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## Twitter's IPO looks like a bonanza for speculators

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World Business Newspaper

### News Briefing

#### Copper supply set to outstrip demand

Copper output could exceed demand next year as a wave of new projects begins production, leading miners and traders said, in a prediction that points to lower prices for the benchmark metal. **Page 13; 'Dr Copper' on recovery, Page 24**

#### IMF fears bond losses

The International Monetary Fund has warned that monetary tightening in the US threatens to expose financial excesses and vulnerabilities that could wipe up to \$2.3tn off bond markets. **Page 2; Tony Barber, Page 9; Lex, Page 12**

#### Telecoms power play

The proxy shareholder statement lodged by Verizon sheds light on the complex negotiations behind the \$130bn Vodafone stake sale – the third-largest deal in corporate history. **Page 13**

#### Bank bailout tax push

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#### US drones gain clout

Backroom political pressure in Congress has kept funding for the use of drones to patrol US borders intact, despite doubts over the unmanned aerial vehicles' reliability. **Page 5**

#### Nobel chemistry prize

Three naturalised American scientists – Martin Karplus, Michael Levitt and Arieh Warshel, who began their work at Harvard – have won the Nobel Prize for chemistry for "taking experiments to cyberspace". **Page 3**

#### S Korea skills surplus

South Korea tops the league when it comes to producing too many overeducated workers, and the subsequent skills surplus and labour underutilisation are taking a toll on the economy. **Page 6**

#### Offshore rupee bonds

India is making a big move to internationalise its currency through a deal with the World Bank to launch the first offshore rupee bond programme. **Page 2**

#### Climate change scores

The OECD is to start scoring countries on how well they are tackling climate change as it steps up a push to wean governments off the fossil fuels it says have put humans on a "collision course with nature". **Page 6**

#### RBS sends forex data

Royal Bank of Scotland has handed over to regulators records of instant message strings sent by and to a former currency trader, amid a deepening sector-wide probe into the suspected manipulation of foreign exchange rates. **Page 13**

#### Trade deficit narrows

A surge from exporters and a fall in gold imports has helped India post its lowest trade deficit in more than two years during September, cutting pressure on the rupee. **Page 2**

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● Minutes show divide over asset purchases ● Little clarity for markets

# Fed split highlights tough challenge awaiting Yellen

By Robin Harding in Washington

Policy makers at the US Federal Reserve were split over the merits of slowing its \$85bn a month asset purchases in September, highlighting the difficult task facing Janet Yellen as she prepares to take the chairmanship of the central bank.

Calling her "one of the nation's foremost economists and policy makers", President Barack Obama nominated Ms Yellen to the most powerful job in the world economy in a ceremony at the White House, just one hour after the release of the minutes from September's Federal Open Market Committee meeting.

"She doesn't have a crystal ball but what she does have is a keen understanding of how the markets and the economy work," said Mr Obama. "She's tough, and not just because she's from Brooklyn."

The minutes showed why she will need that toughness as she seeks to forge consensus at a Fed that was split down the middle on tapering in September, between policy makers who felt the economy was still too weak, and those who felt a decision not to taper would cost them their credibility.

"Conditional on their respective economic outlooks, most participants judged that it would likely be appropriate to begin to reduce the pace of the committee's purchases of longer-term securities this year and to conclude purchases in the middle of 2014," the minutes said. But they offered little clarity on what economic conditions would trigger a taper. Mounting concern over gridlock in Washington and the risk of a US default mean that the Fed's views from mid-September may already be out of date.

Markets were taken by surprise and rallied last month when the Fed chose to keep its purchases unchanged.



Janet Yellen with Barack Obama as the president announced her nomination for the Fed top job Getty

### The doctrine ...

#### On tapering

As market perceptions of the prospects for the economy vary, so too should expectations of the pace and duration of asset purchases  
**(March 2013)**

#### On employment

It will be a long road back to a healthy job market. It will be years before many workers feel like they have regained the ground lost since 2007  
**(February 2013)**

#### On communicating

I believe further improvements in the Federal Open Market Committee's communication are possible, and I expect they will continue  
**(April 2013)**

Ms Yellen, a strong proponent of the Fed's ultra-loose monetary policy, said yesterday the economy had made progress, but had further to go. "The Fed has powerful tools to influence the economy and the financial system, but I believe its greatest strength lies in its power to approach important decisions with expertise and objectivity."

