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## INSIDE EUROPE
Paul Taylor

# ECB caution might not be a virtue

**PARIS** Inflexible, behind the curve, still fighting yesterday's war — bashing the European Central Bank has become the latest fashionable blood sport.

The ECB, in charge of monetary policy for the 16 countries that share the euro, has been slower than the U.S. Federal Reserve or the Bank of England to lower interest rates or resort to more radical methods to fight recession.

But as the bank seeks an exit strategy from the crisis that avoids an explosion of inflation that could result from the monetary easing in Washington and London, Europe may be left with a double handicap of tight monetary policy and a super-strong currency.

The Fed has already begun quantitative easing — buying public or private debt, effectively by printing money.

But the EU treaty prohibits the ECB from providing credit to member governments or from buying their debt directly, and an EU regulation has decreed that this rule cannot be circumvented by buying public debt on the secondary market.

The European bank had to build its credibility from scratch when the euro was introduced in 1999. It has done well to err on the side of caution.

But critics charge that the ECB, based in Frankfurt, remains obsessed with fighting inflation even though price growth is close to zero and the European economy is contracting faster than at any time since World War II.

Data released Thursday showed that industrial production in the euro zone plunged by a record amount in December, pointing to a deepening recession and adding pressure on the ECB to cut rates.

The bank's defenders say that it is right to resist being stampeded into a zero-interest rate policy and printing money when the depth and duration of the recession is so uncertain. It may also be keeping some ammunition in reserve in case the slump deepens.

So far, bank solvency problems are more acute in the United States and Britain than in the euro zone, except for Ireland.

The ECB has a treaty mandate to maintain price stability, in contrast to the dual objectives of fighting inflation and promoting growth assigned to the Fed and the Bank of England.

But legal restraints are only part of the story. Critics say the "stability culture" inherited from the Bundesbank, the German central bank that was the most influential forerunner to the ECB, is impeding it from rescuing the economy.

Political factors also weigh. The ECB president, Jean-Claude Trichet, is sensitive to the need to maintain consensus for European monetary union, a relatively young enterprise in historic terms.

Throwing caution to the winds would alienate countries that are sticklers for fiscal and monetary orthodoxy — above all Germany and the Netherlands.

By general agreement, Trichet had a good start to the crisis. He was the first to provide large amounts of liquidity to banks when fallout from U.S. subprime mortgage defaults froze money markets in August 2007.

The Fed followed suit, although with less flexibility than the ECB, while the Bank of England fretted about moral hazard.

The ECB's major blunder, in many eyes, was to raise its benchmark interest rate to 4.25 percent in July 2008, when inflation hit a 16-year peak of 4 percent, fueled by a spike in oil and commodities prices.

The ECB's main rate is now at 2 percent although it has flagged a cut in March, while the Bank of England has cut its rate to 1 percent and the Fed to a range of zero to 0.25 percent.

But there is scant evidence that ECB interest rates are keeping banks from lending to each other and to businesses. The main reason is fear of future losses and a lack of confidence, which might be exacerbated if the ECB took panic measures.

After all, has commercial bank lending eased in the United States or Britain because of looser monetary policy?

The ECB has taken longer to react partly because of an erroneous initial view that the crisis would mostly affect the United States and Britain, with limited effects on the euro zone.

"At first we thought in Europe that the crisis only affects countries with large financial centers," an ECB Governing Council member, Erkki Liikanen, said in a Finnish newspaper interview published Thursday.

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# U.S. bank plan appears to bypass 'lesson from Japan'

By Hiroko Tabuchi

**TOKYO:** For all the money the United States and Europe have committed to rescuing banks so far, the veterans of Japan's own banking crisis have two words of advice: more, faster.

The Japanese have been here before. They endured a decade of economic stagnation in the 1990s as their banks labored under crippling debt, and successive governments wasted trillions of yen on half measures to restore them.

**News Analysis**

Only in 2003 did the government finally take the actions that led to a recovery: forcing major banks to submit to merciless audits and declare their bad debts; spending two trillion yen, or $22.23 billion at today's rates; effectively nationalizing a major bank at the expense of shareholders; and allowing weaker banks to fail.

By then, the Nikkei stock index had dropped by almost three quarters from its heights. Real estate prices would ultimately fall for 15 consecutive years. Public debt had grown to exceed gross domestic product. And deflation stalked the land.

