate discount rate to calculate the net present value of those costs. All of these calculations are problematic—but it's the last that may prove most tricky.

**There are no right or wrong answers to the questions the commission members are asking.**

Breaking up banks, whether on financial stability or competition grounds, is likely to reduce economies of scale and unpick synergies, potentially leading to higher lending costs and fees. In a global market, anything that pushes up the U.K. cost of capital significantly above other industrialized countries would have negative consequences for the U.K. without necessarily insulating Britain from the effects of banking excesses and bursting bubbles elsewhere in the world. It was for this reason the BOE, in common with other central banks, declined to put up the cost of capital to prick the credit bubble during the boom. Doing so now that the economy is just starting to recover from the deepest recession for 70 years and when credit costs are already high is a harder case to argue. The risk that the City loses competitiveness adds another layer of costs.

In a provocative paper that the commission should adopt as its founding text, Bank of England director Andrew Haldane this year offered some preliminary quantitative arguments for breaking up the banks. While acknowledging the U.K. government may yet make a profit on its bank rescues, he argued the true cost of the crisis lay in the 10% fall in GDP. What's more, he argued, some of this lost output is likely to prove permanent, perhaps somewhere between 25% and 100%. Assuming a trend rate of growth of 3% and a discount rate of 5%, he calculated the cost of the crisis to the U.K. to be between £1.8 trillion ($2.8 trillion) and £7.4 trillion, or between 90% and 130% of 2009 GDP.

Startling stuff. But there are obvious problems with Mr. Haldane's analysis. In his calculation of the costs of the crisis, he doesn't quantify the boost to GDP in the boom years as a result of easy credit conditions and a lower cost of capital. Some of the lost output would never have occurred if not for the boom. Nor does he make any allowance for the current global banking reform initiatives, including global capital and liquidity rules, new central counterparty clearing arrangements, harmonized accounting rules, new governance and remuneration policies, and improved standards of regulatory and investor supervision. These must have lowered both the cost and probability of a repeat of the current crisis.

But the commission's biggest problem in making the case for further reform is likely to lie in the discount rate. When Sir Nicholas Stern was trying to argue for radical action on climate change in 2006, his recommendation that the U.K. spend 1% of GDP now to prevent a 20% fall in GDP in the future was ridiculed because he used a discount rate of just 1%, so that future climate change costs were effectively calculated in today's money.

His decision may have been intellectually defensible, but it took no account of the way ordinary people—and more importantly politicians—think about risks that might occur in the distant future.

Mr. Haldane uses a 5% discount rate, as he says, for no particular reason. But the commission will need to use a much higher number if it is to convince politicians with little interest in risks beyond the lifetime of one or two parliaments to act.

The clue, inevitably, is in the Banking Commission's terms of reference, which require it to have regard for bank lending and the pace of economic recovery, competitiveness in financial services and the wider economy, and risks to the government's fiscal position. The U.K. banks will of course want to be seen to be taking the commission seriously and the commissioners themselves will no doubt enjoy a highly stimulating year at public expense philosophizing over the options. But when the commission sits down to do a detailed cost-benefit analysis, it's hard to believe the banks have anything to fear.

## What's News

■ **Moody's cut** Spain's credit rating one notch to Aa1, citing the country's weak growth prospects and the challenge this presents for fiscal consolidation. The ratings agency expects Spain's economy to grow only about 1% annually on average over the next few years **4**

■ **Abu Dhabi's Etisalat** offered to buy 46% of Kuwait-based Zain in a telecom deal that would be one of the Middle East's biggest transactions in recent years. **18**

■ **BP chief Robert Dudley** expressed confidence the company can resume paying its dividend next year. **17**

■ **Dozens were charged** in an alleged global scheme to use computer viruses to steal at least $3 million from U.S. bank accounts. **17**

■ **A coalition airstrike** killed three Pakistani border guards and led Islamabad to close a key NATO supply route to Afghanistan. **10**

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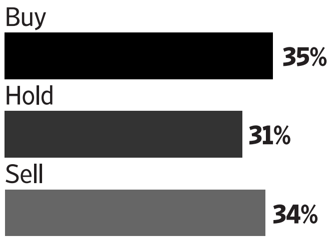



THE WALL STREET JOURNAL EUROPE
(ISSN 0921-99)
Commodity Quay, East Smithfield,
London, E1W 1AZ

**SUBSCRIPTIONS, inquiries and address changes to:** Telephone: +44 (0) 20 3426 1234. Calling time from 8 a.m. to 5 p.m. GMT. E-mail: subs.wsje@dowjones.com. Website: www.services.wsje.com

**ADVERTISING SALES** worldwide through Dow Jones International. Frankfurt: 49 69 29725 390; London: 44 203 426 1111; Paris: 331 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 Baslnevi.

Registered as a newspaper at the Post Office.



Editeur responsable: Patience Wheatcroft M-17936-2003.

Registered address: Boulevard Brand Whitlock, 87, 1200 Brussels, Belgium

NEWS

# Cyclist blames meat for positive drug test

BY PABLO DOMÍNGUEZ

MADRID—Three-time Tour de France champion Alberto Contador blamed contaminated meat for a failed drug test during his 2010 victory.

"It's a case of food contamination in which I'm the victim," Mr. Contador said at a news conference in his hometown of Pinto, near Madrid. He said the International Cycling Union, the sport's governing body, "understands it perfectly."

If he is found guilty of doping, Mr. Contador could lose his Tour title and face a two-year ban from cycling.

In a statement Thursday, the UCI said Mr. Contador tested positive for the asthma drug clenbuterol, a banned stmulant, during a urine-doping control test conducted on July 21—the second rest day of the Tour de France—and that the rider has been suspended.

The UCI said the case required further scientific investigation before any conclusion could be drawn. The body didn't comment on Mr. Contador's claim that this could be a case of food contamination, but said the concentration of clenbuterol was well below the level that antidoping laboratories accredited by the World Anti-Doping Agency must be able to detect.

Clenbuterol, which is sometimes given to cattle to increase their growth rate, has been a popular drug for cyclists because it acts like a stimulant, opens the lungs and enhances breathing and promotes lean-muscle recovery.

**Mr. Contador would be the first Tour de France winner to be stripped of his title for doping since 2006, when Floyd Landis tested positive for synthetic testosterone.**

Mr. Contador said he believes the drug must have come from meat that was bought for the team at a shop in Spain by José Luis López Cerrón, a Spanish cycling organizer.

Mr. Contador, who also won the Tour de France in 2007 and 2009, said he was notified of the test on Aug. 24 and immediately met with UCI officials.

To aid in his defense, Mr. Contador hired Dutch expert Douwe de Boer, a biochemist at the Academic Hospital of Maastricht, to write a report that traced the test results to meat consumption.

The report said it "would be only fair" to regard this as the result of "an accidental intake of low amounts of clenbuterol by meat consumption."

Frank Uryasz, the president of the National Center for Drug Free Sport in Kansas City, Mo., said athletes often claim that positive tests are the result of tainted supplements or food contamination. "Even a low amount detected doesn't rule out the possibility that an athlete used a substance."

If Mr. Contador is sanctioned by Spanish antidoping officials, who will determine his punishment, he would be the first Tour de France winner to be stripped of his title for doping since 2006, when American Floyd Landis tested positive for synthetic testosterone.

Andy Schleck of Luxembourg, who lost to Mr. Contador by 39 seconds in this year's Tour, said on Twitter on Thursday that "I hope he's innocent."

Blandine Roquelet, the team's spokeswoman, said Mr. Contador's Astana cycling team didn't learn of the positive test until early Thursday morning. Jacinto Vidarte, Mr. Contador's spokesman, said on Thursday that the UCI asked the rider to maintain confidentiality and not even notify his cycling team. Mr. Contador said the UCI didn't disclose the test result because it is regarded as food contamination.

