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Israel's new strategy in Gaza battle

Ground attack aims to avoid a recurrence of Lebanon mistakes

By Charles Levinson

ON THE GAZA BORDER—Israeli tanks and troops pushed deep into the Gaza Strip on Sunday, committing to a large-scale ground invasion that risks significant casualties on both sides, but departs sharply from the playbook used in Israel's largely unsuccessful war against Hezbollah in Lebanon two years ago.

Crossing borders

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- Egypt's President Mubarak faces pressure to open the border crossing to Gaza......................7

The land attack, which began Saturday night, followed eight days of aerial and sea bombardment. It marks a dramatic escalation of an Israeli offensive that Palestinian hospital officials now say has left more than 500 Gazans dead and more than 2,200 wounded.

Israeli officials confirmed Sunday that one Israeli soldier died in the weekend ground operation. Another 30 soldiers were injured, two critically, the military said. Four Israelis, including three civilians, have died in Gaza-launched rocket attacks on southern Israel.

The ground invasion significantly heightens regional tensions, which had already escalated dramatically amid Israel's week-long aerial bombardment. Across the Middle East, widespread popular protests have flared against the military action—and against the governments of some moderate, Western-leaning Arab states such as Egypt, which have been criticized for not acting to stem the violence.

The conflict is also deepening the divide between moderate Arab leaders, backed by the U.S. and Western powers, and their more extreme rivals, including Hamas and Hezbollah, both backed by U.S. foes Iran and Syria.

Israel launched the offensive, one of the deadliest Israeli assaults on Palestinians yet, in response to intensified rocket attacks by Hamas against southern Israeli communities, following the expiration in December of a six-month cease-fire.

Associated Press

Israeli infantry soldiers take position on the border before entering the Gaza Strip Sunday.

In the clearest break from a strategy it used to pursue Hezbollah militants in Lebanon in 2006, Israeli leaders have set out clearly defined—and relatively modest—expectations for the current Gaza offensive. Two years ago in Lebanon, Is-

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What's News—

Business & Finance

Volkswagen and BMW are gearing up to expand their share of the U.S. auto market as Detroit's Big Three struggle. VW expects to triple U.S. sales to one million vehicles by 2018. BMW plans to add a small car and expand the company's distribution network. Page 1

■ **Britain's markets** regulator may impose costlier rules on banks, abandoning its previous light touch. Page 1

■ **U.K. borrowing** and house prices continued to weaken at year end, suggesting further rate reductions. Page 2

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■ **Merkel's bid to shield** Germany from the global downturn is being complicated by a rift over tax cuts within the chancellor's ruling coalition. Page 2

■ **Manufacturing activity** globally shrank in December, suggesting the recession will extend well into 2009. Page 6

Markets

MARKET	CLOSE	NET CHG	PCT CHG
DJIA	9034.69	+258.30	+2.94
Nasdaq	1632.21	+55.18	+3.50
DJ Stoxx 600	204.46	+7.56	+3.84
FTSE 100	4561.79	+127.62	+2.88
DAX	4973.07	+162.87	+3.39
CAC 40	3349.69	+131.72	+4.09
Euro	$1.3930	+0.0027	+0.19
Nymex crude	$46.34	+1.74	+3.90

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World-Wide

Israeli tanks and troops pushed deep into Gaza in a ground invasion that risks significant casualties on both sides, but departs from the playbook used in Israel's largely unsuccessful war against Hezbollah in Lebanon. The land attack marks an escalation of an offensive that Palestinian officials say has killed over 500 Gazans. Page 1

■ **Anti-Israel outpourings** in Iran could be a distraction for Ahmadinejad as he faces criticism of his policies. Page 7

■ **New Mexico Gov. Richardson** withdrew his nomination to be Obama's commerce secretary amid a grand jury investigation into how some of his donors won a state contract. WSJ.com

■ **U.S. and Pakistani** military cooperation has increased as the nations push to eliminate militants destabilizing the Afghan-Pakistani border. Page 8

■ **A suicide bomber blew** herself up among pilgrims worshipping at a Shiite shrine in Baghdad, killing at least 38 people.

■ **Opposition leader** John Atta Mills was declared Ghana's new president in a close election.

■ **A French naval vessel** thwarted two pirate attacks on cargo ships in the Gulf of Aden.

Editorial & Opinion

The stakes in Gaza

Israel's success—or failure—will shape Barack Obama's diplomacy with Iran. Page 9

Britain's FSA begins to drop its light touch

By Alistair MacDonald

LONDON—For years, the U.K. sought to demonstrate to the rest of the world that freeing banks from intrusive rules and oversight was the best way to build a financial system. Now, after putting up billions of pounds to bail out its banks, it's opting for a heavier hand.

To the chagrin of some of the banks and executives under its watch, Britain's markets regulator, the Financial Services Authority, is becoming a lot more demanding. It's requiring some of the country's largest banks to provide it with weekly disclosures on risk and performance, compared with the monthly, or even quarterly, requests before the U.K. was rocked by the credit crunch. It's beefing up its staff of supervisors and levying more fines. And it's planning to introduce new rules that it says could cost billions of pounds and "significantly reshape" banks' business models.

While many regulators are taking a tougher stance, the FSA's change of tack stands out because its light-touch approach had long been held up as a model—and as a key factor in London's high regard as an international financial center.

In the past year, though, the FSA has come under criticism, in part for failing to see the warning signs that ultimately forced the government to nationalize two banks and pledge some £500 billion, or more than $700 billion, to keep the sector

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Europe car makers target vulnerable U.S. market

By Kate Linebaugh

Struggling Big Three auto makers, accustomed to intense competition from their Japanese rivals, face a new challenge from European auto makers.

Sensing opportunity in Detroit's weakness, **Volkswagen** AG and **BMW** AG of Germany are gearing up to expand market share in the U.S. in the next few years.

VW is investing in its first U.S. factory in two decades and expects to triple U.S. sales to one million vehicles by 2018. BMW is introducing a new small car and expanding its distribution network.

"The U.S. will be the growth engine of the future," Jim O'Donnell, BMW's U.S. chief, said in a recent interview. "This is where we will continue to focus our efforts."

To be sure, the Europeans have gone this route before. VW opened a U.S. car factory in 1978 and closed it 10 years later due to quality problems, high costs and slow sales. Renault SA of France bought a 46% stake in American Motors but withdrew in 1987 after heavy losses.

This time, European car markers insist more diverse product lines,

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LEADING THE NEWS

U.K. banks tighten credit

Data show rescue didn't spur lending; new measures sought

BY CARRICK MOLLENKAMP AND ALISTAIR MACDONALD

LONDON—A new U.K. lending survey shows banks sharply tightening credit to households and companies, intensifying worries that the government's £500 billion ($725 billion) bank-rescue plan is failing to get money flowing into the economy.

The report shows banks becoming increasingly conservative in their lending practices, reducing maximum credit lines and cutting the size of mortgage loans as a percentage of home values. Banks said they were scaling back mortgage lending even as demand for new mortgage loans remained stable.

The Bank of England's credit-conditions survey, which covers the period after the bailout plan was announced in October, highlights the difficult balance banks must strike as they try to recover from heavy losses while providing new loans to borrowers. It could also increase pressure on U.K. Treasury chief Alistair Darling to ask taxpayers and politicians to support more financial aid to banks.

Mr. Darling has been considering a number of measures to kick-start lending, a Treasury spokesman said Sunday. "But banks have to understand that with billions of pounds of taxpayers' money invested, or being made available to guarantees to the banks, the public and businesses are looking for something in return," the spokesman said.

Prime Minister Brown is looking at new ways to ease the economic slowdown.

The different options under consideration underscore how regulators and banks still are trying to identify the best formula to shore up the financial sector. One option is to extend government guarantees to the loans banks make to companies, or to the securities into which banks bundle assets, such as mortgage and car loans.

The Treasury also has considered creating a so-called bad bank to buy hard-to-sell assets, or injecting more cash into banks in what would be a second round of recapitalizations, a person familiar with the matter said. The bad bank, though, is low on Treasury's agenda, the person said. A fresh cash injection would face serious political opposition after the government already put some £37 billion into three of the country's biggest banks.

Prime Minister Gordon Brown, meanwhile, is looking at new ways to ease the economic slowdown. He has promised to create up to 100,000 jobs by spending on schools, hospitals, infrastructure and environmental industries, a spokesman said. The plan is part of a stimulus package, announced last year, that will include an increase in public investment of £10 billion over two years.

In one bright spot, fewer banks said they were cutting back on corporate and mortgage lending in the final three months of 2008 than in the previous three months, suggesting the tightening might be slowing.

Merkel's stimulus plans await tax-cut decision

BY MARCUS WALKER

BERLIN—German Chancellor Angela Merkel's search for policies to shield Europe's biggest economy from the global downturn is being complicated by a rift over tax cuts within her fractious ruling coalition.

Ms. Merkel's bipartisan coalition begins talks on Monday about new fiscal-stimulus measures to boost domestic demand, to compensate for Germany's dwindling exports to a weakening world economy. The government's response is likely to focus on investments in roads, schools and other public works. But Ms. Merkel's partners are squabbling over whether to cut taxes too as politicians position themselves for national elections due this fall.

Angela Merkel

Germany is aiming to unveil its latest fiscal-stimulus package in mid- to late January, in response to a clamor from business, politicians and economists at home and abroad for Europe's industrial powerhouse to do more to lift the Continent's battered economy.

Germany already presented a stimulus package in November, maintaining it was worth €31 billion ($43 billion), but analysts said genuinely new spending amounted to only €4 billion in 2009—too little to rescue growth in the country's €2.5 trillion economy.

Amid warnings from economists that Germany faces its longest and deepest recession since World War II, Ms. Merkel has since accepted that more needs to be done.

Her next challenge is to bridge the gulf in her cabinet over what to do. Bavarian conservatives, who are allied with Ms. Merkel's center-right Christian Democrats, have threatened to block the stimulus package unless it includes significant income-tax cuts. The center-left Social Democrats, or SPD, who control the finance ministry, are opposed to income-tax cuts that they say wouldn't benefit millions of lower-income households that aren't subject to income tax.

