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Modigliani head draws Paris record €43.2 million

Associated Press

Tête, a sculpture by Amedeo Modigliani, sold for almost 10 times its expected price at Christie's in Paris Monday. The €43.2 million ($53 million) tag was a record for a work of art in France.

Franco-German display of unity on debt crisis

BERLIN—German Chancellor Angela Merkel and French President Nicolas Sarkozy put on a show of unity at a summit Monday, following weeks of tension between the two countries whose fraying alliance is seen in Europe as vital to the Continent's political cohesion.

By Marcus Walker in Berlin and David Gauthier-Villars in Paris

The two leaders strove for compromises on the main issue that has divided them recently: How to overhaul the euro zone to prevent economic crises such as Greece's from tearing the common currency apart.

Ms. Merkel agreed that Europe needs more integrated "economic government"—a French phrase that Germany has long resisted—while Mr. Sarkozy accepted that such coordination should take place mainly at the level of the 27-country European Union, and not, as France has insisted up to now, among the smaller circle of 16 countries that share the euro.

"We both made a step toward each other," Mr. Sarkozy told a news conference after the leaders held talks at the Berlin chancellery.

In recent months the Franco-German relationship has suffered amid a level of tensions rarely seen since the two countries overcame their historic enmity and teamed up to drive European integration in the 1950s. The debt crisis in Greece and other parts of Southern Europe has exposed deep differences between Berlin and Paris on economic policy and on the future shape of Europe.

Germany views the crisis on the euro zone's Southern fringe as a symptom of other countries' failure to copy Germany's fiscal discipline and structural overhauls to its economy. Its proposed remedies focus mainly on pushing other countries to cut budget deficits.

France, however, believes Germany's large trade surplus and weak domestic demand are part of the euro zone's problem, since they force weaker economies to pay for their imports with debt,

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Fed weighs options should growth falter

By Jon Hilsenrath

Federal Reserve officials are beginning to discuss quietly what steps they would take if the recovery unexpectedly falters or if the inflation rate falls much more.

The bar is high for any further action to stimulate growth. Fed officials, who meet next week to survey the state of the economy, largely believe a recovery is on track and their next move—though a ways off—will be to tighten credit, not ease it further.

But fiscal woes in Europe and stock-market declines at home have alerted officials to risks that the economy could lose momentum and that inflation, already running below the Fed's informal target of 1.5% to 2%, could fall further, raising the risk of deflation.

The Fed's official posture is unlikely to change when policymakers meet June 22 and 23: The U.S. central bank is expected to leave interest rates

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Iran's mullahs will help set U.N. policy on gender equality and women's rights. Page 15

PAGE TWO

A tricky job dodging the double-dip

[Agenda]

By Patience Wheatcroft

When does austerity become a route not to salvation but to double-dip recession? That is the question now hanging over Europe, as governments compete to talk tough on the cuts they plan to make in order to tame the dangerous deficits they have bred.

Representatives of the U.K.'s new government were almost falling over themselves Monday in their efforts to verbally wield the ax. Prime Minister David Cameron had already warned that the cuts will be so deep as to change the country's way of life. His deputy, Nick Clegg, and chancellor, George Osborne, waded in with blood-curdling descriptions of what fate awaited the country if it didn't slash expenditures.

Then, to underline the far-reaching nature of the cuts to come, Defence Minister Liam Fox promised that his department would not be immune and that cuts would be made "ruthlessly" and without "sentiment."

Behind closed doors in Berlin, Germany's Chancellor Angela Merkel was surely making similar observations to President Nicolas Sarkozy of France, a somewhat belated convert to the austerity cult.

Frugalism is in fashion. Yet there is no shortage of economists prepared to warn that a fragile economy could be wiped out by cuts that go too deep too soon.

For the time being, those voices are being drowned out by those who want austerity, and want it now. They will have found ammunition to support their case in the latest figures from Eurostat, which showed industrial production in the euro zone recording record growth in April.

That performance is powered by Germany, where the lower euro is doing wonders for its major exporters. The U.K., however, had some gloomier, although well-trailed, news on the growth front. According to the newly created Office for Budget Responsibility, the country's growth rate next year will fall well short of the 3% to 3.5% predicted in the last budget, shortly before the election. The OBR puts the number at 2.6%.

Associated Press

Selling the U.K. is a tough job for ministers and businessmen alike.

Economic prosperity will hinge on lifting that number as well as imposing the discipline of cuts in public spending. It is no easy task. Taking jobs out of the public sector doesn't come without costs. There are some parts of Britain's civil service where there are already hundreds of people effectively jobless but still employed. Branding them as "waiting for redeployment" means that the charges involved in making them redundant are avoided in favor of the continuing drain of keeping them on the payroll.

> **The private sector will be ill-prepared to quickly provide jobs for laid-off public-sector workers.**

Quite where they might be redeployed in the private sector to generate growth is not clear. The latest bulletin from the Bank of England included a paper that suggested that the recession might have led to a possible permanent stunting of capacity within the U.K. economy. Industry had stopped investing and tough credit conditions were perpetuating that trend.

If that is the case, and excess capacity has been driven out of the market, then it explains why inflation has settled at a higher level in the U.K. than the rest of Europe. But it also means that the private sector will be ill-prepared to provide speedy employment for rafts of redundant public-sector workers.

Super salesman for U.K.?

If those budget cuts are not to lead to disaster, then growth is their crucial companion. So who would like to volunteer to be Britain's trade minister? With a brief of traveling the world to market the country at a particularly critical time for the economy, it is an important role. Yet a month after the coalition was formed and David Cameron became prime minister, the post is still vacant. A few potential candidates have been approached but have apparently found the job resistible.

Yet the previous incumbent, Lord Davies of Abersoch, succeeded in making an impact in the role. A former chairman of Standard Chartered Bank who became a Labour member of the House of Lords in order to be trade minister, he is now investigating a return to the private sector, where his skills will, no doubt, be well-rewarded.

One aspect of the ministerial role now on offer that may lessen its attractiveness to some is that it does involve volunteering, in the sense of not being paid.

There might be a rather larger pool of well-qualified people prepared to devote a period of their life to intensive air travel and glad-handing around the globe if they thought financial reward was involved. The new U.K. government clearly hoped that altruism would triumph over such pecuniary concerns, but so far that hasn't apparently been the case.

Or maybe modesty is preventing suitable candidates from volunteering.

A slick solution?