Under the code of the World Anti-Doping Agency, athletes' biological samples are divided in two. If the first sample tests positive, an athlete has the right to observe the testing of the second one before a test can be officially declared positive.

*—Reed Albergotti and Vanessa O'Connell in New York contributed to this article.*

Reuters

Tour de France champion Alberto Contador at Thursday's news conference.


Reuters

People protest Wednesday in Madrid during a nationwide general strike, called to oppose government spending cuts that ratings agencies say are necessary.

# Moody's cuts Spain's rating

By Christopher Bjork
And Clare Connaghan

MADRID—Moody's Investors Service Inc. downgraded Spain's credit rating by one notch to Aa1, citing the country's weak growth prospects and the challenge this presents for improving its financial situation.

The ratings company said it expects the Spanish economy to grow only by about 1% annually on average over the next few years, while growth rates in the rest of the Europe are likely to be higher.

"What differentiates Spain [from the rest of Europe] is that the crisis has exposed specific sectors—construction, real estate. We do think the rebalancing of [the] economy is under way, but it will take a number of years to regain more dynamic growth," said Kathrin Muehlbronner, Moody's lead analyst for Spain.

The downgrade came as the government of Prime Minister José Luis Rodríguez Zapatero presented Parliament with its 2011 budget proposal, which calls for a 7.9% reduction in overall spending as well as tax increases on the wealthy. The government plans to issue €43.3 billion ($59.02 billion) of net debt next year to help finance the budget, down from €76.8 billion in 2010.

Moody's decision didn't come as a surprise. The only major credit-rating firm to keep its rating on Spain at the top triple-A level, Moody's had warned in June of a possible one- or two-notch downgrade. Thursday's move follows a one-notch cut by Fitch Ratings to double-A-plus in May. In April, Standard & Poor's Corp. cut the country to double-A.

Deputy Finance Minister José Manuel Campa said the Spanish government remains committed to pushing through reforms and to reining in the state's budget deficit.

"Spain's credibility over its public accounts and solvency isn't in doubt," Mr. Campa said in a telephone interview shortly after the downgrade was made public. He added that an Aa1 rating still represents "solid asset quality and very low credit risk."

The market took the downgrade calmly. The spread between Spain's 10-year bond yield and that of the German bund tightened, and the stock market was marginally lower. Stocks had dropped and bond spreads widened earlier this week in anticipation of a downgrade.

"Moody's has drawn a line under the downgrades, and good budget figures this week show the fiscal tightening remains on track," said Crédit Agricole strategist Peter Chatwell. He said he expects Spanish debt to outperform both German bunds and high-yielding bonds from other issuers along the periphery of the euro zone.

Moody's said raising Spain's low productivity levels and improving international competitiveness will be among its biggest challenges. Recent labor-market changes are a step in the right direction, it said, but "dismissal costs will remain above the European Union average and wage flexibility more limited than in many triple-A-rated peers."

Spain is suffering from the collapse of a decadelong housing-market boom that pushed its economy into recession and sent its public-sector accounts deep into the red. Its weak budgetary position left it vulnerable to the spread of Europe's financial crisis. Earlier this year, Spain's risk premium, measured by the yield spread on Spanish bonds over bunds, soared to its highest level since the creation of the euro.

Responding to intense pressure from markets and the European Union, Mr. Zapatero has stepped up efforts to cut Spain's double-digit budget deficit and spur economic growth. At great political cost, the Socialist prime minister forced through an austerity budget in May that included cuts totaling €15 billion this year and next.

"The government's determination to reduce its very large fiscal deficit in the near term is an important factor in Moody's decision to limit the downgrade to just one rating notch and to assign a stable outlook," said Ms. Muehlbronner.

Despite the government's austerity measures, Moody's expects Spain's budget deficits to be reduced at a slower pace than envisaged by the government over the medium term. It only expects the public debt ratio to stabilize in 2014, at around 80% of gross domestic product.

The government's efforts to rein in spending have shielded Spain somewhat from renewed turmoil that has sent risk premiums for Portugal and Ireland soaring. Spanish data Monday showed that the central government budget deficit narrowed 42% in the eight months to August, thanks to a 14% rise in tax revenue and 4.6% fall in spending.

# France moves to toughen law on immigration

*Associated Press*

PARIS—French lawmakers adopted Thursday an amendment to a bill toughening immigration law that would strip naturalized citizens of their nationality if they are convicted of murdering a police officer—a measure critics say creates a category of second-class French.

The conservative government's amendment was passed 75-57 with one abstention in a chamber that was more than half empty. It would strip citizenship from people naturalized less than 10 years ago if they're convicted of murdering police or other authorities.

President Nicolas Sarkozy, who introduced the idea in a speech in July, says French nationality "should be earned." However, rival leftist lawmakers contended he was pandering to the far-right National Front party to pump up his lagging poll ratings before the 2012 presidential elections.

Lawmakers opened debate Tuesday on a series of government amendments tacked onto a bill to toughen immigration law—much of which translates into French law, as required, an EU immigration pact. But the amendments are particular to France.

The full bill goes to a vote Oct. 12 before heading to the Senate. However, it was likely that opponents of the measure would put the case before the **Constitutional Council**.

Lawmaker after lawmaker on the left denounced the amendment as unconstitutional—and un-French.

"This measure is politically unacceptable in the land of human rights, in our republic that espouses equality as an essential value," said Jean-Pierre Dufau. He denounced it as a "cynical" operation to "actively court voters of the National Front," a far-right party.

# IMF warns about risks of cutting deficits

By Ian Talley

WASHINGTON—The International Monetary Fund warned that reducing budget deficits, as it has urged many nations to do, is likely to cut growth and raise unemployment, at least in the short term.

The IMF analysis was conducted partly as a response to economists who argue that fiscal consolidation can boost growth. But the IMF work may be seized on by protestors in Europe who have been trying to convince governments to end the slashing of social programs and other benefits.

"We shouldn't kid ourselves, in the short term, tax hikes and spending cuts are going to probably reduce growth and raise the unemployment rate," said Daniel Leigh, a principal author of a World Economic Outlook chapter on the subject.

The IMF said consolidation equal to 1% of gross domestic product typically reduces growth by 0.5%, raises the unemployment rate 0.3 percentage point and sees consumption and investment fall by 1%.

But over the long run—after five years—the IMF said that budget cutting is an economic plus as lower public debt levels reduce interest rates and stimulate private investment. For every 10-percentage-point fall in debt-to-GDP ratios, output rises by around 1.4% in the long term, the IMF said.

Across Europe, from Ireland to Portugal, questions have been raised about the timeliness of austerity measures as countries experience weak growth and high joblessness.

Mr. Leigh said that with central-bank interest rates near zero in many wealthy countries the economic costs are likely to be greater than in previous crises. That is because the central banks can't reduce interest rates further in response to smaller deficits as they have in the past. Compounding the economic toll is that many nations in Western Europe, along with the U.S., are all looking to cut deficits at the same time, reducing demand widely.

The combination of extraordinarily low interest rates and widespread budget cutting "could more than double the costs that we've seen in the past in the short term," Mr. Leigh said.

The IMF said that reducing costs through spending cuts was less harmful to economic growth than raising taxes. Among the possibilities suggested by the IMF: linking the retirement age to life expectancy and making entitlement programs more efficient.

Alberto Alesina, the Harvard University economics professor whom the IMF quotes saying budget tightening can produce growth, said the fund mischaracterized his work.

"On the two critical things—that the spending cuts are better than tax increases and that fiscal adjustment sometimes leads to growth—we are in agreement," Mr. Alesina said. Mr. Alesina asserts, in a paper with Bank of America senior economist Silvia Ardagna, that there are cases in which using spending cuts to reduce deficits can aid growth.