Some students of the Japanese debacle say they see the United States heading for a similar train wreck.

"I thought America had studied Japan's failures," said Hirofumi Gomi, a top official at the Japanese Financial Services Agency during the crisis. "Why is it making the same mistakes?"

Some U.S. critics of the plan announced Tuesday by Treasury Secretary Timothy Geithner said it lacked details. Experts on Japan found it timid — especially given the size of the banking crisis the administration faces.

"I think they know how big it is, but they don't want to say how big it is," said John Makin, an economist at the American Enterprise Institute, referring to administration officials. "It's so big they can't acknowledge it."

He added: "The lesson from Japan in the 1990s was that they should have stepped up and nationalized the banks."

Instead, the Japanese first tried many of the same remedies that the administration of President George W. Bush tried and the administration of President Barack Obama is trying — low interest rates, fiscal stimulus and ineffective cash infusions, among other things. The Japanese even tried to tap private capital to buy some of the bad assets from banks, as Geithner has proposed.

One reason Japan was so timid was fear of public outrage, which grew with each act of the bailout.

But the Japanese experience shows that resolving the mess will require a firm government hand and will be extremely expensive. Delay will only raise the price tag.

A further lesson is that the bank rescue will determine the fate of the wider economy. While Obama has prioritized his stimulus plan, no stimulus is likely to succeed unless the banking sector is repaired. "I think Obama made a tactical mistake," Makin said.

The Japanese crisis of the 1990s and early 2000s had roots similar to the American crisis: a real estate bubble that collapsed, leaving banks holding trillions of yen in loans that were nearly worthless.

Initially, Japan's leaders underestimated how badly the real estate collapse would hurt banks. As in the United States, a policy of easy money had fueled stock and real estate speculation as well as reckless lending by banks.

Many in Japan thought low interest rates and economic stimulus measures would help banks recover on their own. But in late 1997, a string of bank failures set off a crippling credit crisis.

Prodded into action, the government injected ¥1.8 trillion, or nearly $20 billion at current exchange rates, into Japan's main banks. But the injections —

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Eric Piermont/European Pressphoto Agency

Vladimir Weiss/Bloomberg News

Christian Streiff, on screen above, the chief of PSA Peugeot Citroën. President Nicolas Sarkozy, below far left in back row, with officials and auto executives this week to announce assistance to French carmarkers in exchange for preserving jobs at home. Peugeot still plans to cut more jobs in France and keep importing cars from plants, like the joint venture, below left, with Toyota in the Czech Republic.

Pool photo by Michel Euler

# Peugeot sets up a clash with Sarkozy

By Laurence Frost
Bloomberg News

**PARIS:** On Monday, President Nicolas Sarkozy granted PSA Peugeot Citroen €3 billion to safeguard jobs in France. Two days later, Peugeot's chief executive, Christian Streiff, said he would seek to reduce the home work force by 3,000 and pledged to continue building cars abroad.

Peugeot's plans "respect the spirit of the agreement" with the government, as well as the letter, Streiff said Wednesday in an interview.

"Mr. Streiff has given signed undertakings," Sarkozy said Wednesday while on a visit to Kuwait. "I shall make sure they are respected."

The apparent clash between the leader of France and the leader of Peugeot says a lot about the pressures on companies to cast the net wide for solutions as the economic downturn lengthens, and on governments to ensure that taxpayer-financed aid benefits the local economy.

Sarkozy granted Peugeot and its domestic rival, Renault, a total of €6 billion, or $7.7 billion, in five-year loans after the carmakers promised to keep French factories running and avoid compulsory lay offs this year.

The French president also criticized Peugeot for importing the Peugeot 107 and Citroen cars from a plant in the Czech Republic.

Streiff said the Czech plant would remain open.

"We've always been very clear," he said. "I don't believe in investing massively in low-cost countries to supply the French market, but being present in different countries is critical. That's the policy we're sticking to."

Analysts said the Peugeot chief's comments were intended to show strength in the face of rising government involvement in the private sector.

"Streiff wants to show that Peugeot's still in charge and isn't just going to fall into line," said Philippe Houchois, an analyst in London with UBS. "He's someone who doesn't shy away from conflict, but he wouldn't be doing this if he didn't have the Peugeot family's support in standing up to the government."