"We are heading into the negotiations with a clear position: The SPD says no to tax cuts," the Social Democrats' deputy leader Andrea Nahles told mass-circulation tabloid Bild am Sonntag. Instead, Social Democrats want measures to cut the monthly levies that Germans pay for health, pension and unemployment insurance.

All parties in Ms. Merkel's coalition are eager to present the stimulus package as a victory for their own voters as Germany gears up for national elections in September. Social Democrats badly need to raise their popularity after falling far behind conservatives in opinion polls. Ms. Merkel needs her Bavarian allies to win more voters if she is to win the country in the fall—but she also needs a speedy agreement with the Social Democrats, her main rivals, to avert an economic slump and soaring unemployment.

Unlike the U.K., Spain and many other European countries, Germany didn't have a housing or consumer-credit bubble. Germany's public finances are also relatively strong. Many economists say those favorable factors put Germany in a position to raise its domestic demand through higher public spending or lower taxes, thereby giving the whole European economy a lift.

But Germany, which has grown almost entirely through exports in the past decade, has been reluctant to relax its tight fiscal policy after years of strenuous efforts to balance its budget.

Marketplace

Smoke screens

Europe undermines its own laws that keep people from lighting up > **Page 25**

Belarus devalues its currency

ASSOCIATED PRESS

Belarus's central bank sharply devalued its ruble Friday, allowing the currency to fall 20% to help stop the hemorrhaging of its reserves.

The National Bank said the devaluation was also aimed at raising the competitiveness of the Belarusian economy, which has been battered by the global financial crisis. It also was a condition of a $2.5 billion loan from the International Monetary Fund announced on Dec. 31.

The devaluation will make imported goods to the largely government-controlled economy more expensive and likely will speed inflation.

In the past six months, the National Bank has spent about a quarter of its gold and hard-currency reserves keeping the Belarusian ruble stable against the dollar, euro and Russian ruble. The bank said its reserves stood at $3.8 billion on Dec. 1.

CORRECTIONS & AMPLIFICATIONS

Marcelo Trindade, a lawyer and former chief of Brazil's market regulator, said that if Brazilians invested undeclared money in a U.S. investment fund run by Bernard Madoff that collapsed, they are unlikely to step forward. A Money & Investing article Tuesday incorrectly quoted him as saying that monies from Brazilian investors weren't declared to tax authorities. That hasn't been determined.

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This index of businesses mentioned in today's issue of The Wall Street Journal Europe is intended to include all significant references to companies. First reference to these companies appear in boldface type in all articles except those on page one and the editorial pages.

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INDEX TO PEOPLE

This index lists the names of businesspeople and government regulators who receive significant mention in today's Journal.

For more people in the news, visit CareerJournal.com/WhosNews

Gas users feel disruptions

Russia and Ukraine point fingers as flow to six states declines

BY ANDREW OSBORN

MOSCOW—Russia's dispute with Ukraine over natural-gas prices descended into counterclaims and legal threats at the weekend as six European countries downstream said they had begun to record slight supply disruptions.

Russia's OAO **Gazprom** halted deliveries to Ukraine, a major transit country, on Jan. 1 after talks to negotiate a new supply contract for this year broke down amid a price dispute.

Since then, Poland, Hungary, Romania, Turkey, Bulgaria and the Czech Republic have reported slightly reduced supply. Gazprom says it is pumping extra gas via Belarus and Turkey to ensure supply, while Ukraine says it is using its reserves to maintain transit volumes. The European Union gets 80% of its Russian gas imports via Ukraine.

The dispute has forced both Russia and Ukraine to defend their reputations as reliable energy suppliers and evoked memories of 2006, when a similar dispute led to more serious supply disruptions in Europe.

The two countries spent the weekend trading recriminations and lobbying to persuade the international community that they are in the right. Each said the other was to blame for a shortfall of about 50 million cubic meters that apparently failed to reach European consumers during the weekend. That is about a sixth of what Russia pumps to Europe every day.

Gazprom said it had gotten President Dmitry Medvedev's approval to bring a case at the International Arbitration Court in Stockholm against Ukrainian state gas company **Naftogaz Ukrainy** to ensure unimpeded transit. In a statement, it said it would file the case "in the near future." Naftogaz said in a statement that it would counter file at the same court if Gazprom went ahead.

Bohdan Sokolovsky, an economic aide to Ukrainian President Viktor Yushchenko, warned that the dispute could trigger more serious supply shortfalls in Europe in 10 to 15 days if a deal isn't struck.

Lobbying efforts centered on Prague and the Czech government, current holder of the European Union's rotating presidency. The EU so far has refused to arbitrate, calling on Russia and Ukraine to settle their differences bilaterally. An extraordinary meeting of EU envoys is scheduled for Monday to exchange information on the situation. Russia says it sees no need for EU arbitration. Gazprom has, however, written to the European Commission to ask it to monitor the gas-supply situation.

For his part, Ukraine's President Yushchenko wrote to eight world leaders on Friday, including U.S. President George W. Bush, putting forth Kiev's side of the story, according to Ukrainian diplomats.

Ukraine paid $1.5 billion in unpaid bills for 2008 to an intermediary company that is 50%-owned by Gazprom, by Dec. 31. But Sergey Kupriyanov, a Gazprom spokesman, told a news conference Friday the Russian gas monopoly didn't expect to get the funds until Jan. 11. He said Ukraine owed a further $614 million in late-payment fines; Ukraine says it owes no late fees.

In 2006, a similar dispute caused shortfalls in Russian supplies of as much as 50% across Europe, although a deal was struck quickly under heavy pressure from EU governments. Russia on that occasion was widely accused of using gas as a political weapon to punish Ukraine's pro-Western government, a charge Moscow denied and has made efforts to avoid this time.

Late Sunday, face-to-face talks between the two sides had yet to resume. Talks broke down on New Year's Eve after Ukraine rejected a Russian proposal that Ukraine should pay $250 per thousand cubic meters in 2009, up from $179.50 last year, but around half the price paid by EU countries. Ukraine was proposing a smaller increase to $201 but has since said it is ready to pay $235.

After saying on Thursday that it now wants Ukraine to pay $418 per thousand cubic centimeters of gas, Gazprom upped the ante again on Sunday. Chief Executive Alexei Miller said the company now wants Ukraine to pay $450, equivalent to what its closest EU neighbors pay, less transit across Ukraine. He said he hoped that price would bring the Ukrainians back to the negotiating table.

In a statement Saturday, Naftogaz Chairman Oleg Dubyna said accepting an earlier Gazprom offer of $418 would spark a "humanitarian catastrophe" in Ukraine. The country's inefficient Soviet-era domestic heating systems and industries are heavily reliant on Russian gas imports.

Ukraine said, however, that its large gas-storage capacity is full, allowing it to weather a cutoff longer than in 2006, when the Russian cutoff was felt almost instantaneously downstream in parts of the EU.

In recent years Gazprom has raised gas prices toward world levels for all of its ex-Soviet neighbors, which continued to enjoy heavy discounts after the breakup of the Soviet Union. Less compliant neighbors, such as Georgia, now must pay full price, while allies such as Armenia pay lower rates. The annual negotiations with Ukraine have been particularly difficult, however. Moscow has pressed Mr. Yuschenko's pro-Western government to pay world prices since it came to power in the 2004 Orange revolution, while Ukraine has used its leverage as a critical transit country for Gazprom to reach the rich EU market to push for more gradual increases.

CORPORATE NEWS

From HD to 3-D: the next wave in TV

Consumer Electronics Show to feature effort to bring eye-popping visuals to movies, DVDs and videogames

Animation giants have vowed this year to turn three-dimensional technology from a curiosity to a fixture in theaters. Now comes the attack on homes.

The quest to deliver 3-D versions of television shows, movies and videogames to the living room will be a hot topic at this week's Consumer Electronics Show, which kicks off Wednesday night in Las Vegas. The offerings face some big challenges—including a grim economy and the difficulty of persuading users to wear special glasses associated with most 3-D technologies.

*By **Don Clark, Ben Charny,** and **Jerry DiColo***

Yet some industry executives see the technology as an inevitable step to generate user excitement now that high-definition TV sets are reaching a mainstream audience. "The next big wave is 3-D," says Bob Perry, a senior vice president at **Panasonic** Corp.

Some of the key building blocks have already arrived, and more are expected at CES. Companies including **Samsung Electronics** Co., **Mitsubishi Electric** Corp. and **Hyundai IT** Corp. have begun selling what they call "3-D ready" TV sets. Such new sets and computer monitors refresh images at high speed to help reduce the headache-inducing tendencies of early 3-D offerings.

There isn't much programming yet to exploit the new TV sets. But companies such as **Dolby Laboratories** Inc. and **TDVision Systems** Inc. plan to use CES to discuss new formats to encode and distribute 3-D signals, removing a roadblock to creating content.

Many videogames were created using 3-D modeling techniques, making it easy to render them in three dimensions. Chip maker **Nvidia** Corp., for example, at CES is introducing for $199 special glasses and associated software that it says can play more than 350 existing videogames in 3-D for users with advanced displays. In a demonstration, zombie enemies in one shooting game appear to grab in front of the screen, while players dodge and fire around 3-D bushes and trees.

Nvidia Corp.

Special glasses and other technology from Nvidia allow many videogames to be played in 3-D.

"When you've seen it, you kind of don't want to go back," says Dan Vivoli, Nvidia's senior vice president of marketing.

Simulating three dimensions requires two images, one each for the user's left and right eyes. One approach used since the 1950s distinguishes the images using colored filters in paper glasses. That technology, known as anaglyph, has recently been used with DVD versions of 3-D movies released in theaters.

But consumer-electronics companies want to create a much richer experience in the home, akin to the eye-popping effects being shown in theaters by companies such as **DreamWorks Animation SKG** Inc. and **Walt Disney** Co. Their animated movies exploit a projection technology using polarized light and inexpensive plastic glasses, which creates effects that most viewers prefer over anaglyph technology.

For the home, Nvidia and other companies at CES favor what the industry calls active glasses, with shutters that are synchronized to open and close rapidly with the aid of an infrared emitter. Those approaches require fast-refreshing TV sets or displays and are considerably more costly than the anaglyph or polarized glasses.