EUROPE NEWS

# Germany's jobless rate eases

By Nina Koeppen

NUREMBERG, Germany—German unemployment decreased sharply in September, and the total jobless number is expected to fall below the politically sensitive three million in October, underscoring the country's strong economic recovery over the summer months.

The Federal Labor Office said Thursday the number of people out of work fell for the 15th straight month in September, dropping by 40,000 when adjusted for seasonal swings. The adjusted jobless rate fell to 7.5% from 7.6% in August.

The good performance contrasts starkly with other euro-zone states, where unemployment rose markedly during the crisis and isn't expected to fall, because of sluggish economic growth and a dire fiscal outlook.

The German economy is booming, with gross domestic product expected to grow well over 3% this year. Italy, by comparison, will hardly muster 1% growth and the Spanish economy is widely forecast to contract this year and next.

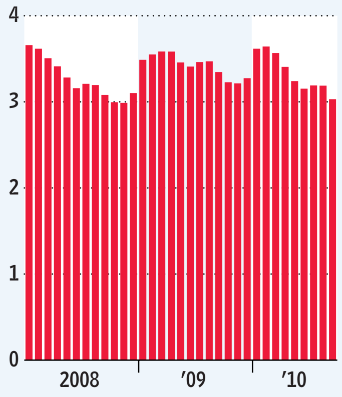
Moody's Investors Service Inc. on Thursday downgraded Spain's credit rating by one notch to Aa1, citing the country's weak growth prospects and a challenging outlook.

"Good economic activity is having a positive effect on the German labor market," said Frank-Jürgen Weise, the head of the country's labor office, citing "strong corporate demand for workers."

German car maker **Daimler** AG has hired new workers, partly by giving temporary hires permanent jobs, citing strong demand for its A-Class and B-Class models. It also plans to take on more than 500 entry-level employees this year, mostly engineers and computer specialists.

**Strong recovery**

Number of unemployed Germans, in millions




Source: Bundesagentur für Arbeit
Photo: Agence France-Presse/Getty Images

Torsten Mansfeld, a jobless linguist, retrained as a teacher as part of a state program.

The German data were much better than expected. Economists polled by Dow Jones Newswires had expected a drop of 20,000 and an adjusted jobless rate of 7.6% for September.

Germany's labor market also looks stellar compared with the euro zone as a whole, where the average jobless rate is 10%, with large national differences. Spain's jobless rates runs at over 20%, and unemployment is especially high among young people. Latest data from the European Union's statistics agency Eurostat showed that 41.5% of Spaniards under 25 are without a job.

"The German labor market has defied many skeptics, and it is hard to find reasons why the current trend on the labor market should not continue," said Carsten Brzeski, an economist at ING Bank in Brussels. "Even the reduction of the short-time work schemes does not affect the positive trend."

A total of 3.031 million people were unemployed in Germany in September, and Mr. Weise predicted the number would drop below the three million mark by November.

Separately, the European Commission's statistics agency Eurostat said that weak growth prospects for large parts of the euro zone, coupled with a sluggish labor market outlook, are expected to keep inflation moderate.

The annual rate of inflation across the 16 countries that use the euro accelerated to 1.8% in September from 1.6% in August. Eurostat didn't provide an explanation for the move, but figures from Germany indicate that higher food and energy prices were behind the pickup in the annual inflation rate.

# House prices hold steady in the U.K.

By Ilona Billington

LONDON—U.K. house prices were little changed in September from a month earlier, but the three-month measure fell for the first time since May 2009 as fewer buyers entered the housing market amid fears over future jobs and earnings, the Nationwide Building Society said.

According to the mortgage lender, house prices rose a seasonally adjusted 0.1% from August and were 3.1% higher compared with September 2009. The latter figure represented the fifth consecutive slowdown in the rate of price growth and was the lowest annual increase since November 2009.

In August, Nationwide said house prices fell a revised 0.8% monthly and rose 3.9% annually. Nationwide previously had reported that house prices fell 0.9% in August from the previous month. The data for September were stronger than expected, with economists estimating that prices fell 0.3% on the month and rose 2.5% from a year earlier.

"September proved to be an uneventful month for house prices," said Martin Gahbauer, Nationwide's chief economist. "Where house prices go next will depend on whether the strong flow of new property onto the market continues into the autumn and on the extent to which existing sellers are willing to compromise on their asking price in order to make a quicker sale."

# *Ireland's bank bailout sends deficit soaring*

*Continued from first page*

bank, **Allied Irish Banks** PLC, after the central bank said it requires an additional €3 billion before next year.

Investors and economists took some relief from Thursday's measures. Irish shares finished the day higher, while the cost to insure the country's bonds against default dropped slightly. Irish bond prices rallied, lowering the country's cost of borrowing a little.

Ireland's small, fragile economy is suffering from a property bust that has crippled its banks, which lent freely to developers who now can't repay their debts. While the government has undertaken several operations to fix its banks, its losses have proved far worse than what officials expected when they guaranteed nearly the entire banking system's liabilities two years ago.

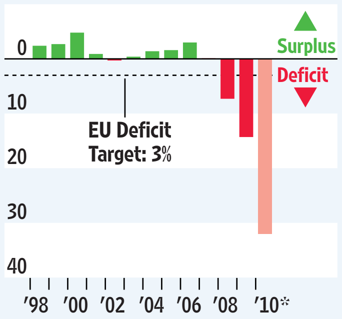
Ireland isn't alone. Investors are also nervous about Portugal, fearing that political wrangling there could prevent the country from cutting its own debts. On Thursday, ratings company Moody's Investors Service downgraded Spain's top-notch triple-A rating to Aa1, citing its weak growth prospects and deteriorating finances.

Ireland's lingering woes offer a cautionary tale of how difficult it will be for Europe's weaker economies to cut their debts while coping with economic stagnation and high unemployment.

Irish officials face a tough balancing act in the months ahead. Concerns about Ireland's debt problems have grown, prompting its finance minister Brian Lenihan to reiterate his pledge to bring the country's deficit back to the EU's limit of 3% of gross domestic product by 2014.

**Deeper in debt**

Ireland's budget deficit as a percentage of GDP




*Ireland's Department of Finance estimate
Sources: Eurostat

But paying down Ireland's debt will require Mr. Lenihan to unveil more measures to curb spending and raise taxes after inflicting €4 billion of cuts this year and flagging at least €3 billion for 2011.

Making things worse, Ireland's economy unexpectedly shrank almost 5%, on an annualized basis, in the second quarter, after emerging from recession earlier this year. A weak economy will make it harder to generate tax revenue and pay down debt.

Ireland's final bank-bailout costs are now expected to rise to as high as €50 billion. Its national debt burden—a relatively low 25% of gross domestic product before the crisis—is expected to approach 100% this year.

EUROPE NEWS

# Bosnian Serb leader takes tough line

By Marc Champion

Agence France-Presse/Getty Images

As polls near, Bosnian Serb Milorad Dodik, shown Wednesday, rejected talk of coalition rule in Bosnia and Herzegovina.

BANJA LUKA, Bosnia and Herzegovina—Bosnian Serb leader Milorad Dodik damped hopes that elections Sunday could help end a crippling deadlock over the future of Bosnia & Herzegovina, describing the country's creation as "a mistake" and ruling out coalition with a moderate Bosnian Muslim party.

Mr. Dodik has for the past four years been the strongest politician in this fractured nation, dominating its political agenda and blocking international efforts at state-building.

Western diplomats say they hold out hopes that Mr. Dodik might lose some support Sunday, emerging weakened and more willing to compromise. They also saw hope in the prospect that he might form a government with the mainly Bosnian Muslim Social Democrat Party, which looks likely to emerge with the most votes Sunday.

In an interview Thursday with The Wall Street Journal, however, Mr. Dodik took a tough line. "Bosnia Herzegovina was a mistake," Mr. Dodik said at his office in Republika Srpska's gleaming new steel-and-glass government complex in the entity's capital, Banja Luka. Serbs want to secede, though peacefully, and in the meantime ethnic Serb legislators sent to the state parliament in Sarajevo after the election "won't be very interested in building up Bosnia," he said. "It isn't our policy."

