Big businesses in Japan remain upbeat, for now

By Michael S. Arnold

TOKYO—Japanese corporate sentiment remains surprisingly optimistic despite the global financial turmoil of recent months, but the outlook going forward suggests businesses remain wary about the subprime-mortgage fallout.

The Japanese central bank's quarterly *tankan* survey of corporate sentiment released yesterday showed that large manufacturers, the main drivers of Japan's economy, remain as positive about business conditions as they were in June, before the U.S. subprime woes sparked a credit crunch that sent global financial markets swooning.

The survey's headline diffusion index, which measures the mood among big manufacturers, came in at 23 for September, unchanged from June. The figure represents the percentage of companies saying business conditions are better minus those who consider conditions worse.

The survey also showed more-robust capital-spending plans and profit expectations among large manufacturers, both positive signs for the health of the economy.

Yet optimism about the results was tempered by several factors. Looking ahead, large manufacturers' forecast for the December diffusion index is just 19, suggesting "businesses are wary about the potential impact of subprime-mortgage-market problems on business conditions toward the end of the year," said Hideo Kumano, senior economist at Dai-Ichi Life Research Institute. In addition, the headline diffusion index for small nonmanufacturers fell to minus 10 from minus seven—its lowest level since September 2005.

Economy Minister Hiroko Ota said the survey showed small and midsize companies "are a little cautious, but as a whole ... the Japanese economy is steadily recovering."

The results, while encouraging, may not be strong enough to convince the Bank of Japan to resume its course of interest-rate increases until it is convinced the subprime storm has passed.

The survey "strengthens the BOJ's hand in the medium term for a rate hike, but it's not such a strong number that it overcomes a reluctance to tighten when everyone else in the world is easing," said John Richards, a strategist with Royal Bank of Scotland in Tokyo. "But it sharply increases the probability of a January or February hike."

Analysts pointed to the survey's investment forecast as reason for optimism. Large industries said they expected to boost capital spending by 8.7% this fiscal year, which began April 1, up from a June forecast of 7.7% and above economists' expectations for a 7.4% rise. In addition, large manufacturers forecast 2.9% profit growth for the year and 4.5% sales growth.

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The gold at crunch's end

Banks may benefit from debt values after rough quarter

Tim Foley

By David Reilly

While the bond-market mess made the earnings reports for the big investment banks feel like a game of roulette, there was one area where they were almost guaranteed to win: profits generated by the falling value of their own debt.

That allowed the firms to book hundreds of millions of dollars in profit, helping to offset multibillion-dollar charges they had to take on commitments to fund leveraged buyouts.

HEARD ON THE STREET

Now some banks may be set to similarly benefit from their own misfortune. Financial titans such as **Citigroup** Inc., **Bank of America** Corp., and **J.P. Morgan Chase** & Co., which will report third-quarter results this month, all opted earlier this year to start applying market values to some of their own liabilities, according to research service the Analyst's Accounting Observer.

This means they, too, might see a boost to profit from declines in the value of their debts during the summer credit crunch. "It might not be unusual at all to be seeing gains on debt issued hitting earnings in the third quarter," the Analyst's Accounting Observer said.

Officials at Citigroup, J.P. Morgan and Bank of America declined to comment.

The brokers and banks are doing nothing wrong or improper in booking such gains. The accounting rules as they stand allow the practice. But some investors are crying foul, saying the rules shouldn't have been changed to allow for such gains.

Here is how the accounting method works: Say $100 million of bonds issued by a bank falls in value by $5 million, or 5%. Under new accounting rules adopted by the banks and brokerages, some liabilities are valued at market prices instead of being recorded at their historical cost. The decline in the bonds' value means the bank's liabilities fell by $5 million. The difference between the current price of $95 million and the original $100 million creates an equivalent gain that ends up on the income statement and boosts profits. Conversely, if the bonds gained in value, it would mean the bank's liabilities went up, producing a loss.

Any gains at the banks could potentially offer one bright spot in what is expected to be an otherwise gloomy quarter. Banks likely face write-downs in the value of commitments that they have made to fund leveraged buyouts and will need to increase reserves for soured loans.

Citigroup analyst Keith Horowitz last week cut his third-quarter earnings-per-share estimate for Bank of America to 85 cents from $1.20, citing the recent financial-market turmoil and the likely need for the bank to increase loan-loss reserves because of its exposure to consumer lending.

Late last week, Lehman analyst Jason Goldberg lowered his third-quarter earnings estimate for Citigroup to $1.05 a share from $1.12, while reducing his estimate for J.P. Morgan to $1.01 from $1.08.