Peugeot is stepping up job cuts as it fights the worst auto slump in 15 years. After outperforming the European market for much of the year, French registrations fell 14 percent in November and 16 percent in December, pushing the company to report a loss of €1.08 billion for the second half, compared with net income of €493 million a year earlier.

Peugeot, the biggest French carmaker, is seeking 3,000 voluntary departures this year, in addition to 3,500 local job cuts announced in December, Streiff said. Strategy is unchanged and will continue to spread production among Western Europe and lower-wage countries, he said.

The division of future job cuts between France and the rest of Europe will be "the same as in the past," Streiff said. There are no plans for French assembly of the Citroen C3 Picasso minivan, which is going into production in Slovakia, he added.

The company's chief financial officer, Isabel Marey-Semper, said Peugeot was aiming to repay its state loan in two years, the earliest possible under the aid terms, after which it would in any case be freed of its commitments to the government.

"It's in Peugeot's interests, as well as the state's, if we can get cheaper finance elsewhere," Marey-Semper said.

The company anticipates that bank credit may become available at affordable rates following the "reassuring" outcome of the aid talks, she said.

Including the 3,000 additional job cuts in France, which the company aims to achieve through worker buyouts, Peugeot will eliminate 14,000 posts in Western Europe this year, most of them in France, Marey-Semper said.

Adam Jonas, an analyst in London for Morgan Stanley, said, "They're bound to do some hidden restructuring in France, following a softly-softly approach." He added, "Even if you don't close plants for two years or fire anybody there are still things you can do. That's the [illegible] here."

Renault, unlike Peugeot, ruled out any French job cuts in addition to those announced in 2008. About 9,000 European positions will be eliminated this year under existing plans, with about half the cuts in France, Carlos Ghosn, chief executive of Renault, said Thursday.

The French government owns 15 percent of Renault, which is based in the Paris suburb of Boulogne-Billancourt.

Streiff said he had the full support of the Peugeot family, the carmaker's largest shareholder with a 30 percent stake. On Feb. 5, as the aid negotiations neared a conclusion, La Tribune, a French financial daily, citing an anonymous government official, reported that the family was split over whether to remove Streiff.

A call to the secretary of Thierry Peugeot, the chairman of Peugeot's supervisory board, was not immediately returned.

## • Renault eliminates its dividend

Renault announced Thursday it would scrap its dividend, halt development of three models and further cut its payroll to face what its chief executive, Carlos Ghosn, said was a crisis "of massive proportions" that would transform the industry, The Associated Press reported from Paris.

Renault reported a net loss of €982 million for the second half of 2008, compared with a profit of €1.42 billion in the similar period of 2007. Ghosn said he expected the outlook to darken further as the economic and financial crisis ravaged car sales.

Renault scrapped its dividend and said it was cutting staff bonuses down to director level.

The company is also reducing inventories, cutting costs, selling real estate and looking to squeeze an extra €250 million in cost savings from its alliance with Nissan Motor.

Nissan this week announced an aggressive restructuring plan of its own, including eliminating 20,000 jobs.

# China firm to invest $19.5 billion in Rio Tinto

By Julia Werdigier and Bettina Wassener

**LONDON:** The state-owned Chinese aluminum company Chinalco agreed to invest $19.5 billion in the mining giant Rio Tinto on Thursday, a deal that would help guarantee its access to raw materials but was also likely to set off opposition from politicians and other shareholders worried about China's growing influence over the global supply of resources.

Under the deal, the biggest foreign investment ever by a Chinese company, Aluminum Corp. of China, as Chinalco is formally known, would buy $7.2 billion in bonds convertible into Rio Tinto stock. It would also pay $12.3 billion in cash for stakes in Rio Tinto's aluminum, iron-ore and copper assets in the United States, Australia and Chile.

Chinalco would own 18 percent of Rio Tinto if the bonds were converted, and the transaction, which is subject to the approval of regulators in five countries, is likely to draw criticism.

For Rio Tinto, which has headquarters in Britain and executive offices in Melbourne, Australia, the deal provides a much-needed cash injection as it seeks to reduce $39 billion in debt amassed through its 2007 purchase of the Canadian aluminum maker Alcan. The company pledged to reduce debt by $10 billion this year, but efforts were made more difficult by sagging profits and lower raw-material prices.