Bosnia's structure was created by the 1995 Dayton agreement that ended a 3 1/2-year war that left at least 100,000 people dead here, the largest number Bosnian Muslims. The agreement created a complex state, with a three-headed presidency to represent the main Bosnian Muslim, Serb and Croat populations.

These were split into two entities—Mr. Dodik's Republika Srpska, and the Bosnian-Croat Federation. The federation alone has three levels of government, 13 prime ministers and 14 legislatures. Federation voters on Sunday will have four separate ballot sheets to fill out.

Bosnians on Sunday will elect the country's three presidents, one from each ethnic community. They will elect the two chambers of Bosnia's state legislature as well as the legislatures of Republika Srpska and the Federation of Bosnia Herzegovina, as well as cantonal legislatures.

Mr. Dodik, who is running for president of Republika Srpska, is expected to win by a landslide.

Bosnia and Herzegovina's bureaucratic maze has helped make it the worst place in Europe to do business west of Ukraine, even as it seeks to join the European Union. Bosnia this year ranked 116th in World Bank's ease of doing business index. Large public payrolls and transfers to war veterans, coupled with political deadlock and a global economic crisis, have helped cripple the economy, economists say. The International Monetary Fund forecasts Bosnia to grow by 0.5% this year.

A squabbling multi-party coalition led by nationalist parties has left the Bosnian-Croat Federation in especially bad shape. While Mr. Dodik privatized Republika Srpska's telephone company and oil-refining business, raising more than €600 million euros to build his government offices and other projects, federation plans to privatize energy and telecoms assets collapsed amid political wrangling.

A recent survey by the National Democratic Institute of the U.S. suggests that voters on both sides of the ethnic divide are sick of nationalist rhetoric and despondent about the country's future. Asked what politicians talked about too much, the top choice of the survey's 2,000 respondents was nationalist and ethnic issues. Asked what was the most important issue to them, the runaway winner was jobs.

Among Bosnian Muslim voters, the shift away from nationalist themes appears likely to have an impact Sunday. The Social Democrat Party has campaigned almost exclusively on economic and social issues, says party strategist Reuf Bajrovic.

The NDI poll predicted the SDP would win 20% of votes for the state parliament and 29% for the federation parliament, more than doubling its performance in 2006. Polls suggest a media magnate promising business-like efficiency in government is also making inroads with a new party.

But polls suggest Mr. Dodik's Alliance of Independent Social Democrats will remain the strongest Serb party. Asked if he would consider a coalition with the SDP under any circumstances, Mr. Dodik said: "No, because they have done everything to Satanize out party."

Dr. Bakir Nakas, director of Sarajevo's Public Hospital throughout the war, said that during the first postwar elections, he had little hope Serb and Muslim politicians would compromise. "You couldn't expect that people who had been looking at each other through rifle sights to work together," he said.

But more recent elections have come as a disappointment. "We really are like a Frankenstein country," he said, adding that he didn't expect real change until the country's many-headed structure is pruned.

Mr. Dodik agrees with the diagnosis, but says the cure is not to rescue Bosnia and Herzegovina, but to carve it up. He said he would press for all 56 areas of competence that have been transferred from the two ethnic entities to the Bosnian state since the Dayton agreement to be returned. Another 15 years from today, he said, "I don't think Bosnia Herzegovina will exist."

Were Mr. Dodik to succeed, said a spokesman for the Office of the High Representative, the international body set up to enforce the Dayton agreement, that would mean "an ultimate victory for [former Serbian President Slobodan] Milosevic and [former Bosnian Serb President Radovan] Karadjic, and a vindication of their policy of ethnic cleansing."

# Investors remain nervous as Hungary votes

By Veronika Gulyas

BUDAPEST—Hungary's governing Fidesz party, riding a surge in popularity after refusing to back down to the International Monetary Fund, is set to win a landslide victory in local elections Sunday.

A second decisive win in six months would give the government the political strength it needs to make sweeping changes to the social-welfare and pension systems as well as the way local government operates.

Such moves will be necessary to reassure investors made jittery by Fidesz's decision to refuse demands from the IMF and the European Union for new austerity measures.

To maintain its strong support as the municipal vote approached, Fidesz has been silent since the April parliamentary elections on its longer-term economic program, and financial markets' patience is running out.

The key question is whether Fidesz will commit to an overhaul of Hungary's social systems, pensions and local administration to make the state budget sustainable in the long run.

"On a positive note, Fidesz success at a local level would allow structural reforms of local government to be carried forward and there would be savings from this in the longer term," Nomura economist Peter Attard Montalto said in a note.

But despite high market expectations, some voters doubt that the Fidesz party will indeed implement long-awaited structural reforms.

"It's most likely that nothing will change after the elections," said Ibolya Betlej, the manager of an office-building canteen, adding that she still plans to vote Sunday.

The new government, having broken its ties with the IMF in July, only committed to a targeted 2011 budget deficit of below 3% of gross domestic product after pressure from the European Union.

The government has changed regulations to publish next year's budget draft after the local elections. Investors consider Hungary's fiscal stance and willingness to keep a disciplined budget key factors in building market confidence in the country.

Hungary's financing needs will increase significantly from 2011 onward because of the repayment obligation on the €20 billion (about $27 billion) EU-IMF standby credit line the country secured when it was hit by the economic crisis.

A regular review of that loan between the government and the international bodies came to a halt in mid-July when the government refused to implement further austerity measures. Hungary has since said it will finance itself from markets.

Associated Press

Hungarian Prime Minister Viktor Orban at the campaign opener on Sept. 10.

Many investors still expect Hungary to return to the IMF for funding. However, that looks increasingly unlikely, barring external shocks. Hungary's 2011 financing plans published Sept. 14 had no word on any IMF assistance.

The municipal vote is crucial because "there is still a widely held view among investors that an IMF deal will be agreed afterwards," Mr. Attard Montalto said, dismissing that idea on the basis that Fidesz has said "very strongly" it won't go back to the IMF or "submit to the Washington policy consensus" because it finds further austerity measures unacceptable.

Hungary's 2011 budget should outline the country's fiscal strategy for the coming years, building on the economic framework already in place, Gyorgy Kopits, the head of Hungary's independent Fiscal Council, said in a recent interview. He called on markets to give the government more time before passing judgment.

"The moment of truth will come when the government submits [to parliament] the 2011 budget," Mr. Kopits said. "I hope in earnest that the 2011 budget won't include stopgap measures but a fiscal strategy for the next four years."

Such a plan could increase the country's credibility and lower risks associated with Hungarian assets.

"Hungary will need a tight fiscal position and supportive global financial conditions," Citigroup analyst Eszter Gargyan said in a note.

What is important for voters, however, isn't necessarily the state of the budget but issues in daily life.

"I would finally like [the local council] to maintain roads, increase public security, assess the situation of homeless people and increase the number of jobs," said Zsuzsa Czere, a public-sector worker.

Latvia is holding a general election on Saturday. Opinion polls show a close race between Prime Minister Valdis Dombrovskis's Unity group and Harmony Center, but more than 46% of voters remain undecided.


Associated Press

The European Union takes gender equality seriously. European Commission President José Manuel Barroso, left, and EU Commissioner for Justice, Fundamental Rights and Citizenship Viviane Reding earlier this year unveiled a Women's Charter aimed at strengthening women's rights.

# EU adviser: insurance pricing is discriminatory

By Charles Forelle

BRUSSELS—A legal adviser to the European Union's highest court said Thursday that insurers shouldn't be able to charge men and women different rates for products, flabbergasting an industry that frequently takes account of sex to write health, life and auto policies.