The first of the 3-D ready TV sets use a rear-projection technology from **Texas Instruments** Inc. known as DLP. But some companies also have begun selling flat-panel models that can play 3-D content. Samsung, for example, in February began selling a 3-D-ready plasma TV set in a 42-inch version for $1,850 and in a 50-inch model for $2,656.

More high-end 3-D ready models are due this year, according to Samsung executives who spoke at at a recent technology forum in San Francisco, saying the technology could help counter a generally weak market for TV sets.

Panasonic at CES plans to demonstrate a special Blu-ray DVD player that will be able to play back movies with 3-D images, with high-definition quality images for the right and left eyes. Filming in 3-D typically requires at least two cameras placed next to each other.

Getting such signals to homes will take time. Some broadcasters aren't eager to explore 3-D yet because they have just invested to upgrade their networks for high-definition TV and are still waiting for a return on that investment, according to Michael Lewis, chairman of RealD.

There are exceptions. On Thursday, the **British Sky Broadcasting Group** PLC—known as the Sky Network in the U.K.—says it has begun filming some sporting events in 3-D.

But there's no agreement on a standard format for broadcasting 3-D events, nor for storing movies on discs to be played in the home. Movies can be adapted for today's 3-D ready TVs, but studios aren't expected to do so until they can be sure they are compatible with most user equipment, Mr. Lewis says.

Meanwhile, exactly how consumers will react to home 3-D isn't clear. The Entertainment Technology Center, a consortium at the University of Southern California funded by major studios, has set up a lab so that 3-D systems can be evaluated by users.

In a soon-to-be released survey conducted by the center and the Consumer Electronic Association, which sponsors CES, 16% of U.S. adults said they are interested in watching 3-D movies or television programs in their home. That's pretty good considering that few people know anything about home 3-D, says David Wertheimer, the center's chief executive. Nearly 19% of the respondents said they would prefer seeing a film at a theater in 3-D.

—Christopher Lawton contributed to this article.

U.S. consumers plan to cut back on high-tech purchases

BY DON CLARK

More than half of U.S. consumers plan to cut back on purchases of high-tech products this year, according to a survey that adds to clouds hanging over two big trade shows this week.

The findings by Forrester Research, scheduled for release Monday, aren't surprising, given the litany of bad economic news since September. But the online survey of more than 5,000 American adults, conducted in November, provides some of the first specifics about spending choices that consumers are likely to make.

The findings are particularly gloomy for newer categories of devices. Some 66% of respondents, for example, said they were less likely to purchase satellite radios this year because of the sour economy, while 62% said they are less likely to buy a portable Global Positioning System navigation device. Even smart phones, a hot category lately, aren't immune: 63% of respondents said they are less likely to buy one.

More established categories of products also fare poorly. Sixty-two percent of those surveyed said they are less likely to buy a new videogame console, Forrester said.

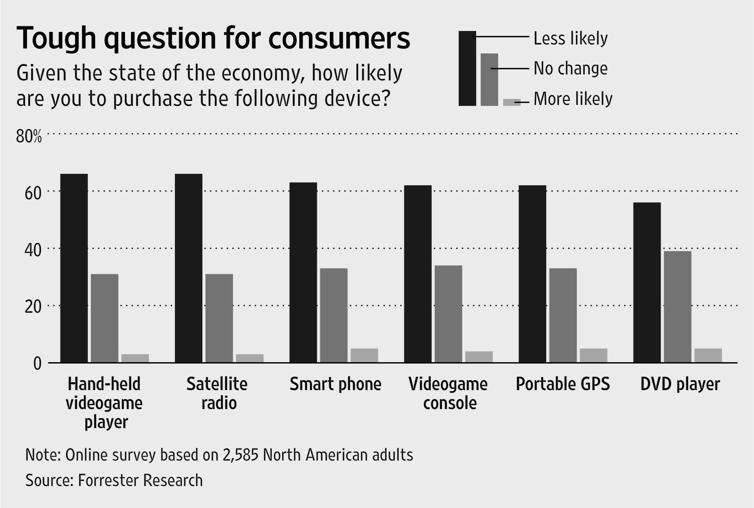
As for personal computers, 45% of respondents said they have delayed plans to purchase new ones, though 40% said they hadn't changed their purchasing plans. Eighteen percent of respondents said they now plan to spend less money on a new system. Television sets fared a bit better, with 44% of respondents saying they haven't changed their plans to buy a new set.

In all, 51% of respondents said they would spend less on technology this year, while 44% said they would spend the same. Only 5% said they would spend more.

"It's pretty grim," said Paul Jackson, a principal analyst with Forrester.

The findings from the Cambridge, Mass., firm are the latest in a series of ominous portents preceding Macworld and the Consumer Electronics Show. The trade shows—in San Francisco and Las Vegas, respectively—are expected to draw hundreds of exhibitors this week despite the tough economic environment.

While the downturn took hold too recently for companies to change plans for introducing products at the shows, many are sending fewer employees while laying plans for new tactics over the course of the year.



Companies such as Forrester and consulting firm Accenture are offering a number of recommendations, including developing fewer, more highly differentiated products and tailoring them to market segments and regions that are relatively recession-resistant.

"There are still some geographies that are performing well," said Marty Cole, chief executive of Accenture's communications and high-tech operating group. "You can't paint it with a broad brush."

Indeed, surveys point to a few signs of strength in the tech sector, particularly in services that consumers feel they can't do without. An Accenture survey found that only 3.7% of U.S. consumers are willing to stop using home Internet access, 8.7% are willing to give up mobile-phone service and just 9.6% are willing to stop using cable or satellite TV services.

Those findings echoed those of the Forrester survey about consumers' commitment to mainstream technology services. But not many people plan to add new services: 58% of respondents said they don't have a digital video recorder service and don't plan to add one, while 69% said they wouldn't add a video rental service akin to that offered by **Netflix** Inc., Forrester said.

"Indications are when it comes time for renewals, people may reduce their service packages," Mr. Jackson said. "That is a long-term danger that may be more keenly felt later."

Gadget makers and service providers can also take solace in signs that consumers will allocate more of their spending to home entertainment. Forrester said 52% of respondents expect to spend less on entertainment outside the home and 56% said they will spend less on eating out. About 58% said they will spend the same amount on entertainment in the home.

CORPORATE NEWS

Ads to go leaner, meaner in 2009

Expect shorter spots, video as marketers cut glitz, get combative

By Suzanne Vranica

With U.S. ad spending expected to fall 6.2% to $161.8 billion this year, marketers and ad firms will be forced to do more with less, say advertising gurus.

ADVERTISING

Evidence that marketers wanted ads to work harder began appearing last year as the economy slipped. Brands such as Microsoft, Burger King, Campbell Soup and Dunkin' Donuts took direct aim at their competitors, a marketing technique deployed more frequently in a downturn. Domino's Pizza is starting 2009 with an aggressive campaign for its Oven Baked Sandwiches that touts results from a taste test claiming consumers prefer its sandwiches to Subway's hoagies.

"Ads have to get combative in bad times," says Nick Brien, chief executive of **Interpublic Group**'s Mediabrands. "It's a dog fight, and it's about getting leaner and meaner."

Industry experts also predict 2009 ad pitches will be less lavish and glamorous. Auto makers' ads will be less prevalent. "Goodbye, A-List spokespeople with unspeakable price tags. Hello, Z-List," says Mark Wnek, chief creative officer of Interpublic's Lowe New York.

Madison Avenue executives say they will deploy a host of other strategies, workarounds and outright gimmicks, from shorter TV commercials to billboards that can see who's looking at them. Here are what ad executives say you will see this year:

Domino's Pizza

U.S. ad spending is falling, and marketers are trying to make spots work harder. Domino's Pizza takes direct aim at Subway in an aggressive new ad.

Short and Sweet

TV ads will emphasize how a purchase will cost you less, and the message will be communicated in less time. Instead of the usual 30-second spots that consumers are used to seeing, expect advertisers to cut back to 15 and even 10 seconds to save money on their ad buys.

—Tim Spengler, president of Initiative, an Interpublic media-buying firm

Less Glitz

Pricey, glitzy ad production will be rare—no problem for the YouTube generation that hasn't been impressed by gorgeous camera work. Hello to video, studio backgrounds and direct-response TV, ads that promote 1-800 numbers. *—Mr. Wnek*

Ads That Watch You

Face-reading technology is upon us. The ability to recognize whether a person looking at a digital sign is male, female, young, old and their ethnicity is here. It will enhance and better align creative to reach its target, thus enabling advertisers to communicate and connect to their consumer.

—Jack Sullivan, director of out-of-home advertising at Publicis Groupe's Starcom

Ads People...Like

People will, amazingly, see more and more advertising they actually like and seek out. It will mean immersive, long-form Internet experiences like Frito-Lay's hotel626.com or Burger King's whoppervirgins.com because, more and more, TV commercials are simply too easy to avoid (and all too deserving of such treatment).

—Jeff Goodby, co-chairman of Omnicom Group's Goodby, Silverstein & Partners

Ivy League Approval

With their endowment funds shrinking and a sudden need for additional revenue streams, look for hallowed institutions of higher learning to endorse consumer brands next year. Well-respected universities in the U.S. would lend credibility to brands in need like financial institutions and automobile manufacturers. *—Mr. Spengler*

Online Tracking

Innovations in location-based services and mobile-phone applications will give consumers more services than Google Maps. People will use Starbucks finders on their cellphones, be able to find friends nearby on Loopt.com, or even search for the nearest toilet at MizPee.com. Local advertisers, such as the neighborhood pizza place, will launch online ad campaigns in 2009 because they can reach customers who are nearby with online ads.

—Tom Bedecarre, chief executive officer of AKQA

Video Explosion

Video will increasingly show up on anything that doesn't move and even some things that do, on cellphones, buses, elevators, fast-food restaurants, billboards and, of course, the Internet. All will be jampacked with more brands.