"This is all part of the recycling of financial reserves around the world," said Justin Urquhart Stewart, co-founder of Seven Investment Management in London. "Rio shareholders may feel upset as they're being bypassed for people who have money, but in the long run it's good news to have a large client as a shareholder."

Some analysts have criticized Rio Tinto's willingness to allow Chinalco to raise its existing stake, saying it would limit Rio Tinto's flexibility and upset some shareholders. Rio Tinto's stock has dropped 64 percent over the past 12 months. In London on Thursday, the stock fell 30 pence, or 1.5 percent, to close at £19.39, or $27.60.

Rio Tinto's chief executive, Tom Albanese, defended the deal, saying it would have been "extremely challenging" to raise the same amount of cash via a rights issue in the current markets.

In addition, Rio Tinto said it would retain "operational control of the joint venture assets, with clear governance arrangements."

Although Chinalco, which is based in Beijing, would be entitled to nominate two new nonexecutive board members to add to Rio's 15 current board members, Rio emphasized that "independent nonexecutive" directors would continue to make up a majority of Rio Tinto's board.

But analysts cautioned that the deal could lend China greater leverage in pricing negotiations for iron ore.

"The perception is that the strategic positioning of Rio will be eroded over time," said Ted Leschke, an analyst at Shaw Stockbroking in Sydney. "It's one thing to retain operational control of the assets; it's another to negotiate over pricing of output."

Even though the deal received unanimous support from Rio's board, it caused discord this month when Rio Tinto's chairman-elect, Jim Leng, quit, less than a month after his appointment, because of an apparent disagreement over how to cut debt.

The Australian government also signaled some possible trouble for the deal. Australian law has limited foreign ownership to 15 percent of equity. Australia's treasurer, Wayne Swan, said Thursday that the government would revise its foreign ownership laws to treat convertible debt as if it were equity, a change that effectively tightens the regulations and would apply to the Chinalco deal.

Chinalco and Rio Tinto said they did not take the move as a "negative signal."

Leschke, the Shaw Stockbroking analyst, said: "The perception is that the

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# German shipyards defy slump

## Brisk business keeps companies investing

By Paul Carrel
Reuters

**HAMBURG:** With economic doom in every headline, shipping businesses here are preparing for the end of the boom times.

Yet even if the recession in Germany is shaping up to be the country's deepest since World War II, some in the eye of that storm see opportunity.

Industrial orders for Germany, which has been the world's biggest exporter of goods since 2003, posted their biggest annual decline in December since reunification as demand for manufactured goods continued to slide worldwide.

VSM, the German shipbuilding association, has said orders have eased after industrial production hit a record high last year. But it says suppliers to the shipbuilding industry are particularly busy; shipyards typically lag behind the cycle.

"We're at full stretch," said Sebastian Kerzel, a 27-year-old machine worker at a ship construction and repair plant in Hamburg, the biggest German port.

One of a stream of workers pouring out of the plant at the end of their shift, he said he and his colleagues were still working flat out. "There have been no cuts to working hours."

How long that will last, however, is uncertain.

Manfred Kuhr, deputy chairman of BLG Logistics Group, which handles 80 percent of the goods going through the port of Bremerhaven, is exposed to one of the weakest sectors of the economy. It is the biggest German port for importing and exporting automobiles, whose sales have slumped by nearly a fourth worldwide.

"I've been in the business for 35 years," he said. "We haven't had anything like this before."

But even though business volumes are down, Kuhr said he expected the downturn to bottom out in the middle of this year, and said BLG was investing in car-transport infrastructure in Russia. "As management we need to be bold and make further, targeted investments in these difficult times," he said.

"People will buy cars again," he added. "So I need to do it. I have to take on debt, though try to limit it, and hold back on other investments here." That way, he said, he will be ready for a recovery "and can make money right away, because I got in on favorable terms."

There are already some indications — possibly unreliable — that a recovery is on the horizon, or at least that the downturn is reaching a low point.

In January, German corporate morale as measured by a business climate index, from the Ifo economic institute in Munich, rose for the first time in eight months, lifted by improving business expectations.

On Tuesday, the Baltic Dry Freight index, the Baltic Exchange's leading shipping index and a gauge of the prices to ship commodities like iron ore, coal and grain on major export routes, rose by more than 8 percent to a four-month high.

"The scenario is not that good for 2009 but it is also not that terribly bad," said Jürgen Sorgenfrei, chairman of Port of Hamburg Marketing, which compiles statistics on the port and is backed by the city authorities and port operators.