Advocate General Juliane Kokott wrote in an opinion that the practice is "incompatible with the principle of equal treatment for men and women," and she said a provision of European law that grants insurers an exception from discrimination rules should be struck down.

Ms. Kokott's opinion is only advisory; the judges of the European Court of Justice may disregard it when they issue their final ruling. But advocates general are court officers, and in practice their opinions—or at least their lines of reasoning—are frequently followed.

Ms. Kokott's line of reasoning is straightforward. The EU's Charter of Fundamental Rights prohibits discrimination on any of 14 grounds; sex is the first listed. The charter also provides that "equality between men and women must be ensured in all areas."

That, she writes, includes insurance policies. She proposed that the judges permit existing sex-based policies to remain in place and allow the industry to continue writing them during a three-year transitional period.

Insurers were taken aback.

If endorsed by judges, the opinion could have "far-reaching implications for the price and availability of insurance," CEA, the Brussels-based industry trade group, said in a statement.

"In some cases, gender is relevant for the risk for very good reason," said Malcolm Tarling of the Association of British Insurers. Women pay less for life insurance because they live longer, he said, and young women generally pay less for auto insurance than men because they cause fewer accidents.

Mr. Tarling stressed that the opinion wasn't a final ruling, but he said that if adopted by the full court, some people will see rates rise. "That's going to be bad news for customers," he said.

In the case of life insurance, women would see their premiums rise, while men would see theirs fall. On the flip side, women in some countries pay more for private health insurance because they consume more services.

Economic theory suggests that if insurers lose the ability to price discriminatingly, they will see lower profits. It is impossible to say by how much.

**That women have, on average, behaved differently than men doesn't necessarily mean any one woman's femaleness is the reason why.**

Ms. Kokott wasn't moved by potentially higher premiums. "Purely financial considerations," she wrote, "do not in any event constitute a material reason which would make discrimination on the grounds of sex permissible."

The case stems from a complaint brought in Belgian court by two men and a consumers' organization that challenged higher male life-insurance premiums.

A 2004 EU law, which broadly prohibits sex discrimination in commerce, contains an exception: Insurers may use sex to set premiums and benefits, if "sex is a determining factor in the assessment of risk" and the assessment is backed up by actuarial and statistical data.

The Belgian plaintiffs challenged that exception, and the Belgian constitutional court asked the European Court of Justice for a ruling.

In proposing to strike down the exception, Ms. Kokott probed a deeper question: Why do women live longer?

Life-insurance discrimination might be permissible under the law, she allowed, if women live longer because they are women, if there is something innate and biological about the female sex that causes longevity.

But, she argued, important causes of longevity are behavioral—eating habits, smoking and drinking, sports, work environments, drug use. That women have, on average, behaved differently than men doesn't necessarily mean any one woman's femaleness is the reason why.

Differences in longevity "merely come to light statistically," Ms. Kokott wrote, and sex is thus just shorthand for whatever is causing those differences. And, she said, "the use of a person's sex as a kind of substitute criterion for other distinguishing features is incompatible with the equal treatment of men and women."

That it is easier for insurance companies to record a person's sex than his or her behavioral habits when building actuarial models doesn't overcome the prohibition of discrimination, Ms. Kokott wrote.

Indeed, the exemption to the EU law in question pertains only to sex, she wrote. Charging people of dark-skinned races different premiums for health insurance "would without a doubt be extremely inappropriate," Ms. Kokott wrote, even if statistics showed racial differences in morbidity. "It is equally inappropriate to link insurance risks to a person's sex."

Still, the practice is widespread. ERGO Versicherungsgruppe AG, the primary-insurance subsidiary of reinsurer **Munich Re**, said German law "actually demands differentiation" in medical insurance "as women are more expensive to insure than men."

If Ms. Kokott's opinion is endorsed by the court, the German law would have to change.

# *Bank bailout is a gamble for Ireland's government*

**[ Brussels Beat ]**

By Stephen Fidler

It's almost an iron law of financial crises: Private debt becomes public debt. So it has been in Ireland. The ratio of Ireland's government debt to the size of its economy stood at 25% at the end of 2007. At the end of 2010, according to Finance Minister Brian Lenihan, it will be 98.6%.

Most of that increase comes from the fact that the Irish government has chosen to pay the creditors of its decrepit, mostly state-owned banks in full.

Shareholders have already been hammered. In a decision over who should suffer the pain of covering the remaining losses caused by years of excessive and evidently foolish lending by its banks, the government has decided that that burden should fall on the shoulders of Irish taxpayers.

Depositors will be kept whole. More controversially, so will the holders of the bonds the banks issued to fuel their lending spree, as well as other creditors. The only exceptions are a minority of holders of subordinated bonds.

It's a gamble. Swelling the government's own debts instead of allowing the banks to default on payments to creditors increases the risks that the government itself will default.

The government's "guarantee of most of the unsecured bank liabilities cannot but create doubt about the ability of the Irish state to prevent default on the sum total of its own debt and the bank debt," said Willem Buiter, Citigroup's chief economist, in a research article last month.

The government, however, decided it would pay creditors in full. The reason, as described by Mr. Lenihan: Allowing the banks to default would be almost as bad as the government itself defaulting.

"We have to fund ourselves as a state with senior debt. And other banks have to fund themselves with senior debt. … You cannot send out a message in an economy like Ireland that senior debt can be dishonored. We're far too dependent on international investment," Mr. Lenihan said.

"Any alternative strategy as advocated by some creates a significant risk of jeopardizing the banking system's and indeed the state's access to international debt markets and cannot be countenanced on that basis," he added.

In the latest financial crisis, most governments in Europe have taken a similar course. Finance ministers never want to be responsible for defaults, says Daniel Gros, director of the Centre for European Policy Studies in Brussels, so if one is on the cards, they have every incentive to push it into the future and the responsibility on to the shoulders of successors.

One European central bank governor said Thursday that even in large countries, banks' outsize political clout influences government decisions in their favor. In small countries, he said, the matter gets even more complicated because many decision makers will be close to other important players.

In the Irish case, most of the losers will be Irish, one way or another. With shareholders largely wiped out, they will be either Irish taxpayers, as currently planned; Irish pension funds, likely the biggest holders of the bonds; or Irish depositors.

Only one European government has chosen to impose significant losses on unsecured creditors in the latest crisis: Iceland. "In retrospect, Iceland looks pretty good compared to Ireland," says Mr. Gros.

**In the Irish case, most of the losers will be Irish, one way or another.**

The size of Iceland's banks dwarfed its economy more even than Ireland's did. Bank assets in Iceland were equivalent to 10 times annual economic output, compared with seven times in Ireland.

But Reykjavik had something else going for it: A large proportion of its bank creditors were outside the country. Iceland changed the rules of the game, promised to pay the banks' domestic creditors in full and allowed the banks to default on liabilities to foreign creditors. Iceland's taxpayers saved huge sums.

Iceland did pay a penalty: Its access to international markets was closed and remains so. Mr. Lenihan says that for Ireland that would be too high a price.

Mr. Gros says there are probably other factors influencing the Irish decision. A default on Irish bank debt would push funding costs higher for banks across the euro zone. He says other euro-area governments would be strongly urging Dublin not to let this happen.

But he disputes the idea that allowing the banks to default would hurt the Irish government's ability to borrow. "A government can still make a clear distinction between its own obligations and the entities that it owns which are limited-liability companies."

Bailing out bank creditors provides no incentive for them to undertake proper due diligence among banks. The European Union is currently grappling with this moral-hazard problem as it debates setting up national resolution funds to bail out troubled institutions.

Mr. Gros says the issue could be solved by offering creditors a menu of options to swap their claims—for example, for bonds with a lower face value, bonds paying less interest with later final maturities, or even an equity stake in the bank—that would more fairly share the pain.