On Wednesday, BP's chairman will meet with U.S. President Barack Obama. It doesn't promise to be a convivial occasion. The anger of the U.S. over the scale of the disaster in the Gulf of Mexico is genuine and understandable. Insisting that the company should put funds into escrow to pay the necessary compensation and cleanup costs is not unreasonable. Indeed, if BP had thought to volunteer it ahead of being told to, it would have enhanced its position.

We can only guess what was said inside the BP boardroom on Monday, but some voices should have been raised in protest about the company's dismal conduct of its public-relations efforts in the U.S. The current BP chairman, Carl-Henric Svanberg, has only limited time left to demonstrate that he is up to the task.

Speculation is growing that there is a potential successor who might be better equipped.

Britain's Lord Mandelson was an adept trade minister and made a success of a difficult role as EU trade commissioner. He is a skilled negotiator and he is brave. He is also unemployed at the moment ...

What's News

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'He sounded clear, moderate, direct and mercifully free of wonkery. He even speaks in sentences.'

Iain Martin: How About That Chap Blair for Labour Leader?

Continuing coverage

Slovakia and Portugal take to the World Cup stage on Tuesday. Follow at **wsj.com/worldcup**

Question of the day

Vote and discuss: Should World Cup organizers ban the vuvuzela horn from stadiums?

Vote online and discuss with other readers at **wsj.com/dailyquestion**

Previous results

Q: Would you drop England goalkeeper Robert Green after his World Cup fumble against the USA?

Yes	25%
No	75%

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NEWS

A World Cup headache for bosses

To minimize productivity drop, managers world-wide juggle worker schedules and bring in televisions

By Dana Mattioli
And Javier Espinoza

Alfred Giancarli for the Wall Street Journal

Fans packed into Nevada Smith's bar in New York during work hours to watch Uruguay vs. France last week.

The World Cup's winner won't be determined until July. But there are already clear losers: bosses.

On Friday, managers on both sides of the Atlantic braced for the quadrennial monthlong productivity drain that football's global championship brings. The tournament lasts more than four weeks, with many matches scheduled in the middle of the workday in the Americas and Europe.

In football-mad countries like the U.K., many companies don't even try to ban the matches. Some let employees watch matches at work. At others, managers juggle staffers' schedules to accommodate match-watching.

In Paraguay, President Fernando Lugo issued a decree giving public workers Monday afternoon off to watch Paraguay's match against Italy.

In past years, the U.S. was mostly immune to the contagion. But this year, Americans' growing World Cup curiosity sparked scattered hooky outbreaks on Friday, the first day of play.

In the U.K., productivity losses tied to the World Cup could total just under £1 billion ($1.45 billion), according to a survey by the Chartered Management Institute. Just over half of working men and 21% of working women intend to watch the matches scheduled to take place during office hours as they happen, according to a PricewaterhouseCoopers LLP survey of 1,000 U.K. workers.

Asda, the British arm of **Wal-Mart Stores** Inc., is giving employees the opportunity to take a "Safari Sabbatical," an unpaid leave of up to two weeks, if they want to go to South Africa.

The company will also let workers swap shifts, take extended breaks and request days off to watch the matches on television. Managers will also tune TVs for sale on the shop floor to the World Cup so that staffers can keep tabs on matches.

"We trust our colleagues who do work to get on with their jobs whilst keeping an eye on the score," says a spokeswoman for the supermarket chain, which employs 170,000 people across 376 stores in the U.K.

Jonathan Grant, who manages a team of seven in London as a director in climate-change services at PwC, is letting staffers come in and leave early on days with afternoon England matches. His staff includes workers of three different nationalities, so he will also redistribute tasks to minimize conflicts with the matches of others' home teams.

But the firm is drawing the line at allowing employees to watch matches on TV in open-layout areas. "The cheering and shouting can be a bit distracting for your colleagues on a conference call," says Mr. Grant, who concedes that "football isn't top of my list for sport."

Americans aren't nearly as fanatical as many Britons are. But football is gaining traction in the U.S. In 2006, a total of 78 million U.S. viewers watched the World Cup on **Walt Disney** Co.'s channels, up from 70 million in 2002, and those numbers don't include Spanish-language viewership. Last June, nearly seven million U.S. viewers watched the U.S. lose to Brazil in the FIFA Confederations Cup Final, according to Nielsen Co.

Already on Friday, there were signs that some U.S. workers weren't paying full attention to their jobs. The morning's Mexico-South Africa match, which kicked off at 10 a.m., right in the middle of the East Coast work morning, became the most watched game ever on ESPN3, formerly ESPN360, which ESPN uses to live stream sporting events via the Internet. Only U.S. viewers can access the live streams.

The match drew more than 500,000 viewers, 178% more than the previous high-water mark, a 2009 American football game between the University of Southern California and Ohio State.

At Nevada Smiths, owner Jack Keane said the popular New York bar was packed Friday morning for the match. "The place is full. A lot of people are coming from work," he said, shouting to be heard over fans. "And most people are drinking alcohol."

Some Americans who ditched work for the match showed more enthusiasm than knowledge. Four Americans, branch managers of **Banco Santander** SA's Sovereign Bank, had a district meeting earlier Friday and were supposed to head back to work. Instead, at 2:30 they popped into O'Lunney's Pub in midtown to watch France play Uruguay. They had noticed there was more hype in the U.S. surrounding this World Cup and were curious what the fuss was about.

It was the first time one of them, Justin Braithwaite, had ever watched a football game at a bar. In the future, "I plan on having more of an interest in soccer," the 33-year-old said. He is rooting for the U.S. this time around, but he and his three co-workers could name only one player on the team: midfielder Landon Donovan.

At **Pony Xpress Printing** Inc. in Garland, Texas, principal partner Jeff Henderson originally gave his employees—many of whom are of Mexican descent—the opportunity to work overtime earlier in the week so they could take off Friday to watch Mexico play. But on Wednesday, the 45-employee screen-printing company got some large rush projects that required a full staff Friday.

Fearing employees might call in sick, Mr. Henderson and his three partners struck a compromise: They told workers that they would have to come in but that TVs tuned to the match would be set up in the warehouse and conference room. "You could see the disappointment on some of their faces," he says.

Everyone showed up, he says, but he acknowledges there was "some decreased production." A fan himself, Mr. Henderson would speak with a reporter only at halftime.

In Manhattan, Zurich-based **Credit Suisse** is showing U.S. and Swiss World Cup matches that fall during the workweek in its auditorium. The company sent a memo inviting employees, with one caveat: They must first get their boss's approval.

—Sarah E. Needleman, Matt Moffett and Michael Carolan contributed to this article.