The port authorities are planning infrastructure investments after booming business in recent years resulted in bottlenecks. "We need to be ready" for a recovery, Sorgenfrei said.

Thomas Straubhaar, director of the HWWI economic research institute in Hamburg, said there was no getting away from the fact that German exports were diving.

"But this dive comes from an unbelievably high level," he said. "After this drop in 2009, there will be a recovery in 2010 because emerging markets will quickly develop further. For that, these countries need modern, and not old, investment goods."

Kuhr, of BLG Logistics, also hopes his company's investments will allow it to emerge stronger from the crisis.

"I am getting that on favorable terms," he said. "When things get going again, I am prepared."

Christian Charisius/Reuters

The port at Hamburg, which plans to invest in infrastructure to relieve bottlenecks.

# Economy of Spain contracts sharply

Bloomberg News

**MADRID:** Spain's economy experienced it biggest contraction in more than 15 years in the fourth quarter, pushing its unemployment rate to [illegible] highest level in Europe, the Nat[illegible] Statistics Institute said Thursday.

The economy contracted 1 percent from the previous quarter and 0.7 percent from a year earlier, the institute said. The economy entered its first recession since 1993 after shrinking a revised 0.3 percent in the third quarter.

Growth in Spain, which outpaced the euro zone for more than a decade on a debt-fueled construction boom, will contract 2 percent this year as the budget deficit swells to more than twice the European Union limit of 3 percent, according to the European Commission.

Once the engine of job creation in the euro zone, Spain now accounts for almost all the increase in joblessness in the zone, with an unemployment rate of 14 percent, almost double the EU average.

"The worst is still to come," said Estefania Ponte, an economist in Madrid with Fortis. "We'll see the wo[illegible]n the first half of this year."

She forecast that the Spanish economy would continue to shrink until the fourth quarter, pushing the unemployment rate to 18.5 percent.

The country's automobile industry, which had contributed about 5 percent of gross domestic product, accounts for part of the jump in unemployment as car sales plunge and export demand weakens. Nissan Motor has said that it would cut 38 percent of the work force at a Spanish factory, and Renault won approval for temporary layoffs of as many as 10,311 employees in Spain.

Spain lost its triple-A credit rating with Standard & Poor's on Jan. 19. S&P cited concerns about public finances after the government pledged about €90 billion, or about $115 billion, in stimulus measures for 2008 and 2009.

### ■ Irish consumer prices fall

Ireland's consumer price index fell 1.7 percent in January from the previous month, resulting in an annual drop of 0.1 percent, the first annual decline since 1960, the Central Statistics Office said Thursday, Reuters reported from London.

The Irish data for January compared with an annual increase of 1.1 percent the month before and was below a median forecast for a 0.2 percent rise in a Reuters poll.

The Harmonized Indexes of Consumer Prices, which the European Union uses for comparisons within the bloc, fell 0.8 percent in January from December and was up 1.1 percent from a year earlier.

# Japan sees its history in U.S. plan for banks

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too small, poorly planned, and based on little understanding of the extent of the banking sector's woes — failed to stem the growing crisis.

Japanese voters, angry at what they saw to be a waste of taxpayer money, punished Japan's ruling coalition at the polls that year, prompting Prime Minister Ryutaro Hashimoto to resign. After that, fear of public outrage slowed the government's hand.

Indeed, fearing more bad news, leaders did not force major banks to come clean on the amount of their bad debt. Banks kept loans to "zombie" companies on their balance sheets, instead of fully disclosing them and writing them off.

Instead, Japan experimented with a series of funds, in part privately financed, to relieve banks of their bad assets — a mechanism similar to what Geithner has proposed in his bailout plan.

Those funds brought about limited results at best, said Takeo Hoshi, an economics professor at the University of California at San Diego. For one thing, the funds were too small to have an effect. The depository for bad loans had no orderly way to sell them off.

And the purchases that did take place failed to stem banks' capital shortages, because the bad assets were priced at steep discounts.

Japanese taxpayers are estimated to have recouped less than half of what it cost the government to bail out the banks. From 1992 to 2005, Japanese banks wrote off about ¥96 trillion, or about 19 percent of the annual gross domestic product.

So far, the Obama administration's plan avoids the hardest decisions, like nationalizing banks, wiping out shareholders or allowing banks to collapse under the weight of their own bad debts. In the end, Japan had to do all those things.