U.S. NEWS

# Crist lags in Senate bid

By Peter Wallsten

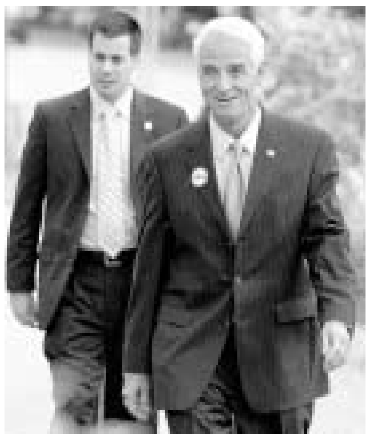
Florida Gov. Charlie Crist, battered by rivals as a political opportunist, is losing ground in his quest to build a bipartisan voter coalition and win a U.S. Senate seat as an independent.

The latest attack came Wednesday in a new Democratic Party ad featuring clips of the ex-Republican, who is courting Democratic voters, praising George W. Bush and Sarah Palin and saying he is "about as conservative as you can get."

Mr. Crist had been leading the state's three-way Senate race in surveys taken after he abandoned his failing Republican primary campaign in April and switched to independent, presenting himself as a middle-of-the-road alternative to both parties.

But surveys now show GOP nominee Marco Rubio, a former speaker of the Florida House of Representatives, taking the lead and Mr. Crist dropping into a battle for second place with Democratic nominee Kendrick Meek, a congressman from the Miami area.

Mr. Rubio is ahead among independents and Mr. Meek is beating Mr. Crist among Democrats, according to a Mason-Dixon poll released over the weekend.


Associated Press

Florida Gov. Charlie Crist, right, is running for Senate as an independent.

The survey showed 40% of voters backing Mr. Rubio, 28% Mr. Crist and 23% Mr. Meek.

"This is hard," Mr. Crist said Wednesday, speaking via cellphone after a campaign appearance in St. Augustine, Fla.

"It was outside the box to run as an independent. The political structure has been built up over years and years and years."

Still, he said he saw a path to victory. His campaign has begun mailing literature to key groups, including seniors and the state's large Jewish community. Some received a mailer lauding Mr. Crist as "tough on crime." Women received information about his vetoes of an anti-abortion-rights bill.

Mr. Crist's campaign has had a money advantage. As of Aug. 4, the last reporting date, Mr. Crist had $8 million in the bank, compared with $4.4 million for Mr. Rubio and $2.6 million for Mr. Meek.

But strategists in both parties say Mr. Crist's history as a partisan Republican made for an awkward transition to life as a center-left independent.

"It would work well for somebody who wasn't quite as overtly politically ambitious as he's been over the last several years," said Brad Coker, who directs the Mason-Dixon survey.

Mr. Crist is also at a disadvantage because he does not enjoy the support of a party organization.



# *A big personality departs as small-agenda era looms*

[ Capital Journal ]

By Gerald F. Seib

Rahm Emanuel, who plans to head for the exits at 1600 Pennsylvania Avenue on Friday, has been one of those rare White House chiefs of staff who played the inside policy game and the outside political game with equal vigor.

Not since James Baker held the same job at the outset of Ronald Reagan's momentous presidency has there been a chief of staff who cut quite the same swath directly across the Washington boundary between politics and policy.

Mr. Emanuel's style was well suited to the initial two-year stretch of high political turmoil and vaulting policy ambition that has marked the opening half of President Barack Obama's term. But Mr. Obama is headed into a quite different period after this November's election—an event bound to be a chastening experience that will usher in a period of reduced ambition and policy consolidation.

The president soon will face a fundamental strategic choice: whether to bend to the power of larger Republican House and Senate contingents in hopes of accomplishing a few goals, or to resist them and risk the onset of full political gridlock.

**It's unlikely the president could find a chief of staff to match the Rahm Emanuel penchant for stirring the pot.**

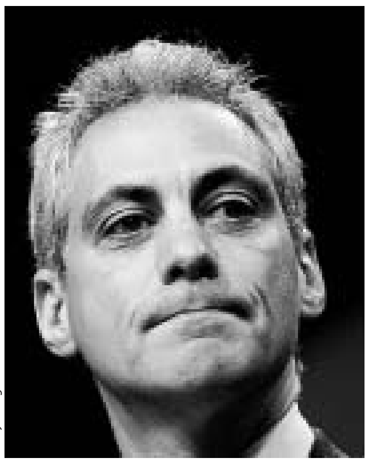
Either way, Mr. Obama's political latitude will be limited and his policy agenda smaller. And limited latitude and small agendas aren't the stuff for Mr. Emanuel, a man of outsized personality and big ambitions who's leaving to explore running for mayor of his native Chicago.

Deciding who will succeed him amounts to the first big decision of the second phase of the Obama presidency. Mr. Obama is expected to pick his former Senate chief of staff, Pete Rouse.

It's unlikely the president could find anybody to match the Emanuel penchant for stirring the pot, even if he wanted to. Mr. Emanuel struck a far higher profile than your average chief of staff. Like Madonna or Cher, he is one of those people known almost universally, by friend and foe alike, by his first name only.

And it isn't clear whether he made the president more friends or foes—though that probably was by design. Mr. Obama likely chose Mr. Emanuel because he wanted alongside him a prominent figure who could serve as his lightning rod—angering those within his party when necessary, or those in the other party when convenient, and who would absorb the shocks rather than the boss.

As it happens, that was the role Mr. Baker played in the first few


Getty Images

Rahm Emanuel steps down on Friday.

years of the Reagan presidency. In those days, conservative activists in the Republican Party lacerated Mr. Baker whenever they were disappointed the president didn't live up to their expectations, claiming his chief of staff wouldn't "let Reagan be Reagan." So did liberal activists in the Democratic Party aim their ire at Mr. Emanuel rather than his boss when they thought they saw him wavering.

And the liberals weren't entirely wrong, for Mr. Emanuel, a prominent alumnus of Bill Clinton's administration and a veteran of his drive to move the Democratic Party to the middle, hails from the more moderate wing of the Democratic Party.

That, in fact, is one of the principal contradictions of Mr. Emanuel's time as chief of staff. To many casual observers—and in the popular shorthand—he was seen as a fierce, almost mindless partisan, eager to tear into Republicans at every turn. But he actually favored a more modest approach to health-care overhaul than many in the mainstream of the Democratic Party (or the president, for that matter). He also was more open than others in the White House to the views of the business community, many of whom grew disillusioned that he couldn't produce policies more to their liking.

Indeed, one intriguing question is whether the president will pick a successor whose instincts run more to the left than Mr. Emanuel's. Such a choice might portend a period of battle, rather than accommodation, with the new Republican contingent on issues such as energy and taxes.

Ultimately, however, Mr. Emanuel's job wasn't to craft the administration's ideology but simply to push through Congress an economic stimulus bill, a health-care overhaul, the final stages of a bank-rescue plan, the bailout of General Motors and a rewriting of the financial regulatory system—all of which happened.

"It took a remarkable personality to juggle all of that and land the ships, and Rahm was that guy," said David Axelrod, Mr. Emanuel's longtime Chicago friend and White House political adviser.

The irony of the Emanuel period is that those accomplishments have done the president and his party little political good for now. The legacy of the last two years depends on whether that changes over time.

U.S. NEWS

# AIG, U.S. agree on exit plan's terms

By Serena Ng
And Joann S. Lublin

Bloomberg News

AIG Chief Executive Robert Benmosche, shown in May, hopes to complete a $2.5 billion equity offering by March.

**American International Group** Inc. and its U.S. government overseers have agreed in principle on a plan that would speed up repayment of the giant insurer's taxpayer debt and pave the way for the U.S. to exit its ownership of the bailed-out company.

As part of the plan, the Treasury Department would convert $49.1 billion of preferred shares it holds in AIG into common shares and increase the government's ownership stake in the company to 92.1% from 79.8% currently. The conversion, which could take place in early 2011 if AIG can meet certain conditions, would position the government to sell off its stake in AIG over time through a series of share sales in the open market.