North Korean broadcast of match probed

By Evan Ramstad

SEOUL—North Korea's TV station showed the opening game of the World Cup on Saturday though it didn't have the right to do so, and South Korea's official tournament broadcaster is trying to figure out if its signal was pirated for viewing in the North.

North Korea Central Broadcasting showed a taped replay of the South Africa-Mexico game, but the screen was enlarged to remove graphic elements from the picture, making it difficult to tell whether the station recorded a transmission from South Korea or China.

North Korea illegally used some South Korean broadcasts of the 2002 World Cup, but in 2006 it obtained TV coverage legally from a South Korean network.

For this year's tournament in South Africa, the South Korean TV network SBS, which purchased broadcast rights for the Korean peninsula from World Cup organizer FIFA, held two meetings with North Korea's state-run broadcaster to pick up its coverage. But the two sides didn't come to an agreement, says Yang Chul-hoon, chief of the inter-Korean department at SBS. The network is now studying the video.

North Korea's football team qualified for the World Cup this year for the first time since 1966.

But analysts say the country is unlikely to show live broadcasts of its own team because of fears by its authoritarian government that the team will perform poorly or that protesters will be given screen time.

North Korea's newscasts, monitored in South Korea, have said virtually nothing about the country's World Cup team in recent weeks.

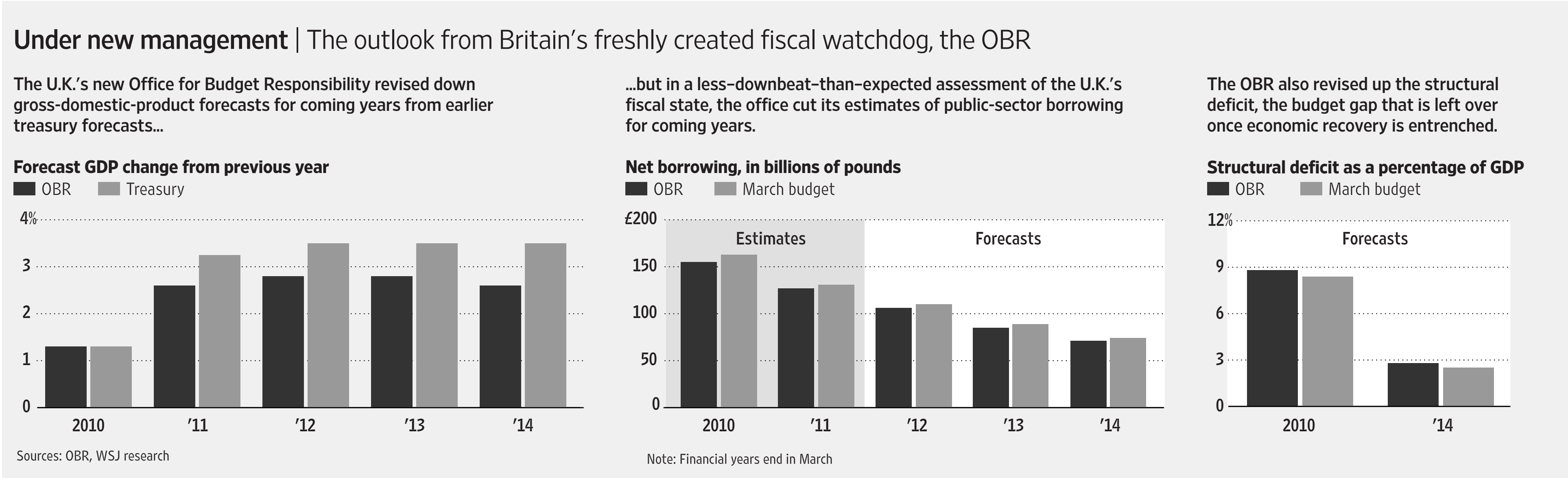
Governing body FIFA said it has signed a broadcast agreement with the Asia-Pacific Broadcast Union, and it is currently working to get a signal to North Korea. The organization didn't respond to questions about whether games were currently being broadcast with a one-day delay or if the transmissions were being recorded from another country.

North Korea's coach, Kim Jong Hun, said at the Ellis Park stadium in Johannesburg that the team's first match against Brazil, one of the tournament's favorites, will be broadcast early Wednesday in his country.

—Jaeyeon Woo in Seoul and Robb M. Stewart in Johannesburg contributed to this article.

Associated Press

North Korea's World Cup squad trains for its opening match against Brazil. This is the team's first tournament appearance since 1966.



U.K. budget office sees lower growth

OBR cuts view of long-term prospects and sets the stage for a budget that the market is expecting to be harsh

By Alistair MacDonald
And Laurence Norman

LONDON—A report from the U.K.'s new budget forecasting office delivered no nasty surprises and predicted the country will need to borrow less than anticipated in the next few years.

But the Office for Budget Responsibility, underscoring the lasting effects of the recession, also reduced long-term growth expectations and increased the nation's structural budget deficit—the budget gap remaining once the economy returns to normal growth.

The office was created by Prime Minister David Cameron's new coalition government to provide independent budget forecasts for the debt-laden U.K.

On Monday it slashed growth forecasts to 2.6% for 2011, from the previous government's 3.25% estimate, and predicted 2.8% growth for 2012 and 2013, and 2.6% for 2014, compared with the 3.5% predicted in March for each of those three years.

Many economists had expected growth downgrades; some say the predictions are too rosy.

On the upside, the OBR revised down Britain's net borrowing forecast slightly more than expected. For the five financial years through to the spring of 2015, the office lowered the net borrowing total by £23 billion ($33.45 billion), to a total of £544 billion. That is due to factors such as expected stronger tax receipts and a lower unemployment rate.

"The No. 1 issue is fiscal sustainability, and the U.K. is better able to do that than the other high-deficit countries and is better placed than people were expecting," said **Michael Saunders**, an economist at Citigroup.

This eased fears that the U.K. could suffer from the same severe troubles as other debt-laden European economies, such as Greece, whose debt crisis was triggered when a new government sharply revised the departing party's financial figures, sapping investors' confidence in the credibility of Greek government data.

Markets reacted favorably to the report. The U.K. pound jumped against the dollar from about $1.4680 before the news, and the spread between British and German debt yields narrowed.

To keep investors' confidence the U.K.'s coalition government now has to prove it can pare a mammoth £156 billion deficit in its "emergency budget" next week. Investors want proof the new government can turn tough rhetoric into fiscal discipline, detailing lasting cuts in a spending review in the autumn and next spring's budget report.

"Rating agencies and ourselves and many other investors are all sitting in a similar position—which is we're all looking for clarity on the budget and a successful completion of the plans," said Mike Amey, a U.K. fund manager for **Pacific Investment Management** Co.