Ms Yellen will be the first woman to lead the Fed. Her nomination will now go to the Senate where she is expected to be confirmed. The president also paid tribute to Ben Bernanke, the outgoing chairman,

The no-taper side of the FOMC 'viewed incoming data as having been on the disappointing side'

saying that he had led "the Fed through some of the most daunting economic challenges of our lifetime".

According to the minutes, the no-taper side of the FOMC "viewed incoming data as having been on the disappointing side", feared the effects of higher interest rates on housing markets and downgraded its economic forecasts.

Those on the FOMC who wanted to taper thought that recent data were in line with guidance the Fed gave in June and worried about the reaction should there be no slowdown in purchases. "Concerns were expressed that a delay could potentially undermine the credibility or predictability of monetary policy," say the minutes.

**Future of the Fed, Page 2**  
**Obama steps up debate, Page 3**  
**Editorial Comment, Page 8**  
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## US fears lift default insurance market

By Tracy Alloway and Vivianne Rodrigues in New York

Growing fears that Washington could miss a payment on its debt have led to a surge in activity in the once-sleepy market for derivatives which insure against a US default.

Average daily trading of credit default swaps, which give investors protection on US government debt, has jumped to €150m in the past week from about €1.6m in recent months, according to the trading desks of two major European banks.

With the government shutdown now in its second week and no sign of a deal before October 17 – the day the US Treasury has said it will run out of funds to meet its debt obligations – the surge in CDS trading is the latest evidence that stress is creeping into markets.

For investors, buying CDS can either be an insurance policy on a country's debt or a way of making a speculative bet on the market's perception of the sovereign's creditworthiness. Sellers of the CDS contracts have to compensate buyers of the derivatives when a credit event, such as a sovereign default, occurs.

The spike in trading activity is unusual for US sovereign CDS, which is traditionally a thinly traded market.

"It's pretty incredible to see this market suddenly going from zero to 100 in just one week," said one CDS trader.

The cost to insure €10m worth of US government bonds over a year has jumped more than tenfold, from about €6,000 in recent months to €66,000 yesterday, according to prices from Markit, the data provider. At the same time the banks which make markets in CDS have sharply increased their activity in contracts on US government bonds.

Investors continued to sell off Treasury securities that they deem most vulnerable to a missed payment. The yield on the Treasury bill maturing on October 17 jumped to 38 basis points on Tuesday, up from less than zero in September.

### Gaza gas push



A long-mooted \$1bn project to develop gasfields off the Gaza Strip is being revived in a drive to develop the economy of the Palestinian Territories. Benjamin Netanyahu's government is 'very supportive' of the project, which would see the fields exploited on behalf of the Palestinian Authority by investors led by BG Group, an Israeli official involved in the deal told the Financial Times.

Report, Page 6

## Defence groups agree \$75bn of sweeteners to win big contracts

By Carola Hoyos in London

Western defence companies have agreed \$75bn of sweetener deals, ranging from helping Omani fishermen to financing an Emirati beachfront metropolis, to win lucrative arms contracts, a Financial Times investigation has found.

The FT probe – based on data provided by IHS Jane's, the defence industry analyst reveals the scale of the outstanding promises or "offsets" made by the world's 12 largest defence companies to win orders from countries seeking investment, jobs and technology.

Defence companies have traded Tunisian olive oil for military transport aircraft; invested in fledgling airlines in Kazakhstan and Jordan; created a domestic aerospace industry for Turkey; and sent the first Malaysian astronaut into space.

In Oman, BAE Systems satisfied part of its offset obligation by luring fish to big, brightly coloured buoys, easing the work of local fishermen.

Lockheed Martin alone is on the hook for at least \$27bn of offset deals – 10 times its net profit last year – while Boeing has \$12.6bn of such obligations and Raytheon has \$7.9bn. In Europe, EADS has the biggest obligations with \$7.6bn in promises, while the UK's BAE Systems and Sweden's Saab have pledged close to \$4bn each.

The numbers represent the value assigned by governments to companies' outstanding obligations under the side deals. Their actual costs vary and depend on how each company chooses to fulfil its obligation to benefit the local economy.

Executives say these side deals are increasingly crucial to winning big defence contracts

as developing countries rank bids by companies' willingness to commit billions of dollars to their economic development.

Penalties for not delivering on side deals – which can run into the tens of millions of dollars – are kept even more secret than the deals themselves. In 2010 alone, Greece applied penalties to 70 offset programmes, while in India 13 of 18 offset contracts agreed between 2005 and 2013 were subject to penalties.