The emergence of debt-induced gains, even if they only offer a slight respite from overall market woes, has rekindled long-standing debate about whether such profits should be allowed. The opportunity for companies to benefit in this way only recently emerged, thanks to new accounting rules that allow companies to apply market prices to their own liabilities.

Opponents of the practice of booking such gains worry that they erode earnings quality and possibly open a new way for executives to massage earnings.

In the wake of the brokers' results, Moody's Corp. urged bondholders to ignore this new kind of profit. The ratings firm said the inclusion of such gains in earnings "can produce counterintuitive and misleading results" and that it doesn't consider them "to be core, sustainable earnings."

Opponents of the practice worry that they erode earnings quality.

Even some supporters of the use of market, or fair, values remain uneasy with companies booking gains on declines in the value of their own debt. "It was premature to allow the effect of that to come through the income statement," said Leslie Seidman, a member of the Financial Accounting Standards Board, the body that adopted the rule that allows companies to book these gains.

Yet brokerage executives defended the gains, saying they were more than just an accounting gimmick. During his firm's earnings call, Sam Molinaro, Bear Stearns's chief financial officer, said "the gains were real," adding that "there's someone on the other side of that trade who lost money."

Mr. Molinaro added that his firm could have easily used financial instruments to cancel out, or hedge, the impact of any change in the value of Bear's own credit standing. But the firm ruled that out, he said. Bear later recognized about $225 million in gains from the change in value of structured notes it sold investors.

The idea of allowing companies to profit from falls in their own liabilities proved controversial when accounting rule makers debated the idea. But many companies, especially in the financial sector, argued that if the rule makers were going to encourage the use of market values, they should allow companies to use them for all their financial assets and liabilities. In addition, financial firms argued that it didn't make sense to require them to use market prices for the value of a derivative contract that may be hedging the value of a company's own liabilities, which would be recorded at its cost.

That would have produced an accounting mismatch, said Edward Ketz, an accounting professor at Pennsylvania State University. Still, the outcome is "counterintuitive," he added.

It may also require investors to "rethink how we are going to evaluate a company's debt-to-equity ratio," Prof. Ketz said. "In the past, we would think that if a firm was having problems they would show a higher debt ratio, but now if they are performing poorly, the debt is going to be going down in value."

Crude futures slide as investors question market fundamentals

Associated Press

Oil prices slid yesterday, dipping at times below the psychologically important $80-a-barrel level, on concerns that oil-market fundamentals don't support the high prices achieved in crude's record-setting September rally.

Oil and refined-products futures typically peak in October, and while prices could still surge to records in reaction to hurricane or inventory news later this month, many investors are betting the rally has largely run its course.

"October is traditionally the worst month to be long in crude oil and refined products," said Tom Kloza, publisher and chief oil analyst at the Oil Price Information Service.

Oil and other commodities denominated in dollars are actually falling in price in the eyes of foreign investors, because the dollar has been sliding against other currencies since the Federal Reserve cut interest rates last month. But oil inventories are high, and demand for crude is expected to fall as refineries shut down to conduct routine fall maintenance. Meanwhile, demand for gasoline is tepid at best.

Light, sweet crude for November delivery fell $1.42, or 1.7%, to settle at $80.24 on the New York Mercantile Exchange. On Friday, the contract rose to within 14 cents of hitting the Sept. 20 trading record of $83.90 a barrel before retreating sharply and closing down $1.22.

Iran's Economic Suicide

By Stuart Levey

Tehran's pursuit of nuclear weapons and its radical foreign policies have provoked international sanctions. Its financial subterfuge has led key banks and businesses worldwide to sever their Iranian business ties, and President Mahmoud Ahmadinejad's blunders are debilitating Iran's economy. As a result of the regime's choices, Iran is headed toward isolation and economic hardship.

Through intense diplomacy, the United States and its allies have built a multilateral coalition resulting in two unanimous U.N. Security Council sanctions resolutions that impose financial measures targeting Iran's nuclear and ballistic-missile programs. Sustained international pressure on Iran is having an impact. The Bush administration is committed to continuing this diplomatic approach.

Voluntary actions by the private sector are reinforcing governmental pressure. One year ago, U.S. Treasury Secretary Hank Paulson launched a world-wide effort to inform the public, government partners and private-sector leaders about the danger Iran's financial deception poses to the international financial system. We have shared information with these groups about how this deceptive conduct enables Iran to support terrorism and its nuclear and missile programs, and about Iran's attempts to lure reputable banks unwittingly into those activities. We cautioned that, absent a change in course, the regime would find it exceedingly difficult to locate partners among the world's reputable banks. That prediction has become a reality.