"The U.S. is repeating many of the mistakes that Japan made, and that's surprising," said Makin, the economist, "because American policy makers were all too ready to supply advice to Japan."

Economists say the blunders meant Japan's financial system did not start to recover until late 2002, six years after the crisis broke. That year, the government of the reformist leader Junichiro Koizumi ordered a tough audit of the top banks. The move, called the Takenaka Plan after Heizo Takenaka, who led the government's financial reforms, finally brought the full extent of bad loans to light.

Adam Berry/Bloomberg

Heizo Takenaka, who led Japan's financial reform effort, brought the full extent of bad loans to light and helped restore faith in Japanese banks.

Initially, banks publicly lashed out at Takenaka. "The government can't order bank management to do this and that," Yoshifumi Nishikawa, president of Sumitomo Mitsui Financial Group, said in October 2002. "It's absolutely absurd."

But Takenaka stood firm. His rallying cry, he said in an interview Wednesday, was, "Don't cover up. Don't distort principles. Follow the rules."

"I told the banks clearly, 'I am in a position to supervise you,'" Takenaka said. "I told them I am not open to negotiation."

It took another three years to get most of the bad loans off of the banks' books.

Resona Bank, which was found to have insufficient capital, was effectively nationalized. But Takenaka's toughness restored faith in the banks.

"That was a turning point in the banking crisis," said Gomi, formerly of the Japanese Financial Services Agency, who worked with Takenaka on the audits. "After that, markets finally trusted the banks again."

By then, other factors had fallen into place that aided economic recovery, including a boom in exports to the United States and China.

But the United States probably will not be able to count on a growing demand for its products as the global economy worsens.

"The way things are going right now," said Hoshi, the economics professor, "the U.S. taxpayers' burden will keep going up and up."

# Europe may hold clue on U.S. banks

ECONOMY, From Page 1

In Britain, four of the country's most troubled financial institutions — two of them were officially nationalized — are already under the de facto control of a newly formed government holding company. Officials are pushing Lloyds Bank and the Royal Bank of Scotland, among others, to pay fewer bonuses and increase lending to homeowners and businesses in Britain.

To be sure, government control of banks in these countries has been more a result of the desperate financial condition of British and Irish financial institutions than bold insight on the part of policy makers. But with this mix of investment and influence, governments are — however reluctantly — overcoming the bugaboo of nationalization, the N word, even as they steer clear of the term and its negative associations.

"The N word is a difficult word," said Richard Portes, an economist at the University of London Business School. "But you need to exercise control in order to get bad assets off the books. The question is, both in the U.K. and the U.S.: What degree of control?"

At a time when the market capitalization of the top U.S. banks is collectively below $500 billion, the International Monetary Fund is estimating that financial write-downs will rise to $2.2 trillion. As a result, a number of analysts contend, the Obama administration will ultimately be compelled to admit that even with recent capital injections, some large banks like Citigroup and Bank of America may well become insolvent.

With the full force of the international spotlight focused on Geithner this weekend, he is facing increased pressure to not only add meat to the skeletal outline of his bank plan but to demonstrate to a skittish global economy that the Obama administration is ready to take charge.

"There is a vacuum to be filled," said Morris Goldstein, a policy analyst at the Peterson Institute for International Economics in Washington. "The United States, as the largest global player, needs to lead the show."

The Irish plan, the most recent policy salvo from a government that has been under withering pressure to address the sick condition of its banks, may provide some guidance. But it is no panacea, either.

"Injecting the first €7 billion is a de facto nationalization," said Brian Lucey, a finance professor at Trinity College Dublin. "And nationalization of the whole Irish banking system is a strong probability."

During a news conference Wednesday night, Brian Lenihan, Ireland's finance minister, said that the government had carefully examined the banks' accounts and made the determination that the bulk of the loans were secured by real properties, not just largely worthless securitized assets.

Unlike banks in Europe and the United States, Irish banks were not great originators or holders of securitized mortgage assets. But they lent with abandon to residential and commercial property owners and now face a growing build up of non-performing loans.

"The government has more control over the banks now," said Scott Rankin, a bank analyst at Davy, a brokerage firm in Dublin. "The level of influence is ratcheting up."