Fears over these deals goes beyond the boardrooms of the big defence contractors. Critics – including the US government, EU, World Trade Organisation and campaign groups such as Transparency International – say they distort the market, leading governments to order arms they do not need, and create opportunities for corruption.

In the spotlight, Page 16

### World Markets

STOCK MARKETS	Oct 9	prev	%chg
S&P 500	1653.53	1655.45	-0.12
Nasdaq Comp	3668.53	3694.83	-0.71
Dow Jones Ind	14785.55	14776.53	+0.06
FTSEurofirst 300	1224.71	1231.27	-0.53
Euro Stoxx 50	2904.73	2903.35	+0.05
FTSE 100	6337.91	6365.83	-0.44
FTSE All-Share UK	3379.25	3392.75	-0.40
CAC 40	4127.05	4133.53	-0.16
Xetra Dax	8516.69	8555.89	-0.46
Nikkei	14037.84	13894.61	+1.03
Hang Seng	23033.97	23178.85	-0.63
FTSE All World \$	(u)	249.35	-

CURRENCIES	Oct 9	prev	Oct 9	prev	
\$ per €	1.352	1.360	€ per \$	0.740	0.735
£ per €	1.593	1.611	£ per \$	0.628	0.621
¥ per €	0.848	0.844	¥ per £	1.179	1.185
¥ per \$	97.2	97.0	¥ per €	131.4	131.8
¥ per £	154.8	156.1	£ index	82.3	82.9
\$ index	85.1	84.6	€ index	95.96	95.97
Sfr per €	1.230	1.228	Sfr per £	1.450	1.455

INTEREST RATES	price	yield	chg
US Gov 10 yr	98.66	2.66	0.02
UK Gov 10 yr	96.15	2.70	0.00
Ger Gov 10 yr	101.64	1.82	0.00
Jpn Gov 10 yr	101.32	0.66	0.00
US Gov 30 yr	98.17	3.73	0.03
Ger Gov 2 yr	100.14	0.18	0.00
	Oct 9	prev	chg
Fed Funds Eff	0.08	0.08	-
US 3m Bills	0.05	0.05	-0.01
Euro Libor 3m	0.16	0.16	0.00
UK 3m	0.51	0.51	-

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Separate section



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## OFFSETS IN THE SPOTLIGHT

Sweeteners offered by contractors to win big military orders overseas are becoming increasingly burdensome, writes **Carola Hoyos**, and will start to attract the attention of investors and regulators

# Defence pledges come home to roost

For the past few years, BAE Systems, Europe's biggest defence contractor, has reaped some of its biggest dividends from an investment that has nothing to do with military equipment.

Eager to sell radars to Kazakhstan, BAE in 2001 improved its offer by agreeing to help President Nursultan Nazarbayev start a domestic airline.

In the end, Moscow intervened and BAE never sold the equipment to Kazakhstan. But, unusually for these sorts of side deals, its 49 per cent stake in Kazakhstan's Air Astana became one of the company's highest-yielding investments.

Even when successful, defence executives and government officials only reluctantly talk about such deals. But keeping these sweeteners shrouded in secrecy may prove increasingly difficult as they become the main weapon for defence companies battling to overcome the sharp downturn in western military expenditure.

In the past three years, Nato countries have cut \$120bn from their combined defence budgets and executives expect tough times to continue for another decade. This has led to companies aggressively expanding overseas, courting countries that demand the kind of side deal – or offset – that BAE made in Kazakhstan.

Over the next decade, the global value of the offset market is expected to reach \$500bn, according to Avascent, the management consultant. And countries are becoming far more sophisticated in their demands, threatening sizeable fines for non-compliance.

Christian Scherer, chief salesman for the defence side of EADS, the pan-European aerospace and defence company, says that offering countries flexible offset deals was part of his company's DNA.