On Monday the government kept up a barrage of speeches preparing Britain for painful cuts. Defense Minister Liam Fox said the government must act "ruthlessly and without sentiment" when looking at how the military can bear its share of budget cuts. Deputy Prime Minister Nick Clegg said the government needs to look into public-sector pensions, the cost of which is set to more than double over £9 billion in 2014-15.

Making the government's task harder, the OBR revised up to 8.8% the structural budget deficit facing the U.K. economy, from 8.4% in the March budget. The structural gap is expected to be 2.8% of GDP in 2014-15, the OBR said.

The report gave insight into how the U.K. economy has changed, such as the expectation that lower immigration will reduce growth. More widely, economists worry over what will take up the slack from the financial services and from Britain's once free-spending debt-laden consumer.

Mr. Cameron's new government set up the OBR as a centerpiece fiscal reform in its efforts to safeguard the U.K.'s AAA rating and cut its deficit, the largest of the major economies. The OBR's economic forecasts will be used to underpin the budget that is due to be released on June 22.

While many nations have independent economic forecasting offices that also monitor the government's performance, the U.K. is one of only a handful that uses the forecasts in its budgeting.

—Natasha Brereton and Neil Shah contributed to this article.

BOE's Posen defends ECB's bond buying

By Natasha Brereton

Bank of England Monetary Policy Committee member Adam Posen defended central banks' purchases of government debt, saying that far from undermining their independence, the move should enhance their credibility.

In a speech in New York, Mr. Posen said it was pointless for central banks to avoid measures purely for appearance's sake, which could be counterproductive if it prevented the adoption of the most appropriate policies.

He also slammed the "preening machismo" of those who said the European Central Bank had lost its "political virginity" through its decision to buy government bonds, to counter the tightening caused by concerns over the creditworthiness of sovereign debt in the region.

"Not only saying yes to, but initiating the right kind of bond purchases under the right circumstances is part of being a responsible adult policy maker," Mr. Posen said. "I am glad that the decision makers at the major independent central banks today were too mature to get hung up on their appearances."

Some commentators have accused the ECB of bending to political pressure in launching its bond-buying program May 10, four days after its president, Jean-Claude Trichet, told reporters that purchasing government debt wasn't discussed as an option at its policy meeting. Bundesbank chief Axel Weber has also publicly attacked the plan.

At the same meeting, Greece was freed of any collateral requirements for ECB funding, despite an earlier promise by Mr. Trichet that no individual country would receive special accommodation.

Mr. Posen likened the hyperbole surrounding the ECB's decision to "shallow" and "nasty name calling," describing it as an "adolescent" preoccupation with appearance.

"Cultures which make a public fixation of virginal purity, of a stylized maiden's reputation, tend to be backward superstitious cultures that impede people exercising autonomy and making responsible choices," Mr. Posen said.

Bank of England Monetary Policy Committee member Adam Posen

"What matters for our independence is our ability to say no and to mean it, and to be responsible about when we choose to say yes."

The BOE in February suspended its quantitative easing policy through which it bought £200 billion ($295 billion) of mostly government bonds with freshly created central bank money, but it has left open the possibility of reopening the program if conditions deteriorate. Its key interest rate remains at a record low of 0.5%.

In his speech, Mr. Posen argued there would be no damage to a central bank's credibility from purchasing government bonds, as long as that action was in the best interests of its economy. Independence is best maintained by taking the most suitable course of policy action—even if those measures are unconventional, he said.

"The only way that central banks can credibly commit to price stability over the long term is to maintain a political constituency in civil society supportive of such a policy regime," Mr. Posen said.

He stressed this meant guiding the economy as to be in the interests of the majority, rather than currying favor with officials.

"This need holds even if sometimes it requires monetary-policy makers to deviate from what is thought to be their reputational norm," he said.

A report in the BOE's Quarterly Bulletin released Monday had found that while the unexpected resilience of U.K. inflation ties in with the view that businesses' production capability has fallen during the recession, the degree to which economic potential is permanently stunted will depend in large part on the evolution of credit conditions.

'Cultures which make a public fixation of virginal purity … tend to be backward superstitious cultures.'

Judging the difference between what a country is actually producing and what it is capable of producing without creating sustained inflationary pressures is crucial for central bank officials to appropriately set policy, but is notoriously difficult.

Reflecting the division of views on the subject, the U.K.'s new fiscal council Monday estimated the output gap at 4%, compared with the 6.25% assumed in the March Budget Report.

EUROPE NEWS

Spain says banks in credit crunch

BY PAULO PRADA

MADRID—Spanish officials acknowledged that the country's banks and companies are having difficulty finding credit, underscoring the pressure Madrid faces to pursue deep structural reforms to win back investor confidence.

Spain has been scrambling in recent weeks to convince markets that it can repair both its ballooning deficit and its troubled banking sector amid concerns that the country may be forced to seek a bailout. One big worry has been the increasing difficulty Spanish banks have faced borrowing from other banks in the so-called interbanking lending market—an important source of funding that banks rely on for short-term liquidity needs.

Spanish officials have largely been quiet on the issue but on Monday Treasury Secretary Carlos Ocaña, speaking at an economics conference, said tightness of credit for Spain "is a problem."

"Obviously we do need for the markets to loosen," he added.

Speaking at the same conference, Francisco González, chairman of Banco Bilbao Vizcaya Argentaria SA, the country's second-largest bank, said credit markets remain "closed" for many companies and urged the country to accelerate the pending reforms.

"It's a priority that we restore market confidence," said Mr. González.

German Chancellor Angela Merkel, responding to speculation that Spain may be forced to follow Greece in seeking aid from the European Union and International Monetary Fund said late Monday that Spain could tap the EU's rescue fund if necessary.

"If there should be problems—and we shouldn't talk them up—the mechanism can be activated at any time," Ms. Merkel said at a joint news conference with French President Nicolas Sarkozy in Berlin. Ms. Merkel said she didn't want to add to market speculation about Spanish banks' predicament.

The comments come as Spain's Socialist government plans on Wednesday to begin pushing through a controversial labor market overhaul. The proposed reform seeks to address a problem that many economists say is at the heart of the economic malaise across much of Europe: rigid labor markets that dissuade companies from investing, thwarting economic growth.

Spain has a two-tier labor market similar to those in France and Germany. The first level includes typically older, skilled workers in jobs that pay well and are protected. The second consists of younger workers who earn less and can be easily dismissed. Critics say this system has resulted in high youth unemployment and argue deregulating the first tier would lead to the creation of more and better jobs.