—Mr. Spengler

Smart Ads

Out-of-home ads will increasingly be linked to use of cellphones and other Web-enabled mobile gadgets. People's growing ability to gather and store information while out and about is critical and necessary for their purchase decisions, and ads will increasingly cater to new information-gathering behaviors. Expect smart signs that will be able to read your grocery-store loyalty cards to offer better sales deals. Also expect digital signs within retail stores that know your wardrobe (because you will let them know that) and will be able to offer up clothing that will match and complement your existing wardrobe. *—Mr. Sullivan*

No Banner Year

Banner ads will be the new junk mail. More and more, reputable companies won't be buying up the space around the Web sites you visit. Clicking these ads will become less and less legitimate as brands will endeavor to do things that add more value to you in the social-media and customer-service space.

—Colleen DeCourcy, chief digital officer at Omnicom's TBWA

Seeing Red

If you were paying attention to the Christmas lights this year, you know red will be the next big color in advertising, taking the throne from orange. *—Mr. Goodby*

U.S. retailers to report grim December results

By Ray A. Smith

When U.S. retailers report December sales on Thursday, the picture won't be pretty.

Sales at stores open at least a year—a key barometer of retail health—are expected to show an average decline of 1.1%, according to analysts' estimates for 35 chains compiled by Thomson Reuters. The reports will likely confirm that the 2008 holiday season was the worst for retailers in decades.

Excluding **Wal-Mart Stores** Inc., which has benefited from a consumer focus on buying necessities as the economy soured, the picture is even grimmer, with December sales falling an average of 6.3%, Thomson Reuters says. Some analysts expect an increase in the rate of gift returns, which could further crimp sales.

The December sales results would likely have been even worse if retailers hadn't slashed prices sharply before and after Christmas to lure shoppers. The discounts "will have turned what would have been a disastrous retail season into a dismal retail season," says Craig R. Johnson, president of Customer Growth Partners, a New Canaan, Conn., retail consulting and research firm.

At **Abercrombie & Fitch** Co., a teen retailer that bucked the discounting trend, sales are expected to have plunged 20% last month, according to Thomson Reuters. That is worse than the expected decline of 14.6% for the teen-and-children's category overall and the 13% drop at **American Eagle Outfitters** Inc.

Among department stores, mid-market chains **J.C. Penney** Co. and **Kohl's** Corp. are expected to post declines of 12% and 5%, respectively, while the estimate for **Macy's** Inc. is a more modest decline of 2%. Chains that sell more-expensive goods are generally expected to do worse. At **Nordstrom** Inc., analysts expect sales to decline 16.5%. **Saks** Inc. is expected to post a decline of 11%.

Wal-Mart, meanwhile, is expected to continue to outperform its competitors, posting a 2.8% sales gain, according to Thomson Reuters. Wal-Mart has benefited from its focus on low prices and its selection of food and more brand names, particularly in electronics.

Spanish car registrations tumble 28% to 11-year low

By Christopher Bjork

MADRID—Spanish car registrations dropped by a record 28% last year to their lowest level in more than a decade.

Car registrations, which are used as an indicator of car sales, fell to 1.16 million from 1.61 million in 2007, Spanish car manufacturers' association Anfac said Friday. The latest figure was the lowest since 1997.

The slump deepened in the second half, including a 50% annual fall from a year earlier in December. In November and October registrations fell 50% and 40%, respectively.

Anfac blamed the drop on tighter financing and an economic downturn that is hurting consumer spending.

Spain's 2008 top seller was **Ford Motor** Co.'s Ford Focus, with 55,837 new vehicles; followed by **Renault** SA's Megane model and **PSA Peugeot Citroën** SA's Citroën C4, each of which sold more than 50,000 vehicles, Anfac said.

Also on Friday, Italy's Infrastructure Ministry said new-car registrations in the country dropped 13.3% to 140,656 vehicles in December.

—Jason Sinclair, Giada Zampano and Liam Moloney contributed to this article.

Losing team weighs NASA protest

By Andy Pasztor

LOS ANGELES—A possible contract squabble threatens to complicate U.S. government plans to rely on commercial-cargo operators who would launch rockets to supply the International Space Station.

A contractor team led by start-up **PlanetSpace** Inc. is considering filing a protest over a contract valued at as much as $1.9 billion that was awarded last month to **Orbital Sciences** Corp., according to people familiar with the details. NASA chose Orbital's proposed commercial-cargo transportation system to provide eight launches. Contracts valued at up to $1.6 billion are slated to go to **Space Exploration Technologies** Corp.

GLOBAL BUSINESS BRIEFS

Intesa Sanpaolo SpA

Home loans are securitized to get central-bank financing

Italian bank **Intesa Sanpaolo** SpA said it has launched a securitization of performing residential mortgage loans valued at €13.05 billion ($18.07 billion) to use as collateral with central banks. The transaction consists of a senior tranche of €12.17 billion and a junior tranche of €876 million. Both classes have been fully underwritten by Intesa Sanpaolo and won't be sold to investors. Such private securitizations highlight how banks have become dependent on central-bank financing.

Enel SpA

Enel SpA applied for a €1 billion ($1.4 billion) loan from the European Investment Bank in December to upgrade Italy's electricity network, according to a filing with the Luxembourg-based lender. The loan is part of a 2009-2011 project valued at €2 billion to €3 billion, the bank said on its Web site. The loan request by Enel was filed Dec. 15. Itay-based Enel borrowed billions of euros to take over Russia's OAO OGK-5, Spain's Endesa SA and Spanish construction company Acciona SA. The utility has said its net debt fell to less than €50 billion at the end of last year from €51.4 billion on Sept. 30.

Dynegy Inc.

Dynegy Inc. said it has dissolved its joint venture with **LS Power Associates** LP and will book a loss on the transaction. The 50-50 venture focused on development of new coal-fired power plants and other energy projects. Dynegy Chief Executive Bruce A. Williamson said credit and regulatory issues have made development much more uncertain since the venture was formed in 2006. Under the agreement, closely held LS Power will acquire rights to projects under consideration in Arkansas, Georgia, Iowa, Michigan and Nevada. LS Power also will receive about $19 million during the first quarter to reflect the value of assets exchanged. Dynegy didn't give an estimate of the expected loss from the dissolved venture.

Chrysler LLC

Chrysler LLC received its $4 billion low-interest federal loan Friday, helping the auto maker continue funding its operations. Undisclosed issues in Chrysler's application process slowed the payout, which was slated to be made by the end of December. **General Motors** Corp. received a loan payment of $4 billion on Wednesday and is scheduled to receive more money during the next two months. Chrysler has been hurt more than GM and **Ford Motor** Co. by the U.S. recession because it relies on North America for about 90% of its sales. Tight credit and a weak economy are keeping consumers away from showrooms. Chrysler's 2008 sales through Nov. 30 were down 28% from a year earlier. Chrysler's majority owner, **Cerberus Capital Management** LP, is interested in finding a partner for Chrysler. The investment firm, which bought an 80.1% stake in the auto maker in 2007, had approached GM about taking control of the company last year.

—Compiled from staff and wire service reports.

ECONOMY & POLITICS

Manufacturing tumbles world-wide

Euro-zone survey hits lowest level in 11 years, suggesting a rise in unemployment and an extended downturn

BY KELLY EVANS AND ROBERT GUY MATTHEWS

Manufacturing activity around the world fell sharply in December, suggesting that the recession hitting the U.S. and many other countries will extend well into 2009, if not longer, and that unemployment will rise globally.

Data and surveys published at the start of the new year—including from China—add to the gloom about the world economic outlook.

A broad index of change in U.S. manufacturing activity fell to its lowest level since June 1980, when the American economy was on the verge of a severe double-dip recession, according to the Institute for Supply Management. Not one of the 18 industries surveyed reported growth, and some, such as wood products, have been in decline for more than two years.

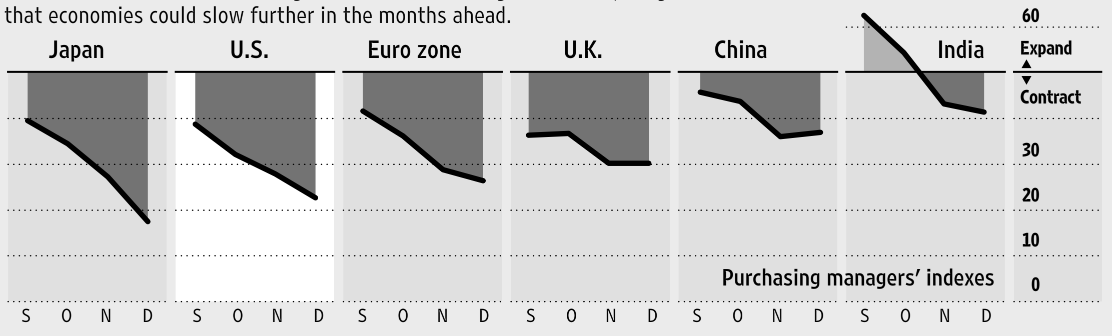
New orders, a gauge of future activity, sank to the lowest index level since U.S. records began 60 years ago. Exports and production also sank, and employment levels declined. The downturn in demand for manufactured goods is prompting U.S. companies of all sizes to lay off workers, shut down plants and reduce production of machinery, steel, plastics and other basic components.

In the wake of the data, a top U.S. Federal Reserve official on Sunday urged "pulling out all the stops" by implementing a fiscal stimulus program to turn around a possible long period of economic stagnation in the U.S., according to Reuters.

"The financial and economic firestorm we face today poses a serious risk of an extended period of stagnation," said Janet Yellen, president of the San Francisco Federal Reserve Bank, according to Reuters. "If ever, in my professional career, there was a time for active, discretionary fiscal stimulus, it is now."

Factory trouble

New orders in the manufacturing sector are contracting world-wide, a sign that economies could slow further in the months ahead.



Source: J.P. Morgan

Separate surveys of manufacturing activity around the world released Friday, the first business day of the new year, also were bleak. Manufacturing is a key component of a country's gross domestic product, and the data often serve as a barometer of future economic growth.

Manufacturing activity contracted in Germany, France, Italy and Spain, pushing the Markit Economics survey of euro-zone manufacturing last month to the lowest level in its 11-year history. In Russia, the VTB Bank Europe manufacturing index fell to its lowest level since it began in September 1997.