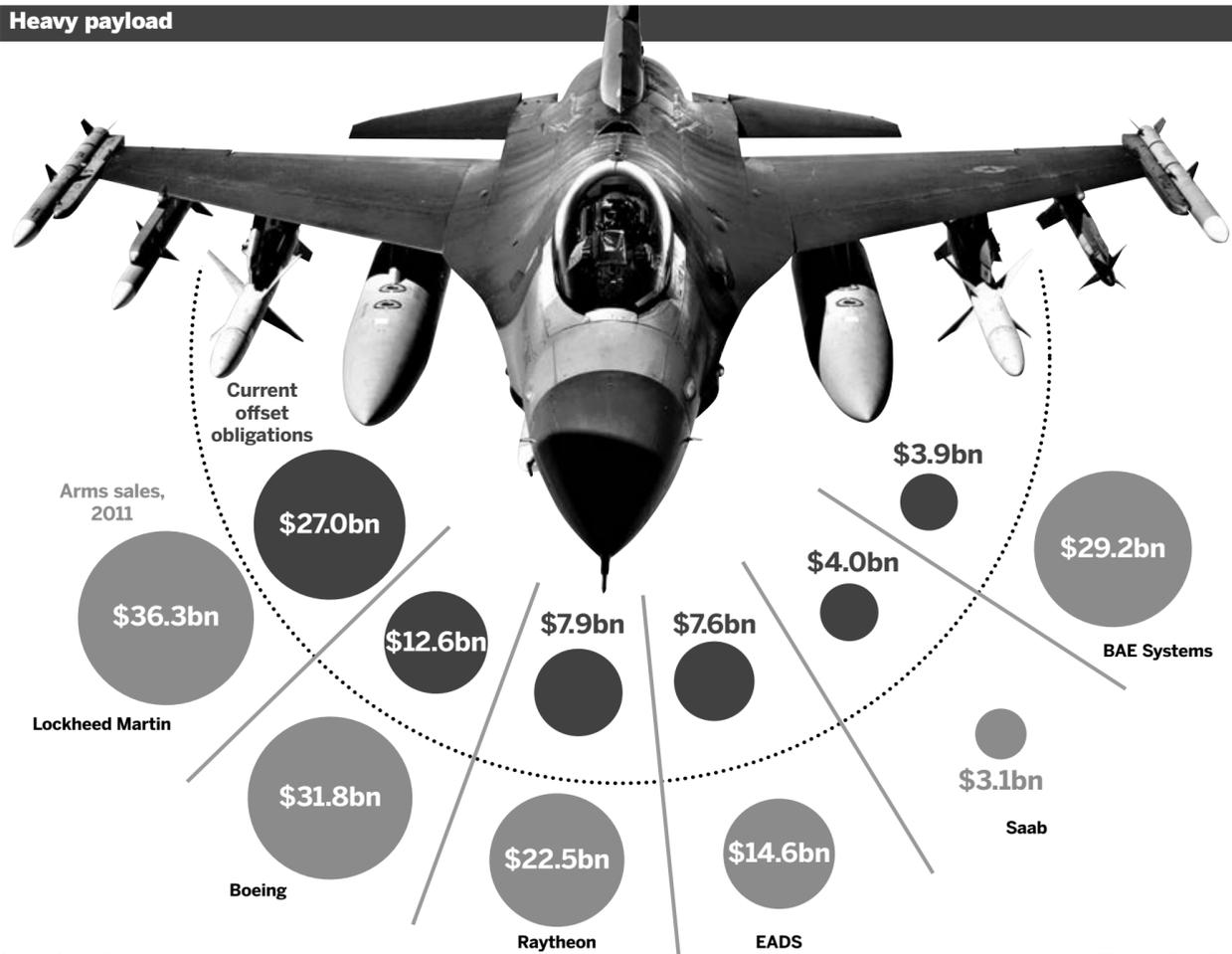
"Clearly the high growth countries today that we are all courting are setting pretty high hurdles for contractors in terms of offsets," he says.

Few companies reveal the extent of this business to their investors and most do not include it in their annual report's list of risks, even though they are on the hook for millions of dollars in potential fines if they fail to keep their promises.

But the Financial Times, using data provided by analysts at IHS Jane's, has for the first time calculated the relative size of the obligations to which top western defence companies have agreed. Even with a very conservative methodology, their total obligations are more than \$75bn, with Lockheed Martin of the US leading the pack at \$27bn and EADS topping the European rankings with a \$7.6bn obligation.

Grant Rogan, founder of Blenheim Capital, which advises both companies and governments, says the industry is at a turning point.

## Heavy payload



Sources: IHS Jane's; Sipri

FT graphic Photo: Getty

Mechanics to track, manage and report offsets have not kept up with their growth

"Because of the sheer size and magnitude of the growth right now, there's going to have to be a greater deal of transparency on the part of both sides: the buyer and the seller. And it is going to happen through self-regulation or it will come down to imposed regulation," he says.

That could prove tough for some. Jon Barney, partner at Avascent, compared the task of measuring offset obligations to pouring sand from a dump truck into an hour glass.

"I don't think anyone expected offsets to become as big as they are today. The mechanics to track, manage and report offsets have not kept up with their growth," he says.