Europe's debt crisis is forcing the Continent's most vulnerable countries to make deep cuts to government spending while also finding ways to spur recovery. Many economists argue that the only chance for countries such as Greece, Portugal or Spain to rebound is for governments to unshackle their heavily regulated economies by making it easier for businesses to operate.

At a time when questions abound regarding the viability of Europe's common currency, Spain is a crucial testing ground. Its €1 trillion ($1.2 trillion) economy is the fourth-largest in the 16-nation euro zone, accounting for about 11% of the region's economic output. By comparison, Europe's other teetering economies, Greece, Ireland and Portugal, together account for roughly 6%.

Plans for the labor-market overhaul come as Spain's government scrambles to prepare other reforms, including a restructuring of the country's banking sector, that are also considered crucial. Investors have been pushing for such changes, amid concerns about Spain's rising debt burden, and lenders have been charging higher premiums.

Last week, in a €3.9 billion auction of three-month bonds, Spain offered investors an average yield of 3.3%, compared with a yield of only 2% for a similar auction in April. The difference, or spread, between the yield on Spanish bonds and German debt recently widened to its highest level since the introduction of the euro, a further reflection of investor concern over Spanish debt.

The central government has to borrow €97 billion this year to finance a €553 billion national debt. The increase in borrowing costs could complicate Spain's effort to progressively lower its deficit down from 11% last year, to 9% by the end 2010, and back to within the euro zone limit of 3% by 2013.

Spain's private sector is also facing tighter credit conditions, as lenders remain wary of the impact that a collapsed housing market and shrinking economy could eventually have on the financial sector. Banks don't know how many more bad loans will develop as borrowers continue to succumb to the downturn. And the value of properties that banks now have on their books continues to shrink along with prices of Spanish real estate.

Spain loosened conditions for the use of short-term job contracts in 1997. The change fueled employment during Spain's real-estate driven boom. But it also created a job market that gobbles up workers during growth periods, but quickly disgorges them during downturns.

Associated Press

Union members march in Bilbao on Saturday, calling for a general strike in the Basque region over Spain's new labor law.

Most of the millions of jobs created in Spain during the economic expansion were short term—leading many workers to bounce from job to job, often with minimal wages. When the downturn finally hit, the labor market collapsed. A jobless roster of 1.7 million people in 2007 soared to over 4.6 million by the end of March—a jobless rate of 20%.

Then there are the millions hired under Spain's old labor laws. The security offered by their job contracts, and progressively better benefits, often means it cheaper for employers to keep them than to pay their severance during downturns.

The measures disclosed in a government draft last week would lower severance pay entitlements for new hires to 33 days, from 45, for each year of the worker's employment. In a bid to encourage employers to rely less on temporary workers, the government would also use a state fund to bear the cost of eight of those days as long as the worker was hired on a long-term contract.

The government, which is now discussing the draft with unions, employer groups, and rival parties, plans to present the decree to parliament next week. The assembly can block a decree if rivals muster enough support—an outcome that in May nearly derailed a €15 billion austerity plan that conservatives deemed too tepid.

—Pablo Dominguez contributed to this article.

Euro-zone output surges at a record pace

BY BRIAN BLACKSTONE

FRANKFURT—Euro-zone factories ramped up production at a record pace in April, providing the strongest evidence yet that Europe's recovery is gathering steam after sluggish gains in late 2009 and early this year.

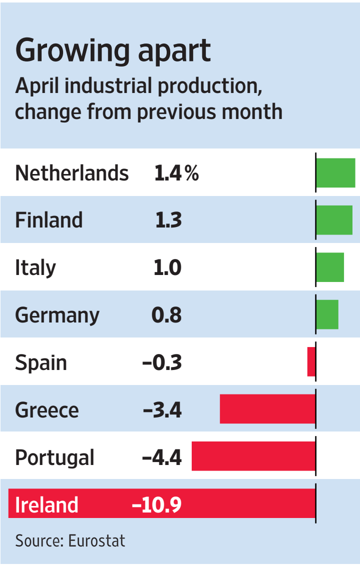
The euro jumped following the release of the data, which soothed some concerns that fiscal crises in the region's southern fringe would derail the economic recovery. Europe's growth rate has significantly lagged behind those of the U.S., China and even Japan. That, as well as the crisis in Greece, has weighed on the shared currency all year.

Monday's industrial-production data mask some worrying trends, economists warn. Production continues to be geared toward capital equipment, or big-ticket items, suggesting the euro zone is still getting its growth from temporary filling of depleted store shelves, investment spending related to exports and overseas demand. That helps out powerhouses such as Germany, but is less beneficial to Greece, Portugal and Spain, which aren't as competitive in export markets.

"Germany is going to forge ahead," said James Nixon, an economist at Société Générale, while smaller countries on Europe's fringe "seem destined to languish in this zero-growth, no-inflation scenario."

Industrial production rose 0.8% in April from March, the EU's statistics office said, nearly double economists' forecasts and the 11th consecutive month of increases.

The figures suggest that after growing just 0.8% in the first quarter, on an annualized basis, gross domestic product in the 16-member currency bloc will expand around 2.5% or 3% this quarter, economists say. Germany, the region's largest economy, accounting for roughly 30% of euro-zone GDP, could expand as much as 5% this quarter, according to economists at JPMorgan Chase.



German factory output increased nearly 14% from the previous year, according to Eurostat. The country's export-led economy is benefiting from global demand and the fall in the value of the euro, which is down about 15% against the U.S. dollar since December.

What Germany is seeing more than its neighbors is a smooth transfer, with exports leading to more investment spending, fewer job cuts and a pickup in hiring, says Volker Treier, chief economist at Germany's chamber of commerce and industry. The government is already seeing the benefits. Sales and corporate-tax revenues rose last month from the previous year, the finance ministry said Monday.

Indeed, the biggest headache these days for Michael Rentschler, vice president at **ERNI Electronics** near Stuttgart in southern Germany, is filling his swollen order books.

"I'm running out of material all over the place," says Mr. Rentschler, whose firm makes connectors and other electrical-transmission equipment for the telecommunications, medical and automotive industries.