The simultaneous woes of manufacturing in rich and poor countries are something new in the global economy. In the past, weaknesses in U.S. and European manufacturing meant a windfall for developing economies, which took up the slack.

The spreading and deepening manufacturing slump has some experts worried that the global economy in 2009 won't fare much better than last year. J.P. Morgan's global manufacturing index, released Friday and compiled from surveys in 19 countries, reached a new low in December, consistent with a "severe" 17% annualized contraction in global activity. J.P. Morgan estimates global output declined 4% in the last three months of 2008 compared with the previous quarter, reflecting reduced spending and available financing on autos, housing and capital equipment.

The job cuts are coming across industries and borders. **Nickent Golf**, a golf-club manufacturer in the Los Angeles area, recently cut assembly workers in China and the U.S. to cope with falling demand. In Elbow Lake, Minn., **Cosmos Enterprises** Inc., which makes metal and plastic parts for manufacturers including car and farm-equipment makers, has cut capacity, and in October it laid off five machinists and one quality inspector.

The struggles of big steel companies are particularly troubling, because that industry's health is considered an early indicator of how other industries are faring. **ArcelorMittal, U.S. Steel** Corp. and **AK Steel** all have announced layoffs in the U.S. or Canada. In the U.S., mills that produce raw steel are working at only about 43% of capacity.

The U.S. shed some 1.9 million jobs in 2008, through November, and the unemployment rate, currently 6.7%, is expected to rise when the government reports December figures this Friday.

The surveys "underscore the depth of the global recession, which we believe will prove to be the worst in the postwar era," says Nigel Gault, an economist with IHS Global Insight. His firm estimates that U.S. gross domestic product declined at a 5.6% annualized rate in the fourth quarter. "With no evidence that the rate of contraction is moderating, we expect declines almost that large in the first quarter of 2009," he says. "The long-awaited fiscal-stimulus package cannot come soon enough."

In Germany, Europe's largest economy, machinery, equipment and auto makers are struggling. **Volkswagen** AG, Europe's largest car maker, said Dec. 9 that waning sales may make it harder to reach growth targets for 2010. **BMW** and **Mercedes-Benz** both saw about 25% drops in November sales.

Unemployment across the euro zone hit 7.7% in October, its highest level in nearly two years. The rate is expected to continue rising this year. In December, European Central Bank staffers forecast the euro-zone economy will contract by about 0.5% in 2009. Many private-sector economists contend that prediction is too optimistic, arguing that the bloc could face its sharpest recession since World War II.

The global manufacturing decline could put pressure on governments to pull harder on monetary and fiscal levers. The European Central Bank, in particular, has been criticized for failing to move rapidly enough, despite cutting its key rate by 1.75 percentage points since October, to its current 2.5%. By contrast, the U.S. Federal Reserve has slashed its lending rate to near 0%. Investors are betting the ECB will lower its rate by another half percentage point, to 2%, at its next meeting, on Jan. 15.

The International Monetary Fund's campaign to get countries to boost government spending by a total of 2% of global GDP—more than $1 trillion—could get a lift as well. In the U.S., President-elect Barack Obama has been talking of a stimulus plan of between $675 billion and $775 billion over two years, largely geared to construction spending. China has talked of greatly increasing spending with a four trillion yuan ($586 billion) stimulus package, although some analysts say the numbers Beijing is using are inflated. European nations, more concerned about budget deficits, have been more reluctant to adopt such tactics.

—Joellen Perry, Conor Dougherty, Chester Yung, Terence Poon and Paul Hannon contributed to this article.

The fix is in: prescriptions for repairing the U.S. economy

BY JUSTIN LAHART

Nothing focuses the mind like a crisis, and the global financial crisis and the recession that it produced have focused the minds of economists like no other event in their careers.

THE OUTLOOK

At the American Economic Association's meeting in San Francisco over the weekend, an annual event that draws economists from around the world, there were dozens of panels devoted to examining aspects of the global downturn—to say nothing of the informal discussions that popped up along hotel hallways.

The overarching question: How are we going to get out of this mess? Here are some prescriptions:

Barry Eichengreen, University of California, Berkeley: There needs to be a two-pronged approach. First, an additional $300 billion for banks and a mechanism for removing toxic waste from their balance sheets. Second, a minimum of $800 billion for fiscal stimulus. "I would like to see mainly payroll-tax cuts and block grants for states," he says. "Infrastructure means bridges to nowhere."

Kenneth Rogoff, Harvard University: A little inflation would be a good thing, inducing people to spend, making it easier to pay off debts and, most important, quelling worries about the possibility of deflation. Central banks should make it clear that they believe this and that they control the printing presses. "Worrying about a couple of years of elevated inflation is like worrying about the measles when you're going to get the plague," he says.

New lows

U.S. consumer-confidence index dropped to 38.0 in December

Source: Conference Board

Robert Hall, Stanford University, and Susan Woodward, Sand Hill Econometrics: The husband-and-wife team argue that infrastructure spending can cause bottlenecks—if there are only so many people who can install broadband, much of a big broadband package will go to overpaying the installers, for example. But moves like tax rebates just increase saving. So they argue for a massive sales-tax holiday, which would induce consumers to spend more, putting the stimulus right where it is needed.

Alan Blinder, Princeton University: The downturn is still young, it is going to go on for much longer, and it will be very deep. "We need to think of having time-release capsules," he says, that will help boost the economy a year from now. Infrastructure spending, which some economists argue against because it takes awhile to be put in place, does exactly that.

Anil Kashyap, University of Chicago Booth School of Business: Policy makers should stay focused on recapitalizing the banking system. The $350 billion of funds from the Troubled Asset Relief Program hasn't been sufficient to repair the balance sheets of financial institutions sitting on hundreds of billions, if not trillions, of dollars in losses. And financial firms won't start lending again until their balance sheets are in better shape. But bad banks should be shut down or nationalized more aggressively. "It is a complete waste of taxpayer money to bail out somebody who is insolvent," he says.

Jeremy Stein, Harvard: The government needs to aggressively audit banks, separating the insolvent from the solvent. The key underlying problem is the ad hoc bailouts that have taken place. That leaves market participants uncertain of the government's strategy "and therefore paralyzes potential private-sector investors," he says.

José Scheinkman, Princeton: After determining which banks are insolvent, the next step is figuring out what to do with them. "We have three options," he says. "You can merge them with good banks, invite foreign banks that are not so active in the U.S. to take control, or have the government nationalize them and clean them up. I suspect we will need all three."

Douglas Diamond, Chicago Booth: There needs to be a better way to resolve problems at bank holding companies than their threatening bankruptcy and then getting bailed out. "You have lots of carrots and no sticks right now," he says. One alternative would be legislative changes that would allow regulators to quickly wipe out existing shareholders at problem banks without invoking bankruptcy, and convert long-term debt issued after the legislation went into effect to equity.

—Jon Hilsenrath contributed to this article.

Gaza may boost Iranian hard-liners' power

Ahmadinejad stands to gain if sentiment against Israel rises

As Israel gambles on a potentially messy ground invasion of Hamas-controlled Gaza, Iranian President Mahmoud Ahmadinejad also has a lot at stake in the outcome of the fighting.

Mr. Ahmadinejad's history of criticizing Israel, and his recent

*By **Chip Cummins** in Dubai and **Roshanak Taghavi** in Tehran*

strong condemnation of the Gaza assault, has helped to garner a new measure of popular respect across the region. That comes as more moderate Arab states, especially Egypt, draw sharp rebuke for failing to act forcefully enough to stop the violence.

Condemnation of the Israeli offensive has also become a rallying cry for thousands of Iranians. If the ground invasion drags on, popular, anti-Israel outpourings in Tehran—on display during a large demonstration Friday—could serve Mr. Ahmadinejad as a convenient distraction. He faces mounting criticism of his economic policies ahead of presidential elections this year.

Mahmoud Ahmadinejad

Last week, Mr. Ahmadinejad introduced a series of economic reforms aimed at reducing expensive fuel and other subsidies. Economists say the move is necessary to relieve mounting fiscal pressure on Tehran amid sharply falling oil prices. But the measures, if they're enacted, are expected to be deeply unpopular among everyday Iranians.

Large demonstrations in Tehran, like the anti-Israel protests staged recently, are tightly controlled by the Iranian leadership. Some analysts also suggested recent demonstrations—including the brief storming of the British diplomatic compound in Tehran on Tuesday—could be a subtle way for hard-line supporters of Mr. Ahmadinejad to send a message to more moderate politicians considering a presidential challenge to Mr. Ahmadinejad.

In Tehran on Friday, a crowd of about 6,000 marched from prayers at Tehran University to Palestine Square, chanting "Death to Israel" and "Death to America."

Hard-liners "want to warn competitors" that they still command strong popular support, said Saeed Laylaz, a prominent Iranian economist in Tehran.

Regionwide, the fighting represents the latest chapter in a competition for influence in the Middle East between moderate, Western-aligned Arab leaders on one side, and Iran and Syria on the other. Key to Tehran's recent regional ambitions is its backing of Hamas and the Lebanese political and militant group Hezbollah.

Last year, Hezbollah took to the streets of Beirut in a show of force that ultimately won the group a bigger say in a new power-sharing government with Western-leaning politicians. The move boosted Tehran's standing considerably as a regional power broker, at the expense of the U.S., which designates Hezbollah and Hamas as terrorist organizations.

Agence France-Presse

Iranian students hold portraits of the late founder of the Islamic Republic, Ayatollah Ruhollah Khomeini, during an anti-Israel protest in Tehran on Sunday. Large demonstrations in Tehran are tightly controlled by the Iranian leadership.

Western governments accuse Tehran of funneling cash and weapons to Hamas, which won Palestinian-wide elections in 2006 and took control of Gaza in a bloody sweep in 2007. Iran has denied arming Hamas.

With Gazan borders sealed by Egypt and Israel, Tehran can offer little real assistance to militants battling Israeli tanks and troops. But if Hamas manages to bog down Israeli troops during the invasion—as Hezbollah fighters did in southern Lebanon in 2006—Tehran stands to gain once again.

Similarly, if Israel delivers a crushing blow to Hamas, Iranian officials could see one of their most effective irritants against Washington and Israel significantly degraded. Nine days of pounding aerial bombardments have already destroyed much of Hamas's governing infrastructure, including police stations and security posts.