The contest between western defence groups looking to

country the best offset deal is fierce: competing with powerful state-owned defence companies in Russia and China is even more difficult.

Guy Anderson, analyst at IHS Jane's, says it is difficult for western companies to match their state-owned competitors' freedom of manoeuvre.

"To win the Algerian orders, Russia forgave billions of dollars of sovereign debt and opted for energy exploitation rights in lieu of straight cash returns," he says. "To put a deal like that together, it helps when your major banks; energy companies and defence giants are all under state control."

Offsets come in two forms, direct and indirect. BAE's Kazakh investment is an example of an indirect

offset, because it had no direct link to the radar it was trying to sell.

Other indirect offsets include Raytheon, the missile maker, setting up a shrimp farm in Saudi Arabia; a group of defence companies helping the UAE buy 10,000 European petrol stations and five refineries; and EADS's offer to help South Korea kick start its civil aerospace industry if the country buys the European company's Typhoon jet fighter.

While indirect offsets can be costly in the short term, direct offsets, which force defence companies to shift much of the eco-

Direct offsets often require local manufacture



## The good, the bad and the ugly ...

### United Arab Emirates

Defence company executives fear they have exposed themselves to millions of dollars of penalties in the United Arab Emirates after signing investment agreements that may now prove difficult to fulfil.

When Abu Dhabi, the most powerful and wealthiest of the emirates, went on its recent \$25bn shopping spree, defence companies signed ambitious sweeteners – so-called offset agreements – to set up local joint ventures that would create high-paying jobs for locals, while generating profit and export revenue.

Analysis of contracts signed between the UAE and western defence companies suggests the emirate values the companies' outstanding offset obligations at more than \$15.4bn.

The UAE also seems serious about holding companies to their promises, demanding bank guarantees of 8.5 per cent of the value of the offset.

Raytheon, Lockheed Martin and Boeing of the US, and Europeans Thales, EADS, Finmeccanica and Rolls-Royce all have significant exposure to the UAE having signed deals there recently.

People with experience in the country's offset market say the UAE's demands have become unrealistic because too many companies are chasing joint ventures in an economy not big enough to cater for them all in the timeframe set by the regulations. One analyst said it was akin to requiring a Silicon Valley start-up fund to have a 100 per cent success rate, meaning that every one of

its investments turns a profit within a few years. Christian Sylvain, head of Ecco, a European offsets group, says the UAE's finite ability to absorb all its offsets has much to do with the lack of qualified emiratis. "There is only so much wooden furniture you can make in the desert," he said.

A meeting last month of defence executives and emirati officials in London was one of the first signs that Abu Dhabi is willing to entertain the companies' concerns. "This time, the outcome is less certain," says one person who was at the table but declined to be named. He added that the first offset projects had failed to meet the new target deadlines, but that companies were still waiting to hear whether the UAE would enforce the corresponding penalties.

Many countries have tried to use offset programmes to create an indigenous defence industry, but Turkey is one of the closest to succeeding. Despite persistent doubts about the efficiency of the country's defence industry and the realism of its ambition to be self-sufficient, Turkey's 30-year journey has yielded an indigenous capability other developing countries are still far from matching.

Ankara had coveted the ability to rely on its own defence industry ever since it was put under an arms embargo following its invasion of Cyprus in the 1970s. It began the process in 1984 with a deal for the purchase of 160 F-16 fighter jets from General Dynamics of the US.

Under the accompanying offset agreement, General Dynamics subcontracted the assembly of all but eight of the aircraft to a newly formed Turkish aerospace company, Turkish Aerospace Industries (TAI). TAI eventually grew to about 4,000 employees assembling 46 F-16s for the Egyptian Air Force and upgrading Jordan's and Pakistan's fleet of fighter jets. TAI's growth has helped spawn other Turkish defence companies co-producing helicopters, armoured fighting vehicles and submarines. "TAI has been a successful investment for Turkey," says Haldun Solmaztirk, a retired Brigadier General of the Turkish Army. Indeed, in 2012, Turkish defence exports reached \$1.2bn, a 35.7 per cent increase from 2011, putting the country among the world's top 20 defence exporters.

But the country's defence industry can still not sustain itself. "If you look at Turkish aerospace and defence exports, historically up to 80 per cent of exports are linked to offsets," says Guy Anderson, analyst at IHS Jane's, the consultants.

"If you removed all offsets today, it would be like removing life support."