Before the conversion of the Treasury's shares can occur, AIG would have to repay a $20 billion secured credit facility from the Federal Reserve Bank of New York in full. AIG said it plans to use proceeds from major asset sales and the forthcoming initial public offering of its pan-Asian life-insurance unit to pay down its taxpayer debt and terminate the credit facility well before it is scheduled to expire in 2013.

AIG Chief Executive Robert Benmosche said in an interview he hopes to complete a $2.5 billion equity offering and a small debt sale by March 2011 to test investor confidence in its turnaround plan.

The stock and unsecured debt sales won't proceed unless ratings companies agree in advance they won't cut their ratings on AIG, Mr. Benmosche said.

"If they say 'you're not there yet,' we're not going to do it," Mr. Benmosche said. The ratings companies met with company executives in advance of the announcement.

AIG's publicly traded shares closed Wednesday at $37.45. At that level, the 92.1% stake the Treasury is expected to hold in AIG implies a stock market value for the company of well over $60 billion, which would make it one of the largest publicly traded financial institutions in the U.S. after the conversion. The Treasury will receive 1.655 billion common shares in AIG.

In early afternoon trading Thursday, AIG shares were up 3.7% at $38.84.

About $5 billion of AIG shares are held by private investors, who would be given as many as 75 million warrants that would let them benefit from gains in the stock alongside the government. The strike price is $45 a share. The government could profit on its investment if its AIG shares can be sold above $30 apiece, a person familiar with the matter said.

In a recorded message on the insurer's website Thursday morning, Mr. Benmosche said he is confident AIG would repay taxpayers at a profit.

The Treasury is also going to take over the majority of the New York Fed's interests in two special-purpose vehicles that are positioned to recoup $26 billion from the sales of AIG's overseas assets.

Mr. Benmosche said the agreement "vastly simplifies current government support for AIG" and the plan will enable AIG to "concentrate our full attention on managing our businesses for the benefit of all our stakeholders."

The exit plan marks a milestone for both AIG and government officials. The company, a fraction of its former self after it nearly collapsed in September 2008, is trying to regain independence and access to private-sector financing, which it hasn't tapped in two years. The government, which has provided more than $120 billion in taxpayer support to AIG, is eager to get the controversial and costly crisis-era bailout behind it. Treasury Secretary Timothy Geithner said in a statement that the AIG exit strategy "dramatically accelerates the timeline for AIG's repayment and puts taxpayers in a considerably stronger position to recoup our investment in the company."

"While there is a lot of work ahead to execute the terms of this agreement," Mr. Geithner said, "today we are much closer to seeing a clear path out."

Still, analysts note, the exit plan is just a beginning; it could take years for the government to completely dispose of its shares in AIG, and much will depend on the insurer's business performance and market conditions. Some federal officials are hoping the sales would take as little as 18 months to complete, according to another person familiar with the matter.

On Thursday morning, AIG also announced it has reached a deal to sell two Japanese life-insurance units to **Prudential Financial** Inc. for $4.8 billion, of which $4.2 billion is cash AIG will use to repay the government. AIG is also preparing for a Hong Kong IPO at the end of October of its pan-Asian business, known as **AIA Group** Ltd., aimed at raising as much as $15 billion.

Separately, AIG is set by year end to close a $15.5 billion deal to sell its second-biggest overseas-based life-insurance unit, **American Life Insurance** Co., or Alico, to **MetLife** Inc. Alico has a large presence in Japan and Europe.

AIG's board of directors and federal officials met until late in the evening Wednesday, and in some cases into the early hours of Thursday, to finalize the terms of the widely anticipated exit strategy.

Robert S. "Steve" Miller, AIG's chairman, said completing the talks over the exit package "was a real marathon" for board members and executives. "The last 48 hours have been just nonstop nailing down one open point after another," he said in an interview Thursday morning after wrapping things up past midnight. "Anything we could have missed could have stopped the deal."

Among other things, Mr. Benmosche called several state insurance regulators Wednesday about the pending exit plan, Mr. Miller said. "We gave them assurances that we were not going to increase the risk to the individual insurance companies regulated by the states" because the plan would recapitalize the holding company without taking "resources away from the entities being regulated."

The plan required approval from the Treasury, the Federal Reserve, AIG's board, and three trustees that oversee the government's majority interest in AIG. A statement from the trustees Thursday said they voted unanimously in support of the AIG recapitalization plan.

**Morgan Stanley** advised the New York Fed on the exit plan and the broader AIG restructuring.

*—Deborah Solomon contributed to this article.*

# New safety rules unveiled for offshore drilling

By Siobhan Hughes
And Tennille Tracy

Associated Press

A rig drills a relief well at the site of the Deepwater Horizon in August.

WASHINGTON—Interior Secretary Ken Salazar on Thursday unveiled new offshore-drilling and workplace-safety rules, saying they are the first in a wave of regulations aimed at avoiding a repeat of the Deepwater Horizon accident.

The safety regulations, some of which formalize rules established months ago, also create new costs and hurdles for an industry where much work has been stopped for four months. Since late May, oil-services companies have laid off workers because of a government-ordered deep-water drilling ban while they wait for the regulations the Obama administration says are necessary for drilling to resume.

"I recognize that there will always be risks associated with deep-water drilling," Mr. Salazar said in a speech. "We will only lift the moratorium when I as secretary of the interior am comfortable that we have significantly reduced those risks."

He also said the Interior Department would propose requiring that equipment known as blowout preventers have a second set of blind shear rams—the parts that can shut down wells in the event of a catastrophic blowout. The equipment would also be subject to additional design requirements under the proposed regulations, such as improved instrumentation and more tools for activating the shear rams.

The drilling-safety rules, effective immediately, establish new standards for each stage of well drilling, from the design to the cementing, casing and testing of the well. The move reverses years of leaving design up to the industry.

The rules, opposed by the industry and to be adjusted in weeks ahead, require companies to have procedures in place to keep workers safe. An outside auditor would have to ensure the safety of the systems—something called for by environmentalists.

On April 20, 11 people died when the Deepwater Horizon rig leased by **BP** PLC exploded, causing nearly five million barrels of oil to spill into the Gulf of Mexico.

Oil and gas companies hope the rules will pave the way for the government to lift its moratorium and allow them to resume drilling in deep waters. The Interior Department chief has made clear that stricter safety regulations are one of three conditions that must be met to allow drilling to resume.

But the moratorium might not be the only thing that prevents oil and gas companies from obtaining new permits. The Interior Department's planned rules for blowout preventers could require costly changes to drilling equipment and its continuing evaluation of the environmental risks associated with each new well could also lead to delays in approving drilling permits.

"What remains unclear is industry's ability to obtain the necessary permits that will actually allow a return to work," **Royal Dutch Shell** PLC said in a statement. "We need clarity around the effectiveness and timeliness of the permitting process."

Republicans criticized the Obama administration for failing to announce when it would lift a moratorium on deep-water drilling and when it would begin issuing new drilling permits. Unless rules are clear, "a de facto moratorium could remain in place for years that will cause more American job losses and more companies moving operations overseas," Rep. Doc Hastings (R., Wash.), the top Republican on the House Natural Resources Committee, said in a statement.

The head of the Interior Department's offshore-drilling agency is expected to present recommendations on the conditions under which drilling could resume as early as Friday.

Besides safety regulations, the industry also must show it can contain spills when they do occur and respond to them.

WORLD NEWS

Associated Press

Dilma Rousseff, campaigning on Tuesday, was long favored to win Brazil's presidential vote in the first round.

# Brazil corruption scandal clouds presidential vote

By John Lyons

SÃO PAULO, Brazil—A corruption scandal rocking Brazil's government has turned what recently seemed a sure first-round victory for the ruling party's presidential candidate into a closer call, potentially bolstering the influence of minor candidates and creating uncertainty about the country's plans to cool off its soaring currency.