"I don't think the Iranian government is happy with the situation," said one Tehran-based political analyst. "To them, Hamas is one of their deterrents. This is one of the things they threaten the West with."

As Western officials conferred with Israeli officials in recent days about the terms of a possible cease-fire arrangement, Iranian officials met with Syrian counterparts and Hamas representatives. Saeed Jalili, secretary of Iran's powerful Supreme National Security Council, met with Syrian President Bashar Assad Saturday, according to Syria's state news agency. He met the day before with Hamas's leader-in-exile, Khaled Meshal, who resides in Damascus.

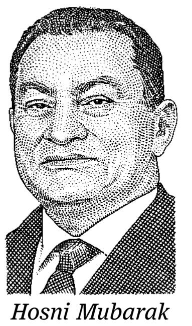
Mubarak faces pressure to open border crossing to Gaza

By Farnaz Fassihi

RAFAH, Egypt—As Israeli troops push into Gaza, Egypt has become a flashpoint in the deepening divide between moderate Arab leaders, backed by the West, and their more extreme rivals, including Hamas and Lebanon's Hezbollah, backed by Iran and Syria.

That has put President Hosni Mubarak in a suddenly precarious position. Widespread protests across the Middle East, as well as condemnation from radical Islamist leaders from Beirut to Tehran, have targeted Mr. Mubarak since Israel launched its aerial attack 10 days ago.

Mr. Mubarak is under intense popular pressure across the Arab world to open Egypt's border crossing here with Gaza, the only land route the sliver of territory shares with a country other than Israel. The border is currently only open to emergency medical aid going in and a trickle of wounded Palestinian patients coming out.



Hosni Mubarak

But Mr. Mubarak has plenty of reasons to want to keep his border sealed. Hamas has long been an Egyptian irritant. The group traces its roots to the Muslim Brotherhood, Egypt's own Islamic political opposition. Egypt has outlawed the group, a transnational Sunni Muslim movement. Over the weekend, riot police clashed with pro-Hamas protesters in Cairo and arrested dozens, including members of the Brotherhood.

If Egypt bowed to Arab street demands and opened its border, it would risk a heavy influx of Palestinian refugees, many of whom, officials say, might be sympathizers or members of Hamas. The border could also be used to re-arm Hamas as the fight with Israel intensifies, or as a conduit for suicide bombers or other assailants who could make their way to Israel via Egypt.

Mr. Mubarak also is under pressure from Israel, with which it signed a peace treaty in 1979, and from the U.S., a top donor of foreign aid to Cairo, to stand firm against Hamas.

So far, Mr. Mubarak has continued to insist that Hamas, which overran Gaza in 2007, agree to share power with its rival and more-moderate Palestinian faction, Fatah, which controls the West Bank.

"Egypt is in a very critical position and has to balance its domestic situation against its interests," said Abdel Monem Said, a member of the Egyptian senate and director of the Al-Ahram Center for Political and Strategic Studies. "The pressure is very hot and very tense, but as much as we hate what Israel is doing, we cannot jeopardize ourselves."

The Rafah crossing here is at the center of the controversy. Ambulances from Gaza hospitals make daily runs to the crossing, delivering dozens of critical patients to Egyptian medical teams, which have set up emergency triage units inside the no-man's land of the border crossing.

Reuters

Humanitarian-aid workers shout pro-Palestinian slogans as they wait for the Rafah crossing to be opened to allow aid into Gaza Strip from Egypt on Sunday.

So far, Egypt has taken in more than 170 patients, including several children, mostly with severe head and abdominal injuries from shrapnel wounds, according to Health Ministry officials. Egypt also has allowed in trucks of humanitarian aid.

That isn't good enough for Egypt's critics, who are calling for Mr. Mubarak to open the crossing wide to Palestinians fleeing the bombardment and ground invasion.

"We need real support from Egypt and other Arab countries. Not just a few trucks of food, flour and medical aid," said Gaza hospital nurse Ismaeel Zaki, 25 years old, adding: "Mr. Mubarak should come to Gaza and see with his own eyes how we are suffering."

Smugglers use an elaborate underground tunnel system near here to send weapons, as well as electronic goods, clothes and food into Gaza. In the past week, Israel has heavily bombed the tunnel system, cutting Hamas's smuggling lifeline but also damaging the economy in this border town.

Rafah sits fewer than 100 meters from Gaza, and many of the residents have relatives living on the other side. During the weekend, Israeli fighter jets regularly dropped bombs along the border as Egyptian spectators watched.

Close proximity and economic ties to Gaza, however, don't necessarily translate into blind support for Hamas. Like many Egyptians, Rafah residents are divided on whether their government should open the border. They say Hamas also shares the blame in the violent crisis.

"If you open the border you are inviting trouble," said Mohamad Salama, 45, who runs a small shack selling drinks and snacks at the Rafah border crossing.

Mansure Mosalem, a 35-year-old high school teacher, takes the opposite view. "Egypt should open the border. It's shameful that we are collectively punishing our Arab brothers because of politics." He said his two children are terrified from explosions and are growing up hating Israel. "If they open the border, many people here would go to fight Israel," he said.

U.K., U.S. in Gitmo talks

European nations are open to receiving additional detainees

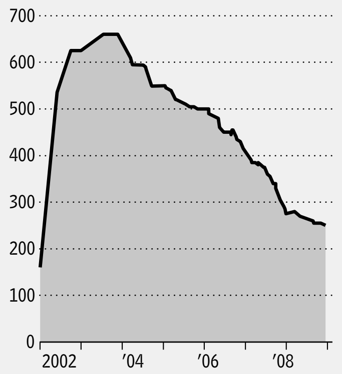
The Bush administration is holding preliminary discussions with the British government to potentially ship additional inmates to the U.K. from the Guantanamo Bay detention facility in Cuba, according to a senior U.S. official.

The discussions come as European countries, particularly Portugal and Germany, are displaying a greater willingness to assist Washington in addressing the status of some 258 detainees held at the Guantanamo facility, European and U.S. officials said. On Friday in Australia, the government said it was considering a similar move.

By ***Jay Solomon*** *in Washington and* ***Alistair MacDonald*** *in London*

Rise and fall

Approximate number of detainees at Guantanamo Bay



Sources: Defense Department; globalsecurity.org

The Pentagon has already cleared 60 of these detainees, including Chinese Muslims and North Africans, for resettlement in their own, or third, countries, according to U.S. officials.

American and European diplomats said Europe's shift on Guantanamo is being accelerated by the election of Barack Obama, who pledged during the campaign to break from the Bush administration's detention policies and shut the Cuba facility.

London has long pressed the Bush administration to return British nationals, and former British residents, held in Guantanamo to the U.K., said British officials.

To date, the U.S. has returned nine Britons and four former British residents. Washington and London, however, have failed to agree on the status of two former British residents, Binyam Mohammed and Shakar Aamer, whom the Bush administration is seeking to try through an American military tribunal system for alleged terrorist activities.

The senior U.S. official said, however, that the Bush administration has received indications from British officials in recent weeks that London could respond to a call by Portugal's Foreign Ministry for European countries to do more to assist the incoming Obama administration in shutting down Guantanamo.

Portugal's foreign minister, Luis Amado, recently wrote European Union countries and challenged them to match Lisbon's willingness to accept some of the 60 Guantanamo Bay detainees cleared for release. So far, only Germany has publicly committed to following Portugal's lead. But the Bush administration is optimistic that London could follow.

"We've heard through working-level discussions that the British government is considering joining European nations in taking" additional Guantanamo detainees, said the senior U.S. official. "This hasn't been communicated at the highest levels, as London is not leaning as forward as Germany and Portugal."

A British Foreign Ministry official confirmed London's interest in doing more to assist the U.S. in shutting Guantanamo.

"We've already received non-national Guantanamo detainees, and we have been pushing for our partners to follow our lead," said the official. "We recognize the difficulties [in closing the facility], and that the U.S. will require assistance from allies and partners."

However, the official said that the .K. hasn't been asked by the U.S. to take those who are neither British citizens nor have any connection with the country.

U.S. officials acknowledged that in response to growing European assistance, Washington would likely have to agree to resettle some of the 60 in the U.S.

The biggest Guantanamo problem facing Mr. Obama could be what to do with prisoners who the government asserts are dangerous, but against whom solid evidence is lacking.

In June, the Supreme Court ruled that the detainees may challenge their indefinite detention in federal court. Already one federal judge has ruled that no credible evidence supported the detention of five detainees, and three of them were returned last month to Bosnia, where they were taken from in 2002. Mr. Obama will have to decide whether he wants to follow the Bush administration's policy on keeping the men detained, or release men who fall into this gray area, bearing the risk that critics will seize on such decisions should any freed detainees be implicated in future terrorist acts.

—Jess Bravin in Washington contributed to this article.

Pakistan–U.S. militaries rebuild strained alliance

By Yochi J. Dreazen

TORKHAM, Afghanistan—U.S and Pakistani military cooperation has increased as the two nations push to eliminate militants destabilizing both sides of the Afghan-Pakistani border, a marked change from last year's tense relationship.

Senior American military officers say the U.S. is allowing Pakistani officers to view video feeds from unmanned drones flying over Pakistan's ungoverned border regions. The U.S. is also granting access to American intercepts of militant cellular and satellite phone calls inside Pakistan.

The Pakistani military is using the U.S. intelligence to carry out strikes against extremists in its Federally Administered Tribal Areas, which are widely thought to harbor senior members of al Qaeda, the Taliban and other armed Islamist groups. U.S. officials believe Afghanistan is deteriorating because of insurgents based in these "safe havens."

The cooperation is a contrast from earlier last year when Islamabad, reacting to public anger over U.S. ground and air strikes inside the country, withheld military cooperation. The once-solid relationship between Washington and Islamabad deteriorated over the summer after an American missile killed 11 Pakistani soldiers.

Maj. Gen. Jeffrey Schloesser, the top U.S. commander in eastern Afghanistan, said the number of insurgents crossing into Afghanistan from Pakistan has begun to decrease, reducing a major cause of instability in Afghanistan. Gen. Schloesser said U.S. and Afghan forces, which were hit by up to 20 rockets a day over the summer, are now hit by two or three.