Iran uses its state-owned banks to finance proliferation and terrorism: The United Nations has blacklisted Bank Sepah for its role as the financial linchpin of Iran's missile programs, and Bank Saderat has been cut off from the U.S. financial system for financing terrorism. Iranian banks, including its central bank, take special care to hide their involvement in illicit business by asking other banks to remove their names and all references to Iran from transactions—a clear acknowledgment of their wrongdoing. This routine practice is specifically designed to deceive those who might reject the transaction if they knew who, or what, was really involved.

Sanctions and poor decision making are starting to bite in Tehran.

Before the passage of U.N. Security Council Resolution 1747, which imposed financial sanctions on Iran's nuclear and missile programs, the Central Bank of Iran abused its relationships with upstanding financial institutions to shield Bank Sepah's assets from the impact of impending sanctions. Other Iranian banks also helped Sepah evade sanctions after its Security Council designation.

As they become aware of this misconduct, more banks world-wide are refusing to deal with Iran in any currency, determining the business is too risky. Foreign-based branches and subsidiaries of Iran's state-owned banks are increasingly isolated—threatening their viability—as banks and companies resist dealing with them for fear that their business will be disrupted by additional U.N. sanctions. And there has been a devastating reduction in the foreign investment Iran needs to develop its vast oil reserves. France has now asked its largest firms not to bid for projects in Iran.

This financial pressure is amplified by the regime's economic mismanagement. Despite Iran's increasing oil revenues, President Ahmadinejad has failed to deliver on his promises to improve the lot of average Iranians. Most independent experts estimate Iran's unemployment rate to be double the regime's claim of "only" 11%. Similarly, Iran admits its inflation rate is 17%; experts estimate the true figure is even higher. Instead of trying to ease inflation, President Ahmadinejad has thrown fuel onto the fire, ordering the central bank to cut interest rates far below the inflation rate despite objections by the bank's former governor—an act of economic malpractice.

Corruption is widespread, depriving average Iranians of economic opportunity. The Ahmadinejad regime awards lucrative "no-bid" contracts to cronies in Iran's Revolutionary Guards Corps, whose leadership has been sanctioned under U.N. resolutions.

Yet the regime continues to send hundreds of millions of dollars every year to support deadly terrorist groups abroad while the population is neglected. At a time of record oil prices, the country's oil revenue reserve fund should be growing to benefit the future of the Iranian people. Instead, it is being spent down to mask the effects of the regime's misguided economic policies.

All of this has not gone unnoticed. The OECD recently increased Iran's risk classification for the likelihood that the country will pay its external debts to its second-worst rating—equal to that of Gabon and Swaziland—thereby increasing the cost of financing for Iranian companies.

Those who have dared to tell the truth about the pain these policies are inflicting on the country have paid the price. President Ahmadinejad just ousted the central bank governor who resisted cutting interest rates in the face of persistent high inflation. He also sacked Iran's oil minister, who acknowledged that Tehran was having difficulty funding oil projects as a result of decreased cooperation from overseas banks and financiers and who called Iran's energy problems a looming "catastrophe."

Iran is experiencing the consequences of its deceptive financial conduct and defiant policies. Its leaders are inflicting hardship on the Iranian people and steadily turning their country into a financial pariah. Whether to continue down this path of isolation is a choice Iran must make.

Mr. Levey is undersecretary for terrorism and financial intelligence in the U.S. Treasury Department.

Orange Revolution—Reloaded

By Taras Kuzio

KIEV—Not since the heady days of the Orange Revolution has the atmosphere in Kiev been so electric. At the newly completed Hyatt, this city's only five-star hotel, the gathered journalists, international observers and Western political consultants awaited the arrival on Sunday evening of the woman who has changed the rules of Ukraine's political game.

Yulia Tymoshenko strode into her election headquarters surrounded by a throng of bodyguards to a receptive welcome. Her bloc has become the pivotal political force in Ukraine. Kiev is ripe with expectation that Ms. Tymoshenko is set to return as prime minister of a rejuvenated Orange coalition with President Viktor Yushchenko's Our Ukraine-People's Self-Defense party. If so, she will have saved the Orange Revolution and Mr. Yushchenko. He would have become a lame-duck president had the governing Party of Regions won. Now he can even dream of a second term.

More importantly, the relaunch of the Orange coalition would give the country another chance to introduce the reforms that millions of Ukrainians fought for three years ago, when they stood on the freezing Independence Square for 17 long days. If Mr. Yushchenko fails to seize this moment he'll be a spent force and few people will attend his political funeral.