Brazilians are debating whether Dilma Rousseff, the candidate for the populist Workers Party, will clinch victory in Sunday's first round of voting, or be forced into a runoff with another candidate at month's end.

"There is more of a possibility now than there was one week ago that we are going to have a second round," said Paulo Sotero, who heads the Brazil Institute at the Woodrow Wilson Center in Washington.

With a lead of about 20 percentage points in most polls over the second-place candidate, Ms. Rousseff is still widely expected to become Brazil's president. But whether her victory comes Sunday or in an Oct. 31 runoff has implications for everything from the makeup of her eventual government to the timing of pending policy decisions, such as imposing a tax designed to keep the Brazilian real from rising.

Ms. Rousseff had been breezing toward a first-round victory on the strength of support from Brazil's popular President Luiz Inácio Lula da Silva, who after two terms is ineligible for re-election. Then, two weeks ago, a close Rousseff aide, Erenice Guerra, resigned from her new post as Mr. da Silva's cabinet chief amid charges that family members she had hired to work for the ministry had solicited bribes in exchange for access.

Ms. Guerra denies wrongdoing. A federal police investigation is underway.

Ms. Rousseff hasn't been implicated in the alleged influence-peddling. She denies knowledge of it and often calls the allegations an irrelevant "factoid."

Ms. Rousseff's leading opponent, former São Paulo Gov. José Serra, has accused her of either being complicit in the wrongdoing or irresponsibly unaware, considering her closeness to Ms. Guerra.

Adding an element of mystery are diverging results by two of Brazil's most respected polling firms about the scandal's impact on Ms. Rousseff's lead. A poll released Wednesday by Ibope said Ms. Rousseff could win 55% of valid votes, above the 50% needed for a first-round win. The pollster also said the scandal isn't denting Ms. Rousseff's support.

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"Without a shadow of a doubt, if the election were today, there would be a victory in the first round," said Rafael Lucchesi, operations director for the National Confederation of Industries, which commissioned the Ibope poll.

But another respected Brazilian polling firm is calling it differently. A Datafolha poll released Tuesday showed Ms. Rousseff lost three percentage points in just five days, to 51% support. Given the poll's two-percentage-point margin of error, "it would be impossible to indicate a [Rousseff] victory in the first round, in event that the elections were now," Datafolha wrote in an analysis of its results.

International currency and fixed-income traders are now attempting to figure out when Brazil may tax some short-term fixed-income investments to slow the rise of the Brazilian real. Conventional wisdom is the tax will be applied only once Ms. Rousseff has been elected.

"They don't want to risk making a move that could risk upsetting investors in the middle of an election," says Gray Newman, senior Latin America economist at Morgan Stanley.

The biggest winner in a runoff may be Brazil's Green Party candidate Marina Silva, a former Amazon rubber tapper and environment minister. Since the scandal broke, Ms. Silva has gained 3 percentage points to 14%, according to Datafolha. In the event of a runoff between two candidates—presumably, given current polling, Ms. Rousseff and Mr. Serra—Ms. Silva could force a candidate to adopt parts of her pro-environment platform in exchange for her support.

The biggest loser would be Ms. Rousseff, analysts say. To win the election, Ms. Rousseff's left-leaning Workers Party has entered into a national alliance with the rival, populist Democratic Movement Party. Leaders of this party could be emboldened to seek a bigger role in an eventual Rousseff government, demanding more ministry posts and positions at state-run companies.

Though most observers have counted Mr. Serra out, a runoff may also breathe new life into his campaign, his supporters say. Once leading the polls, Mr. Serra appeared aloof and failed to differentiate his own center-left economics from those of Ms. Rousseff. Even as Ms. Rousseff's poll numbers have slipped, Mr. Serra's have remained steady around 28%.

"Historically, people decide their votes at the last minute, and now we have these accusations against Dilma," says Andre Cesar, a political analyst with CAC Consultoria in Brasilia. "Dilma may win in the first round, but it will be close."

# NATO strike fuels Pakistan tensions

By Matthew Rosenberg
And Zahid Hussein

KABUL—Coalition helicopter gunships fired on targets inside Pakistan for the third time in a week, signaling what appears to be a new willingness by allied forces in Afghanistan to strike across the border.

Thursday's airstrike killed three Pakistani border guardsmen and brought a swift and angry response: Pakistan promptly closed a key border crossing for trucks carrying nonlethal supplies to coalition forces inside landlocked Afghanistan, and Pakistani officials openly questioned their often strained alliance with the U.S.

"We will have to see whether we are allies or enemies," Interior Minister Rehman Malik told reporters.

While a significant percentage of nonlethal supplies—including food and fuel—passes through the crossing, North Atlantic Treaty Organization officials in Afghanistan played down the closure, saying another major crossing in southern Pakistan remained open. Allied forces have weathered supply disruptions before, such as during the recent flooding in Pakistan, they added.

Of more immediate concern to officials on both sides of the border was what appeared to be rising tensions between the U.S. and Pakistan after a week of cross-border helicopter attacks.

U.S. and allied military officials in Afghanistan, who only months ago were urging patience with Pakistan, have recently become more hawkish in their private statements about Taliban havens inside the South Asian nation's tribal areas, saying they are more of a problem than previously thought.

The Central Intelligence Agency, meanwhile, has stepped up its campaign of targeted strikes by drone aircraft against the Taliban and al Qaeda in Pakistan's tribal areas, a loosely governed strip of mountainous borderland where the Pakistani army is also battling Islamist militants.

Pakistani officials have secretly aided the CIA campaign. It has paid dividends for both countries: The U.S. has seen major al Qaeda leaders killed while senior members of the Pakistan Taliban, an offshoot of the Afghan movement that has attacked the Pakistani army and government, have been slain, including the group's founder.

But the drone campaign is intensely unpopular in Pakistan, where polls indicate most people view the U.S. as an enemy, in part because of the strikes.

That antipathy toward the U.S.—also present among elements of the military and civilian government—has seen Pakistani officialdom draw a sharp distinction between the drone strikes, which they dislike, and cross-border raids by NATO aircraft or ground troops, which they protest strongly.

Prime Minister Yousuf Raza Gilani expressed his country's concern about the missile strikes and helicopter incursions during a meeting Thursday in Islamabad with CIA Director Leon Panetta.

"Pakistan, being a front-line ally in the war against terror, expects its partners to respect its territorial sovereignty," Mr. Gilani said, according to a statement from his office.

A senior NATO officer said Thursday that the new allied commander in Afghanistan, Gen. David Petraeus, understood Pakistan's concerns but was growing increasingly impatient with cross-border attacks on coalition forces from havens inside Pakistan. Therefore, NATO forces were being more "proactive" in their response to immediate threats from across the border, the officer said.

There were slightly differing accounts of what happened Thursday. Pakistani officials said a pair of NATO helicopters crossed over the border of the Upper Kurram tribal agency around dawn and fired on a Frontier Corps outpost located 200 meters inside Pakistan.

The Pakistan troops "retaliated" with rifle fire, and the helicopters responded by launching a pair of missiles or rockets, Pakistan's military said. The post was destroyed and three of six troopers manning it were killed, it said.

NATO's Afghanistan task force, however, said fighting began when insurgents were spotted inside Afghanistan trying to fire mortars at a coalition base. NATO "aircraft did enter into Pakistani airspace briefly as they engaged this initial target," the task force said in a statement.

"After the initial strike, the aircraft received what the crews assessed as effective small arms fire from individuals just across the border in Pakistan," it continued. "Operating in self defense, the [NATO] aircraft entered into Pakistani airspace, killing several armed individuals."

European Pressphoto Agency

A Pakistani soldier guards NATO-supply trucks at the Afghan border Thursday.