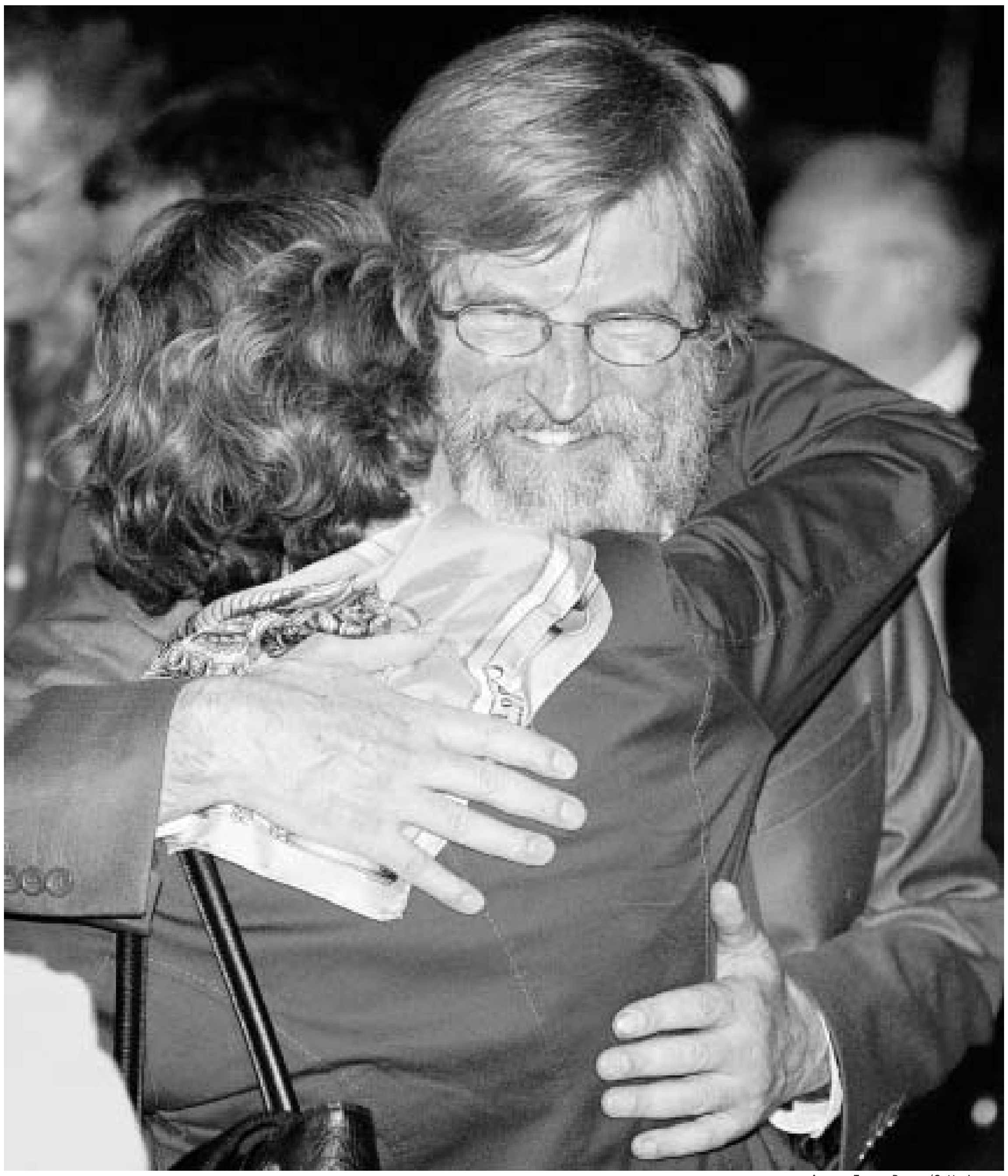
Other Northern European nations including the Netherlands and Finland posted production gains in April. Europe's periphery continues to suffer, with Greece, Portugal and Ireland seeing declines, in Ireland's case by double digits.

Volatile swings in production aren't unusual in those countries. The trend, analysts say, appears to be toward some stability in Portugal and Ireland, which posted large output gains early in the year. There is no such silver lining in Greece, where production is down more than 6% from a year ago.

Economists worry that Europe is still too dependent on demand in other regions such as the U.S. and Asia and—if those recoveries falter—could slide back into a period of very weak growth later on this year.

—Andrea Thomas and Bradley Davis contributed to this article.

Swiss detainee returns home after two years in Libya



Agence France-Presse/Getty Images

Max Goeldi, the Swiss businessman held in Libya since July 2008, embraces a relative at Zurich airport on Monday.

Germany, France strive for unity

Continued from first page

rather than through exports to the German market, Europe's biggest.

Ms. Merkel and Mr. Sarkozy clashed in May over Germany's reluctance to back a bailout fund for euro-zone countries that, like Greece, lose access to bond-market funding. Germany agreed to the fund's creation only under strict conditions, including painful budget austerity for countries that seek aid.

Amid market concern that Spain might become the next euro member to ask for aid, in order to prop up its ailing banks, Ms. Merkel said she didn't want to participate in speculation that could become self-fulfilling. However, she said Spain, like other euro countries, knows it has access to EU financing help if necessary.

Monday's Franco-German summit was supposed to take place a week ago, but the meeting was called off at the last minute, with officials from both governments blaming each other—a state of affairs that highlighted what officials in Berlin and Paris have described as an "icy" climate lately.

Monday, however, the two leaders were at pains to present a united front. "More than ever, Germany and France are determined to speak with one voice," Mr. Sarkozy said. The two leaders made conspicuous efforts to smile and nod at each other's answers at the news conference.

The French president said that what outside observers may view as tensions between the two leaders stem from their hard-nosed characters: "Madame Merkel likes to be convinced [through argument] and so do I," he said.

Both nations remain far apart on the question of what Europe's 'economic government' should do.

Mr. Sarkozy backed down on France's demand for new structures to coordinate economic policies among the 16 members of the euro zone.

Instead, he said he agreed with Ms. Merkel that coordination should take place at the level of all 27 EU members. "We don't want to divide Europe. ... We don't want first-class and second-class members," Ms. Merkel said.

Mr. Sarkozy, however, said he and Ms. Merkel agreed that the 16 euro-zone leaders will convene ad hoc meetings in case of emergency. "The natural frame for economic governance is at 27," Mr. Sarkozy said. "In case of problems, as far as the euro zone goes, we will have the possibility of gathering the 16 members of the area."

Germany wants the wider EU to remain Europe's main forum for high-level diplomacy, partly because Berlin has more allies in the larger organization than in the euro zone, where it has often been isolated on economic issues this year. France, on the other hand, has an easier time assembling a majority within the euro zone than in the wider EU, where it often has policy disagreements with noneuro members.

France and Germany remain far apart on the substantive question of what Europe's "economic government" should do. French Finance Minister Christine Lagarde has called for "a coordinating and efficient executive" that would make sure economic imbalances between strong and weak countries are reduced.