According to the terms of the recapitalization, the Irish government will receive preference shares paying 8 percent interest and a warrant to take a 25 percent stake in the banks in five years time, at today's low prices. That would allow the Irish taxpayer to profit from any improvement in the bank's value.

But that could be a long wait for the latest two banks aided. Write-downs of Irish banks will be significant; Bank of Ireland, warned on Thursday that it would report a loss for the second half of this year and estimated bad loan charges of €4.5 billion through 2011. Allied Irish banks is expected to write off a similar figure.

Such a figure dwarfs the company's respective market valuations — €600 million for Bank of Ireland and about €1 billion for Allied Irish, a reflection of the extreme pessimism in the market. Both banks have equity capital ratios of about 6 percent, in line with other major European banks.

In Britain, banks like Royal Bank of Scotland — now 70 percent owned by the government — and Lloyds Banking group, which is 43 percent owned, have been hit by a brutal mix of reckless deal making, balance sheets infected by securitized mortgages and exposure to a slumping British economy.

While home lenders Northern Rock and Bradford & Bingley are fully nationalized, the government's control of RBS and Lloyds is less overt, though its influence is by most accounts just as strongly felt.

UK Financial Investments, which manages the British government's investments, is pushing RBS, for example, to be a more aggressive local lender, and, as the uproar over bonuses has grown here, the body has worked closely with its chosen chief executive, Stephen Hester, to cut back on payouts.

"The idea of a holding company for bank shares is a good one," said Howard Davies, director of the London School of Economics. "The advantage is that it can put the banks at arm's length and set policies for the government's investment, and eventual disinvestment."

For finance ministers, the G-7 meeting on Friday and Saturday will mostly be an opportunity to compare notes. U.S. Treasury officials say their primary focus will be to achieve more global coordination on efforts to recharge economies.

But one thing is certain: as countries around the world take drastic steps to deal with their respective bank crises, much more is being expected from the new Treasury secretary.

"Coming to the exam unprepared is unacceptable," said Ed Yardeni, an independent market analyst. "You can't have a seven-page letter of intent as opposed to a detailed presentation. But it is not too late — he can bounce back."

# U.S. bank regulators to wield new power

By Eric Dash

**NEW YORK:** Nearly 100 U.S. government banking regulators descended on Citigroup in New York on Wednesday. Dozens more fanned out through Bank of America, JPMorgan Chase and other big banks across the nation.

It was just another workday. For years, regulators have embedded themselves in the major U.S. banks to monitor their financial health.

But now these regulators could become the arbiters of American finance. Treasury Secretary Timothy Geithner is empowering them to decide which banks are strong enough to survive on their own — and which must be compelled to accept new bailouts from Washington, along with any strings that might be attached.

At the center of this effort, part of the plan by the administration of President Barack Obama to shore up the U.S. financial industry, is a new stress test for banks that government officials are devising.

Details are scant. But examinations for 18 or so of the biggest banks are set to begin immediately, and the first results could arrive within weeks. They are not expected to be made public for every institution. Regulators were also discussing whether to apply the stress test to small and midsize banks, according to an administration official.

The new test is likely to be more stringent than the standards used to determine which banks would receive money under the first round of the government rescue. And unlike in the government's initial investments, the amount of capital that banks receive will be based on the depth of their problems.

Regulators plan to assess the potential losses a bank could face over the next two years, rather than the typical one year, according to government officials close to the situation. They are also expected to look at banks' exposure to derivatives and other assets normally carried off their balance sheets and to make sure banks carry an additional capital cushion. Their assumptions will be guided on a "worst case" basis.

The exams could be used not only to determine which large banks would receive additional aid but also to help weed out small, unhealthy banks, hastening consolidation in the industry.

Analysts said the program hinted at creeping nationalization of the banking industry. "There is no way you can survive the failure of the stress test without having the government inject large amounts of taxpayer money," said Jaret Seiberg, a policy analyst at the Stanford Group in Washington. "That means the government will own a majority of the bank."

**For some, the plan smacks of nationalization of the banking industry.**

Paul Miller, a longtime banking analyst with Friedman, Billings, Ramsey, said the test might provide the government with political cover to take a more heavy-handed approach. "It gives them the mechanism they need to take giant steps with capital infusions," he said.

Martin Lowy, a banking lawyer who advised the Federal Deposit Insurance Corp. on troubled banks during the savings and loan crisis 20 years ago, said, "Maybe the thought is that we will put in so much capital that even under these stringent circumstances, this bank will not fail."