Reporting by Carola Hoyos, Antoine Amann and Daniella Tsar

Turkey's defence industry still cannot sustain itself

When in the 1990s South Africa agreed a \$4.8bn deal to buy warships, aircraft and submarines from Germany, Sweden, Italy and the UK, the companies involved promised to create 65,000 jobs and to generate revenue almost four times the cost of the military equipment.

But those benefits never materialised, academics and former South African politicians say.

J Paul Dunne and Guy Lamb of the University of Cape Town, wrote a study that concluded in 2004 there were "considerable doubts about whether South Africa as a whole has or will benefit from the deal".

Instead, several senior officials and politicians were accused of having received bribes and a study by the attorney-general found unlawful practices in the evaluation of the bids, according to Transparency International, the campaign group.

The South African government's final investigation, however, found no evidence the government as a whole had acted improperly or unlawfully, TI noted.

Andrew Feinstein, a former deputy, has become an outspoken critic of offsets. "I think it's worth saying that there's a fairly extensive academic literature that suggests that there have been some offsets successes in more advanced industrial countries as a result of arms deals, but that in developing countries the results have tended to be disastrous for the buying country," he says.

Reporting by Carola Hoyos, Antoine Amann and Daniella Tsar

### South Africa

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Reporting by Carola Hoyos, Antoine Amann and Daniella Tsar

benefits of producing their equipment to the country buying it, have a more pernicious long-term effect.

The end goal for many countries demanding direct offsets is the creation of their defence industry. Turkey, Brazil and India insist defence companies manufacture part of their equipment domestically to build up the nations' supply chains and labour pool, while also handing over valuable technical knowhow and intellectual property.

Fabrizio Giulianini, chief executive of Selex ES, the defence electronics arm of Italy's Finmeccanica, says industrial participation is unavoidable. "We have to do it. We would be very happy to ship it [from Italy] but unfortunately we can't," he says, adding that the secret to survival is to come up with new technologies faster than they give away the old ones.

Even in the shorter term, building complex defence equipment in foreign countries adds costs and creates quality control challenges – as France's Dassault Aviation is finding amid protracted negotiations with India over where and how to build a \$10bn fleet of Rafale fighter jets.

The most efficiently addressed local demands add costs of 3 to 5 per cent to a contract, but bad management can quickly make them spiral beyond the 7-10 per cent profit margin on big deals, defence executives say.

But the reputational costs of direct and indirect offsets can be even greater, analysts say. Critics argue that offsets prompt governments to spend money they do not have on weapons they do not need and that the secrecy surrounding them creates havens for corruption and bribery.

Offset deals have also sparked corruption investigations into politicians and defence companies in Portugal, India, South Africa and Austria.

"Without a doubt, offsets pose a material risk to investors," says Mark Pyman, director at Transparency International. "It would be well in the interest of shareholders, the overall integrity of the defence industry and ordinary citizens if offset transactions were disclosed."

The US Department of Commerce is worried enough about how offsets demanded outside the US accelerate the shift of jobs, technology and tax revenue from west to east, that it closely monitors and measures the trend.

Europe is behind the curve, says Christian Sylvain, who heads Ecco, the closest thing Europe has to an offsets trade group. "Each time a country requires localisation of production or a transfer of technical knowhow, we are losing a part of our GDP, 75 per cent of which is based on knowhow," Mr Sylvain says.

## Contracts & Tenders

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Project In-charge

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## MORE AT FT.COM/OFFSETS

In-depth For full coverage of the FT's investigation

Portuguese probe Corruption allegations surrounding Portugal's 2004 purchase of a pair of submarines from German contractors HDW, Ferrostaal and Thyssen for €1bn have prompted two investigations

Q&A For an explanation of offset agreements, why they have so many opponents and why companies compete with each other to offer them to countries in the Middle East, Asia and Latin America in particular

Methodology Most defence companies do not reveal the value of offset obligations and the few that do use proprietary and differing methodologies. Therefore our study took a bottom-up approach

Timeline For a history of defence offsets, from moves by US President Dwight Eisenhower after the second world war to present-day needs in the Middle East and Asia, go to [www.ft.com/offset-history](http://www.ft.com/offset-history)

Slideshow For a breakdown of offset obligations by company, including such industry leaders as BAE Systems, Boeing, Dassault, Lockheed Martin and others, go to [www.ft.com/offset-investigation](http://www.ft.com/offset-investigation)

Video What do a UK-based fisheries consultancy and Malaysia's first astronaut have in common? Their origins lie in big arms deals. Defence correspondent Carola Hoyos explores the opaque world of offsets, set to become a half-trillion dollar industry [www.ft.com/video](http://www.ft.com/video)