That, as Ms. Lagarde has repeatedly said this year, means Germany should boost its domestic demand in order to help growth in Southern Europe, instead of restraining wages in Germany in order to maximize German exports.

Berlin continues to reject such advice, fearing a loss of German global competitiveness. Instead, its proposals have so far focused on ways to get other countries to impose more budgetary discipline.

"The Germans think they have the right economic model, and they aren't aware that they may be part of the problem," said Ulrike Guerot, senior fellow at the European Council on Foreign Relations.

EU moves to curb short-selling, CDS

Commission mulls bans during emergencies

BY STEPHEN FIDLER

The European Union gave new insights Monday into how it might regulate some of the markets at the center of concerns about global financial stability, but its executive arm indicated it wasn't seeking an outright ban on so-called naked credit-default swaps.

German Chancellor Angela Merkel and French President Nicolas Sarkozy have urged the European Commission to consider prohibiting naked CDSs, which they consider have intensified speculative pressure on euro-zone government bond markets.

Credit-default swaps provide a form of insurance for bondholders, paying out in the event of a default on the debt. But people can buy CDSs on a naked or uncovered basis, meaning they get paid if a bond defaults even if they don't hold the bonds being insured.

However, the European Commission did suggest temporary restrictions could be imposed on CDS transactions and short selling of shares and bonds during in a financial emergency. It proposes that the European Securities Market Authority—a new body being set up under other legislation—would be able to override national authorities if they took such actions in the absence of an emergency.

The greater clarity of the commission's thinking on these issues came in consultation documents it released Monday on proposals for tougher regulations of derivatives markets.

After the consultation, which closes next month, the commission will propose new legislation in September. That will then be discussed separately by EU governments and the European Parliament before a final version emerges.

Michel Barnier, the commissioner in charge of financial regulation, said the commission wanted to ensure European proposals converged with others around the world. "Europe will be ready to adopt strong regulation on derivatives, in a way that is coherent with proposals now being finalized in the United States," he said.

The proposals are meant to conform with similar exercises in the U.S. in an effort to prevent regulatory arbitrage, allowing firms to shop around for the weakest regulatory regime.

However, the commission said it did intend to bring into the regulatory net foreign-exchange derivatives, an area of the markets that the U.S. considers functioned well during the financial crisis and therefore need not be regulated as tightly as other parts of the derivatives market.

The proposals are meant to encourage a large proportion of derivatives trades to be cleared through so-called central counterparties, which place themselves on the other side of every sale or purchase that they clear. The consultation is seeking public comment on ways of making sure that the central counterparties themselves don't become a source of extra financial risk.

The proposed measures would also require the reporting of every over-the-counter derivatives trade, including those in CDSs. A separate set of proposals are also expected to emerge later in the year aimed at driving more derivatives trading to exchanges, away from bank-dominated over-the-counter markets.

The requirements are aimed at reducing any risks to the financial system posed by CDSs, but the commission says "they would also increase the upfront cost of engaging in speculative derivatives deals."

The proposals have already been the subject of intense lobbying by financial firms and some non-financial companies. This has been partly successful in encouraging the proposed exemptions for non-financial firms. The commission said it hadn't proposed a limit on trading in derivatives trading by non-financial firms, because that would risk companies trying to game the system.

One senior official said the commission believed an exemption from the rules was justified for industrial and service companies carrying out hedging activities that were integral to their business, but not if they started acting like financial firms. "If there is any tendency to drift across the barrier...then they are going to be caught," he said.

The commission also asks whether exemptions to the short-selling rules are justified for market makers and whether any exemptions are needed for shares whose main market is outside the EU.

One of the goals of the proposals is to unify regulation across the 27-nation EU, where a patchwork of different rules apply that provide opportunities for firms to seek out the weakest regime.

For example, 11 countries require disclosure of short selling, six countries have introduced some bars on naked short selling—selling shares with the intention of buying them back later when the price falls, but without prior arrangements to borrow the shares to be sold. Denmark, France and Ireland ban short selling of some financial shares, while Greece bans short-selling entirely.

Details of the consultation

Excerpts from the document sent to interested parties for feedback. Questions include:

■ What should be the scope of the exemptions for non-financial corporations regarding central clearing of derivatives?

■ How can central counterparties be prevented from becoming a source of risk?

■ Should disclosure rules require notification of all short selling beyond a certain threshold to regulators, and a higher threshold to markets? Or should only significant net short-selling positions in EU sovereign bonds be brought to the attention of regulators and/or markets?

Source: European Commission

Fine time for Washington to grow frugal

[Capital Journal]

By Gerald F. Seib

Sometimes political change comes rapidly and dramatically. Sometimes it creeps in on little cat feet.

A change of the latter variety is unfolding right now in Washington, as worries about deficit and debt are slowly overtaking all other priorities. Given the nation's depressing long-term deficit picture, this is understandable and laudable.

It also raises a question, though: Is Washington finding religion on the deficit at exactly the wrong time?

Evidence of a kind of religious revival on the deficit is popping up all over. Over the weekend, a Democratic president, Barack Obama, had to send a letter to a Democratic-controlled Congress urging lawmakers to agree to send billions of dollars in emergency aid to state and local governments to prevent "massive layoffs" of teachers and public-safety officers.

The political imperative of showing that Obama gets the gravity of the deficit is running smack into a short-term policy desire to keep priming the economic pump.

A year ago—or perhaps at any time in recent memory—scattering federal money across the country to keep teachers in the classroom and cops on the beat, and to provide juice for a sluggish economy, would have been a no-brainer. The only question would have been: How fast can we do it?

Not now. Congress is balking.

But that's only one straw in the wind. Because of deficit worries, lawmakers also have been slow to pass an extension of unemployment benefits, and have backed away from extending health benefits for the uninsured. Both would have been motherhood-and-apple-pie ideas less than a year ago.

As it is urging spending on some fronts, the White House is trying on other fronts to get out in front of this deficit-cutting mood.

It has proposed a three-year freeze on nonsecurity discretionary spending. It is trying to give agencies an incentive to cut spending by proposing that if they save money in one program, they can shift half of the funds to another program rather than lose those funds. It has proposed reviving "pay-go" rules requiring that any spending increases be offset with cuts or tax increases elsewhere.

None of these moves is sufficient to make a real dent in a federal budget deficit expected to run $1.5 trillion for the year ending Sept. 30, and another $1.3 trillion next year. But together they tell of a shift in the capital's zeitgeist: Deficits are no longer an abstract problem, but a real political threat both parties think they must address.