U.S. officials attributed the declines to American missile strikes on insurgent targets inside Pakistan and the coordinated military campaign known as Operation Lionheart, which involves U.S. moves against militants in the Kunar region of Afghanistan and a large Pakistani campaign in the extremist stronghold of Bajaur.

"The operations in Bajaur and the Predator strikes in Waziristan have caused a disruption across the border," Gen. Schloesser said. The general's comments mark one of the first times a senior U.S. official has publicly confirmed the use of U.S. missile strikes in Pakistan.

Pakistan's chief military spokesman, Maj. Gen. Athar Abbas said Operation Lionheart had succeeded in pushing many militants out of Bajaur, which had long been the main extremist stronghold in northwestern Pakistan.

U.S. officials credit the turnaround in part to Gen. Ashfaq Kiyani, the head of Pakistan's armed forces, who has come to believe that militants pose an extreme threat. Gen. Kiyani replaced the head of the powerful Inter-Services Intelligence, which has long maintained covert ties to the Taliban and other armed groups, and has devoted significant military resources toward the fight in the border regions.

Pakistan's fragile civilian government has also taken a harder line toward the militants than many U.S. officials expected.

William Wood, the U.S. ambassador in Kabul, said in a recent interview that Pakistan was "unquestionably taking more effective action" against militants. "The only reason I wouldn't refer to it as a bright spot is that the problem is such a big one," he said.

—Zahid Hussain contributed to this article.

REVIEW & OUTLOOK

Israel's Gaza Surge

Israel's ground incursion into Gaza raises the strategic stakes for the Jewish state, for its moderate Arab neighbors, and also for Barack Obama's looming Presidency. Having committed to disarming Hamas, Israel can't now afford to lose its second war in two years.

Though the analogy isn't perfect, in some sense this Hamas exercise can be understood as Israel's version of the U.S.-Iraqi "surge" in Iraq. The year 2006 was the worst in more than a generation for Western interests in the Middle East, with al Qaeda and Iran's proxies advancing in Iraq, Hezbollah fighting Israel to a draw in Lebanon, and Hamas rising in Palestine. The 2007-2008 surge reclaimed the advantage in Iraq, and now Israel is attempting to do the same against Hamas.

The strategic question is larger than merely stopping Hamas missiles from landing in Israeli cities, though that is justification enough for Israel's bombing and the ground operation. A nation like Israel, with enemies on all sides, must maintain an aura of invincibility if it is to have any chance at peaceful co-existence. It was that aura after two wars that induced Egypt to agree to peace with Israel in the 1970s. By contrast, the 2006 Lebanon campaign convinced radical Arabs and Persians that Israel had grown soft and could be beaten. Israel can't let Hamas maintain a similar mythology at the end of this operation, or the costs will be far higher down the road.

Israeli leaders are talking as if they realize this strategic reality, though it's hard to know for sure because their war aims remain publicly ill-defined. Haim Ramon, the Israeli vice premier, says the goal is nothing short of the elimination of Hamas rule in Gaza, though that hasn't been repeated by Prime Minister Ehud Olmert or other senior war leaders. Defense Minister Ehud Barak has said the operation "won't be easy or short," though understandably without much elaboration given the need to keep Hamas in the dark.

Obama's Iran diplomacy needs a Hamas defeat.

We don't agree with those who claim that Israel faces only two bad options: either a limited campaign that scores a tactical victory while allowing Hamas to claim to have survived as a military force; or a return to the full-scale occupation that Israel abandoned in 2005. Israel could re-occupy some parts of Gaza, this time without Israeli settlements to defend. More realistically, given Israel's domestic reluctance for such a presence, it could fight long enough to eliminate Hamas as a military threat, then announce a policy that every rocket fired at Israel would be met by a "proportionate" airstrike or other reprisal. This would allow Israel to claim military victory in the short term, while creating a deterrent going forward.

The costs of either operation will be high. But the costs of inaction since Israel abandoned Gaza in 2005 have also been high, especially in allowing Hamas to build an army of some 15,000 men. Hamas now has missiles that can hit targets 20 miles inside Israel, leaving the entire south of the country vulnerable, and on present course longer-range missiles will eventually hit Tel Aviv. Whether or not Palestinian President Mahmoud Abbas is willing to reassert control of Gaza, Hamas has to be destroyed as a military force.

For the broader Middle East, the issue is the expansion of Iranian influence and terror. Like Hezbollah in Lebanon and the Sadrist "special groups" in Iraq, Hamas has become part of Tehran's bid for regional hegemony. The Bush Administration's regional setbacks in 2006 went far to encourage that Iranian ambition, though the surge has contained it in Iraq. Hezbollah remains stronger than ever in Lebanon, however, and Hamas has been pressing to humble Israel with an eye to deposing Mr. Abbas's Palestinian Authority on the West Bank as it has in Gaza.

This is where Mr. Obama comes in. The Bush Administration has rightly given Israel the diplomatic cover it needs to pursue its war aims, amid the usual Arab, European and U.N. denunciations. Similar denunciations were of course never aimed at Hamas missiles fired at Israeli civilians. As Israel's operation continues, the clamor will build for the U.S. to force Israel to stop short of defeating Hamas. Such an intervention by Secretary of State Condoleezza Rice allowed Hezbollah to claim victory in 2006, and Mr. Obama should not repeat the same mistake.

Much as Mr. Obama takes office in a stronger position thanks to the Iraq surge, his foreign policy would also benefit from Israeli success in Gaza. The President-elect says he intends to pursue a grand bargain with Iran, and the mullahs are going to be a lot more interested in diplomacy if their military proxies have been defeated. A Hamas humiliation would also show Tehran that Mahmoud Ahmadinejad's regional militarism has more costs than benefits.

The Israelis have done Mr. Obama a favor by striking back at Hamas before he takes office so President Bush can endure the usual global denunciations for U.S. support for Israel. But Mr. Obama will soon need to return the favor by showing Israel—and Iran—that the new President understands the U.S. stake in the success of Israel's Gaza surge.

Credit Default Swamp

Could the political campaign to blame the financial panic on unregulated derivatives be losing momentum? Let's hope so, because this might save Washington from making new mistakes in the name of fixing the wrong problems.

The predicted disaster for credit default swaps (CDS) following the Lehman Brothers bankruptcy never happened. The U.S. government also still hasn't explained how AIG's use of CDS to go long on housing would have destroyed the planet. And now the New York Federal Reserve's effort to regulate the CDS market is mired in a turf war. The Securities and Exchange Commission and the Commodity Futures Trading Commission have backed rival efforts in New York and Chicago.

The Fed wants to give the blundering rating agencies even more power.

But it is the New York Fed proposal that may pose the most immediate threat to taxpayers, because it is designed to include firms on at least one end of 90% of CDS contracts. After announcing its intention to begin by the end of 2008, the New York branch of the central bank, headed by President Timothy Geithner, is still awaiting approval from the Fed's Board of Governors to launch a central clearinghouse for CDS trades. Credit default swaps are essentially insurance against an organization defaulting on its debt, and they provide a real-time gauge of credit risk. This has proven particularly valuable because the Fed's method of judging risk—relying on the ratings agencies S&P, Moody's and Fitch—has been disastrous for investors.

Under pressure from the New York Fed, nine large CDS dealers—giants like Goldman Sachs—agreed to construct a central counterparty, which would backstop and monitor CDS trades. Called The Clearing Corp., it failed to catch on in the marketplace. So the big dealers recently gave an ownership stake to IntercontinentalExchange (ICE). In return, ICE agreed to make this government-created but privately owned institution work.

ICE has given the venture, now called ICE Trust, operational street cred, but the Fed-imposed architecture should still cause taxpayer concern. That's because it takes the widely dispersed risk in the CDS marketplace and attempts to centralize it in one institution. If not structured correctly, it may reward the participating firms with the weakest balance sheets. For this reason, some of the dealers who have resisted a central counterparty because it threatens their profits may now embrace it as a way to socialize their risks. What's more, if it allows these big Wall Street dealers to build an electronic trading platform on top of the central clearinghouse, the big banks could prevent pesky Internet startups from threatening their market share.

Here's how the New York Fed's central counterparty would change the market: Right now, CDS trades are conducted over-the-counter as private contracts between two parties. They are reported to the Trade Information Warehouse, so the market has some transparency, but nobody is on the hook besides the two parties to the agreement. This provides an incentive for each party to make an informed judgment on whether the counterparty can be relied upon to pay debts. The buyer of credit protection—who is paying annual premiums for the right to be compensated if a company defaults on its bonds—has every reason to study the balance sheet of the seller of a CDS contract.

In the New York Fed's judgment, the recent panic showed there wasn't enough transparency in CDS trades. The Fed's solution is to force CDS contracts into its central counterparty. There is a virtue here: A particular bank cannot throw out its collateral standards to please one large favored client, because the same standards apply to all participants. The nine large dealers plus perhaps four or five more participating firms would each contribute roughly $100 million to the central counterparty, and they'd have to cough up more money if failures burn through this cash reserve.

However, this system also introduces new risks, because all participants become liable for the potential failure of the weakest members. How does one appropriately judge the credit risk of a participant? ICE Trust and the Fed haven't released details. Sources tell us that participants will need to have a net worth of at least $1 billion, and, more ominously, that the Fed wants a high rating from a major credit-ratings agency as a crucial test of financial health.

If regulators learn nothing else from the housing debacle, they should recognize that their system of anointing certain firms to judge credit risk is structurally flawed and immensely expensive for investors. As Columbia's Charles Calomiris has explained, one reason the Basel II standards for bank capital failed is because they subcontracted risk assessments to the same ratings agencies that slapped AAA on dodgy mortgage paper.

Unfortunately, the Fed stubbornly refuses to learn this lesson. With its various lending facilities, the Fed continues to demand collateral rated exclusively by S&P, Moody's or Fitch. A rival ratings agency reports that the Fed recently rejected a request from a clearing bank to consider a ratings firm other than the big three.