Counterintuitively, the election result is also good news for Prime Minister Viktor Yanukovych's Regions party and the broader political culture in Ukraine. Only in opposition can Regions develop to a normal, democratic party for all Ukrainians. If it had managed to stay in power, it would most likely have continued its corrupt ways and remained a party that exploits the country's linguistic divide instead of bridging it.

Ms. Tymoshenko has done the unthinkable by challenging Regions even in what it considered its Eastern Ukrainian fiefdom. There Ms. Tymoshenko's party got a respectable 15%-20% outside of the two traditional Regions strongholds of Donetsk and the Crimea. Regions garnered 50%-60% of the votes there. Her success in breaching traditional Regions territory in Russian-speaking Eastern Ukraine makes her party the country's only all-national political force.

Country-wide, Ms. Tymoshenko's bloc came in a remarkably close second. Having had a slim lead after the early returns came in, her party stood at 31.8%, compared to 32.6% for the Regions party, with 80% of the vote tallied. Mr. Yushchenko immediately ordered an investigation into the vote counting. But even with this slightly diminished outcome, the Orange coalition

Ismael Roldan

should still have a comfortable majority in parliament. It remains a remarkable comeback given that in last year's elections, Ms. Tymoshenko's party came in 10 percentage points behind Regions.

Mr. Yushchenko has nobody but himself to blame that his party only marginally improved its 2006 result of 14% to now 15%. As president, he was supposed to stand above the political fray and abstain from intervening in the elections. The Central Election Commission though was forced to reprimand him for campaigning on behalf of his party. In many of Ukraine's regions the local governors, who are appointed by the president, also worked for Our Ukraine. Mr. Yushchenko's unconstitutional election interfering turned voters off. Orange supporters disillusioned by Mr. Yushchenko's failure to act as a harbinger of revolutionary change turned to Ms. Tymoshenko.

Tymoshenko changed the rules of Ukraine's political game.

Without her support, Mr. Yushchenko—with approval ratings of less than 20%—cannot hope to be re-elected for a second term in two years time. Mr. Yushchenko now has the opportunity to rectify his biggest strategic mistake when he dismissed the Tymoshenko government in September 2005 after only eight months in office. The dismissal led to an 18-month split in the Orange camp and the return from political oblivion of Viktor Yanukovych and his Party of Regions.

The renewal of the Yushchenko-Tymoshenko alliance is not without its potential pitfalls. President Yushchenko has found it difficult to work with two strong prime ministers—Ms. Tymoshenko and Mr. Yanukovych. That cooperation is only going to be more difficult since last year's constitutional reforms increased the powers of the parliament and the government vis-à-vis the president. Mr. Yushchenko can no longer simply remove the prime minister, as he did in 2005. Some in Mr. Yushchenko's entourage therefore prefer a grand coalition with Regions but with a technocrat at the helm, such as Yuri Yekhanurov, prime minister from 2005 to 2006, instead of Mr. Yanukovych.

But those in the Yushchenko camp who favor shunning Ms. Tymoshenko still fail to understand the ramifications of Sunday's elections. They can either choose between Ms. Tymoshenko as an ally and prime minister now or as a competing Orange presidential candidate in 2009. With her support, he'll probably stand a good chance of being re-elected for a second term. If he has to compete against her, she'd almost certainly eliminate him in the first round of the presidential elections and probably defeat any Regions candidate the opposition could possibly field in the next round. Reviving the Orange coalition is Mr. Yushchenko's safest bet.

Ukraine's second free and fair election in less than two years demonstrates a level of maturity of its democratic culture that has still not been fully recognized abroad. Western journalists in Kiev note the absence of anti-Western xenophobia they encounter in Moscow. Ukrainian voters have held politicians accountable for their actions. The attempt by Regions to mobilize Russian-speakers for a referendum to make Russian an official language and forswear future NATO membership failed to resonate with voters.

But despite these achievements, the pro-reform forces are not powerful enough to successfully complete the postcommunist transition. They need outside support. In that respect, Ukraine is similar to other swing countries in Eastern Europe. It is unlikely that Romania would have been able to overcome the Ceaucescu legacy without the carrot of European Union membership. Sunday's election results have provided a new lease of life for the Orange Revolution. They also give the EU a second opportunity to replace its passivity toward Ukraine with true leadership. Ukraine deserves the same EU membership lifeline that was so instrumental in cementing Eastern Europe's new democracies in the early 1990s.

Mr. Kuzio is a research associate and former visiting professor at the Institute for European, Russian and Eurasian Studies, George Washington University.

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