"That will take a huge amount of capital, if they are going to do it honestly," he said. "Why that is different from nationalizing, I don't know."

If a bank fails the test, its regulators will demand that it raise additional capital. But with few investors willing to put in fresh funds, the bank may have to return to the government.

The government could inject capital into the bank without declaring it insolvent, since it might meet other industry standards. It might also require that the bank have enough common equity to start lending again, something investors increasingly demand.

According to a government official close to the situation, regulators will continue to require that banks maintain a minimum 6 percent Tier 1 capital ratio, a common measure of financial health. Regulators are also expected to insist that at least half of that figure, or 3 percent, come from common stock.

As part of the new program, companies that receive new preferred equity investments from the government can convert them into common shares. Senior administration officials are also considering allowing the Treasury's original investments under the Troubled Asset Relief Program, or TARP, to be converted into common equity, but no final decision has been made.

The government's new investments will carry several additional restrictions. Banks will be banned from paying quarterly dividends in excess of a penny, repurchasing their shares or pursuing acquisitions. Senior executives will be subject to caps of $500,000 on annual cash compensation until the government is repaid.

The government could become the largest shareholder of many banks, setting the stage for it to play an even more powerful role.

Some analysts questioned whether the approach would work.

"What you are left with is that we are going to nationalize banks that fail the stress test," Seiberg said. "How many big companies are going to want to do business with government-run banks?"

# Cautious stance of ECB might not be a virtue

ECB, From Page 11

The more radical responses by the Fed and the Bank of England mirror an "Anglo-Saxon" boom-and-bust culture that embraces debt and risk.

The ECB's caution reflects a more conservative Continental European tradition that prizes savings and security. It is also shaped by the enduring trauma of previous years of hyperinflation in Germany.

The ECB did not follow the former Fed chairman Alan Greenspan, hailed as a sage at the time, into the excesses of easy credit, notably after the dot-com crash in 2001.

That the European economy has grown more slowly than those of the United States or Britain for much of the decade is due to the main Continental governments' reluctance to liberalize service and labor markets rather than to ECB policy.

Now the ECB may be biding its time in case there is still no sign of the start of a recovery in the second half of the year.

Despite treaty constraints, EU officials believe the bank has legal wiggle room to buy government and corporate debt on the secondary market, provided it communicates the policy transparently and does not discriminate among member states.

That would exclude the suggestion from a Belgian economist, Paul De Grauwe, that the ECB give preference to buying Irish, Greek, Spanish and Italian government bonds, which have suffered widening spreads against the benchmark German Bund.

Such targeted purchases would be political dynamite in a German general election year, since they could appear to reward countries that had loose fiscal policies.

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*Paul Taylor is a Reuters columnist. See more of his work online.*

## BRIEFING

### ECB president hopes for recovery in 2010

**OSNABRÜCK, Germany:** Jean-Claude Trichet, the president of the European Central Bank, said Thursday that there could be a world economic recovery next year.

"It seems to be a reasonable working hypothesis that after an exceptionally difficult 2009, we will see an economic recovery in 2010," Trichet said in a speech in Osnabrück, Germany.

"The economic prospects are still marked by an exceptionally high degree of uncertainty. Since the end of 2008, virtually all economies, both the industria[illegible]d countries and the emerging markets, have been moving in the same direction. This considerably contributes to the scale of the downturn." *(Bloomberg)*

### EU approves aid plan for Hungarian banks

**BRUSSELS:** Plans by Hungary to recapitalize its banks suffering from the financial crisis and to give them new debt guarantees were approved by the European Commission.

The package includes a measure making new capital available to credit institutions in exchange for preferential shares. The commission said the package contained elements of state aid, but it was acceptable because it ensured equal access and did not distort competition. *(Re[illegible]s)*

### 3 companies selected to build British trains

**LONDON:** The British government said it had chosen three companies to supply a fleet of intercity trains.

The Department for Transport said it had selected a consortium, Agility Trains, as preferred bidder to build and maintain new "super-express" trains.

The consortium comprises Hitachi, the Japanese train maker; Barclays, the British banking group; and John Laing, the British project management group. The government said the project, costing £7.5 billion, or $10.8 billion, would create or protect about 12,500 manufacturing jobs. *(Reuters)*