* * *

No doubt ICE Trust has a strong incentive to monitor counterparty credit risk. Our concern is that the Fed's failed policy on credit ratings will increase risks even further if it is allowed to pollute the $30 trillion CDS market. The credit raters have shown they are usually the last to know if a bank is in trouble, yet under a credit-rating seal of approval such a bank could maintain the illusion that all is well. If you have trouble conceiving of such a scenario, reflect on the history of Enron, Bear Stearns, Lehman, Citigroup, the mortgage market, collateralized-debt obligations, etc. Now try to imagine how long it will take the Fed to commit taxpayer dollars if this central counterparty fails.

Any plan that seeks to minimize marketplace risks by concentrating them in one institution deserves skepticism. Relying on ratings from the big three to assess these risks would be an outrage.

Pepper . . . and Salt

THE WALL STREET JOURNAL

"I'm a bit disappointed by the organic clouds."

The Journal Interview with Boris Johnson / *By Matthew Kaminski*

London's Mayor Issues a Challenge to Gordon Brown

London

"London stands at a crossroads. Can this new Conservative mayor help the world's leading financial center weather the economic downturn, or will he be caught out? Can he persuade North Americans to come to this great city and spend their dollars? Can he deliver air-conditioning on the underground system for the first time in 150 years? Can he reduce bus crime, make transport safer, and simultaneously jump-start the frozen housing market? Yes, he can, my friends!

"That's your blistering introductory paragraph, to get your piece off to a really flying start," says Boris Johnson. Behind schedule, just arrived at City Hall on his bike, London's mayor proposes to spare us the hassle of an interview and simply dictate this article for me. I've heard worse offers.

Until his surprise win last May, Mr. Johnson was one of Britain's best-known journalists. This half-parody of his former craft and new life in big-league politics manages to capture some of his challenges and give a taste of an inimitable style toned down, but hardly dulled, by the recent metamorphosis.

"I have to do things my way, otherwise I'd kind of explode," he says. "But . . . I'm afraid there are just times"—here comes one of numerous playful jabs at the gray Scot at 10 Downing Street—"when you have to be Gordon Brownian. You just got to, got to, got to."

Previously (in)famous because of a propensity for petty scandals and lively logorrhea, Mr. Johnson convinced enough voters he was serious to unseat London's cockney king, "Red Ken" Livingstone, the two-term incumbent and favorite—"Mayor Leavingsoon," in Mr. Johnson's campaign shorthand.

Seven months in, here's the bigger surprise: Even detractors say Mr. Johnson is doing a good job. He's the most popular figure among Tory faithful (though not the party leadership) and by some accounts in the country as a whole. All of Britain knows him as Boris; close family use Al, from Alexander Boris de Pfeffel Johnson. If David Cameron stumbles in his bid to force Labour from power at the next election, Mr. Johnson—the only Tory politician to win an executive post since 1992—would be the favorite to take over Margaret Thatcher's old party.

Days after his election, this all seemed highly improbable. New York Mayor Michael Bloomberg stopped by, and there was a little mix-up over the customary gifts. Mr. Bloomberg gave the new London mayor a Tiffany & Company signature box with a crystal apple symbolizing New York City. In return he got a button-down dress shirt covered with a map of London's subway system from Mr. Johnson, who confessed it was an impromptu choice.

The mayors of the world's two financial capitals now claim to have a special relationship—"very friendly relations," in Mr. Johnson's words. Is the gift episode forgotten, I wonder?

"I am a very proud user of his crystal apple. Where is his crystal apple?" Mr. Johnson looks around and comes up empty-handed. "Someone shot-putted it into the Thames. I don't know what happened to it. Very, very, very, very beautiful object. I'm very grateful to New York and its citizens for my crystal apple. And I'm a proud citizen of New York, a point I would not hesitate to remind you of." Mr. Johnson, mischievous smile and all, was born in Manhattan.

> 'Bring it on you great big quivering gelatinous invertebrate jelly of indecision.'

Back to serious matters. This autumn, when the financial system nearly collapsed, Mr. Johnson stood up to defend bankers. His was a rare voice. "Someone had to," he says. Financial services account for nearly a tenth of Britain's economy, far larger in London. Mr. Johnson says he approached Mayor Bloomberg with an idea: "Why don't we form an alliance against ill-thought regulation now, or mistakes we could make now that impede the financial sector, the Anglo-Saxon model, from developing in the future, and let's see if we could find some things in common."

The response? "I have to say I got a bum's rush there. His view was actually, for one reason or another, he didn't see much scope for cooperation. And the reality is that these two great metropolises. . . metropolaise. . ."—the Oxford classics graduate, author of a survey of the Roman Empire, suddenly wants to stick the ending. "Metropoli?" chimes in his aide. "If it was Greek, it would be poleis," he says, ending the digression. The cities, in any case, "are in competition."

Created in 2000, the London mayor's job lacks the New York post's powers, which could hinder Mr. Johnson's ability to implement his campaign promises to cut into rising crime and ease transport headaches. So far, Mr. Johnson has managed the high expectations well.

In one of his first acts, he banned alcohol on public transport—a Bloomberg-like act, I point out. "I'm by nature a libertarian," Mr. Johnson shoots back, "but I thought there was a general freedom that people ought to have to be able to sit on the Tube late at night without having some guy with a six pack of beer leering at them in a threatening way."

On the night before the ban went into effect, Londoners rung out the old tradition of boozing in transit with parties/protests on subway trains and buses. "Thousands of young people were hurling execration at my name," says the mayor. "I thought: This is fantastic. It took Margaret Thatcher 10 years before she had mobs of urban youth denouncing her."

In another headline-grabber, this past fall Mr. Johnson pressured out the Metropolitan Police chief, Sir Ian Blair. A favorite of Labour, Sir Ian was criticized by the right for turning a blind eye to Islamic hate preachers in London. Mr. Johnson took the politically risky move, but cited other reasons, and ducks questions about the terrorist threat in his town. "The best and most effective way of defusing the extremists is to engage and support the moderates," he offers—a line that his journalist self might have dismissed with a neat word like bilge or pablum.

* * *

Municipal government would seem ill-suited to a man noted for a quick wit and a short attention span. But he acts the part, his own way. Mr. Johnson describes in some detail a tunnel planned under the Thames, which, he says, "is going to have a quite colossal bore"—clearly the opening's too tempting not to take—"a bore even more colossal than Gordon Brown himself."

Talking up the need for bigger apartments at the introduction of his new housing strategy, he says Londoners have grown too fat to live like Hobbits. He indulges his passion for cycling by seeking to make London friendlier to bikes—for aesthetic green reasons, he says, to get people out of cars and fat burned off their bodies. Recently, he infuriated earnest greens by describing climate change as "a religion" in his weekly column. "Not all religions are bad!" he says. "Climate change might be the faith that supervenes and brings the human race together. Fear of the Sun God . . ." he adds, before trailing off in a chuckle.

Mr. Johnson won a safe Tory seat in Parliament in 2001 while keeping a foot in journalism. He looked finished in politics on numerous occasions. He is a walking Bartlett's of political incorrectness. A

Ismael Roldan

Boris campaign pitch: "Voting Tory will cause your wife to have bigger breasts and increase your chances of owning a BMW M3." On Portsmouth: "[A city of] drugs, obesity, underachievement and Labour MPs." On Liverpool, after a Liverpudlian was beheaded in Iraq: "Wallow[ing in] victim status . . . and their sense of shared tribal grievance about the rest of society."

On London hosting the 2012 Olympics, spoken while in Beijing this summer: "I say to the world: Ping Pong is coming home!" On his talent for gaffes (see entries above): "My friends, as I have discovered myself, there are no disasters, only opportunities. And indeed, opportunities for fresh disasters." On himself: "Beneath the carefully constructed veneer of a blithering buffoon, there lurks a blithering buffoon."

The image of an upper-class Clown Prince from the fields of Eton made Mr. Johnson easy to like and to dismiss. But he is no shallow English toff. He excelled at school. Nor is his background as posh as his accent might suggest. On his paternal side, Mr. Johnson is a second-generation immigrant; his great-grandfather was interior minister in the last Ottoman government. Throw in some Jewish ancestors and a direct lineage to King George II, and the image takes on new dimensions.

So, I ask him, are the gaffes now history? Mr. Johnson says flatly, "No," then extrapolates, "What is a gaffe? A gaffe is in the eye of the beholder." I offer Michael Kinsley's definition—when a politician tells the truth—and Mr. Johnson says, "Yeah, I would have thought one of the reasons I get elected is because people think I might accidentally blurt the thing they're thinking."

What's the biggest misconception about you? He turns to false flattery: "It's a brilliant question, it's a brilliantly devised, an elaborately constructed trap. I can see the stakes winking at me at the bottom of this leaf covered pit. . . . There are obviously plenty of criticisms that people make of me that I could individually try to demolish, but life's too short."

The Tories are no longer Mrs. Thatcher's party. After three consecutive drubbings in national elections, Mr. Cameron, a former ad man, has revived the party's fortunes, freshening up its image without resolving what these new Tories truly stand for. The party, says Mr. Johnson, is a "much broader, more generous operation," but some Thatcher bedrock principles remain. Such as, he says, standing by "people who are getting hit by high taxes, insecurity on the streets, crime that could be dispelled with a little bit of common sense."

* * *

I keep asking repeatedly—as others do—what else? Mr. Johnson never looks irritated, though he probably should be. At last, "Oh boy, you know what conservatism is. Do I have to describe it? A belief in the old ways of doing things and all that sort of jazz."

The next elections are due in 2010, perhaps sooner. In the fall of 2007, Prime Minister Brown raised expectations and then got cold feet on calling early elections. His popularity plummeted. Now he's back up in polls and so is speculation. On Mr. Johnson's desk sits a tabloid cover mooting a possible June 4 poll. I point to it.

"Bring it on!" says Mr. Johnson, lighting up. "My message to Gordon Brown through The Wall Street Journal is: You great big quivering gelatinous invertebrate jelly of indecision, you marched your troops up to the top of the hill in October of [2007]. Show us that you've got enough guts to have an election June 4. Gordon: Man or Mouse?!"

His press aide shakes her head, puts it in her hands and laughs. Boris Johnson is enjoying himself.

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

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