This new zeitgeist was aptly captured one morning last week in a subterranean meeting room at the U.S. Capitol. The occasion was a conference hosted by the American Action Forum, a new think tank started by Douglas Holtz-Eakin, former Congressional Budget Office director and Republican presidential campaign adviser. The leadoff speaker was Sen. Judd Gregg (R., N.H.), fiscal scold and newly minted member of a bipartisan commission on "fiscal responsibility" that's supposed to figure out what to do about America's addiction to deficits and debt.

Mr. Gregg began the proceedings with a PowerPoint presentation that was designed to be frightening, and that achieved its purpose. Slide after slide painted a picture, mostly in red, of an industrialized world awash in debt, with Japan's problems the worst but America's not far behind.

One showed U.S. government debt recently passing the average that has prevailed since 1960—37% of gross domestic product—then shooting almost straight up to top 65% in the next two years.

Another showed cumulative debt tripling in just 10 years, between 2008 and 2018. And so on.

These are the pictures that animate the tea party political movement, and the images that are sinking in across official Washington as well. One reason, of course, is that Greece's shaky walk toward insolvency has scared thinking people in Washington into asking: Are we headed there, too?

For a variety of reasons, the answer is, probably not. Indeed, an equally valid question is: Is this really the right time to make deficit-cutting the top priority, when the economic recovery looks more fragile than it did just a few weeks ago, when state governments laying off people might help kill off recovery in its cradle and when a little juice from Washington is what's needed to prevent that from happening? Especially when financial markets, seemingly unspooked by deficits, remain willing to lend the government money at historically low rates?

That is precisely what White House economic advisers are asking. The result is that Mr. Obama finds himself in an exquisite political and policy dilemma. The political imperative of showing that he gets the gravity of the deficit is running smack into a short-term policy desire to keep priming the economic pump.

That has left Mr. Obama in the unenviable position of arguing—as he did in his weekend letter to Congress—that spending be increased and cut at the same time. Welcome to the wacky world of a deficit-aware Washington. Get used to it; we'll be here for a while.

Special Advertising Section

ROMANIA

Foreign funds can now find many fertile fields

Government proposes austerity program to put country back on its path of growth

By Catherine Bolgar

While Romania's prospects for a return to growth this year have dimmed, for foreign investors the news is brighter.

A controversial proposal to cut public-sector wages 25% may hold down salaries in the private sector as well, while the depreciation of the leu (which fell 15% against the euro during 2009) makes Romanian exports more competitive. The government has pledged to get its budget deficit under control.

For nearly a decade, Romania had red-hot growth topping 4% annually, among the fastest in Europe. The country's entry into the European Union in 2007 gave Romania the benefits of free trade in Europe, while offering far lower costs. But its cost advantage started to erode as a boom took hold and wages shot up. Companies were "hiring people hand over fist every six months" because everyone was hopping to new, better-paying jobs, explains Matei Paun, managing partner of BAC Investment Bank, a regional investment bank, and one of the founders of the Romania Think Tank, an independent organization based in Bucharest.

FABRICE COFFRINI/AFP/Getty Images

French auto maker, Renault, bought state-owned Dacia in 1999.

Now, "pressures on the labor market have subsided, so it's easy to find well-qualified, inexpensive people here," he says. "If there was an argument to invest here two or three years ago, that argument is even stronger now. Costs are down but people haven't gotten less qualified."

Romania has turned out to be a gold mine for Renault SA. The French auto maker bought state-owned Dacia in 1999 and today has waiting lists in some markets for the Dacia Logan models, which are sold in 47 countries. Starting with the Logan sedan, Dacia expanded with station wagon, van and pickup models. The plant also makes the Sandero hatchback and Duster 4x4 models. The new Duster is so popular, buyers face a six-month wait, though the plant is adjusting its production to better accommodate demand.

Renault has invested €1.5 billion in modernizing the main plant at Pitesti, 120 kilometers from Bucharest, as well as creating, in 2006, a regional engineering center and, in 2007, a design center, all for the Logan. Renault and Dacia employ 17,500 people in Romania, with annual production of nearly 300,000 vehicles as well as parts for vehicles assembled in other countries.

Ford Motor Co. of the U.S. also has invested in Romania, buying the Craiova assembly plant from the government in March 2008 for €57 million. The plant started producing light commercial vehicles last fall, and is expected to also make a new small car and engines. Ford plans to invest €675 million to modernize the plant, which is about 360 kilometers from Bucharest. The plant is expected to produce up to 300,000 vehicles and 300,000 engines a year and employ 7,000 people.

The auto sector's success drives other industries, says Liviu Voinea, executive director of the Group of Applied Economics, or GEA, an independent think tank in Bucharest. "The rubber industry is booming," he says. "The other supplier industries are benefiting."

Privatizations are likely to continue. The government has committed to selling off minority stakes in 150 companies, says Mr. Paun of BAC Investment Bank. The cargo business of the national rail company may go on the block. Meanwhile, Romgas, the national gas company, is looking to list on the stock exchange and Petrom, the state oil company, may list up to 10% of its shares. "This could be something of a boon to local capital markets," Mr. Paun says.

The economy could use it. "It's a V [shaped trajectory] turning into an L," Mr. Paun says. "Which is not the worst thing. The worst thing would be for the recession to deepen."

The International Monetary Fund, which gave Romania a €12.9 billion loan last year even before the country felt the effects of the global recession, has revised its estimates for slight growth this year to a modest decline, with a return to growth next year.

Between 2005 and 2008, the previous government raised pensions and salaries and increased the number of state workers, says Paul Dragos Aligica, senior research fellow at the Mercatus Center at George Mason University in Arlington, Virginia. The moves "left the country with a budget deficit and a bloated state sector," he says.

"If there was an argument to invest here two or three years ago, that argument is even stronger now."

President Traian Basescu announced a package of budget cuts, including slashing public wages 25% and pensions 15%, which brought tens of thousands of Romanians out on the streets to protest last month. The fact that the president unveiled the plan is notable, Dr. Aligica says. "It's the government's reform program, not the IMF's reform program."

The IMF had suggested tax increases. "The government considers that raising taxes would have been a worse measure than cutting salaries and pensions," says Mr. Voinea of GEA. He fears that tax revenue will decline as Romanians, facing smaller paychecks or pensions, spend less. The other option, he concedes, likely would have fueled inflation, which for now is under control.

Dr. Aligica praises the central bank for keeping inflation (predicted by the IMF to be 4% this year) in check.

Meanwhile, the slump is "a great opportunity to come in and scoop up market share," says Mr. Paun. "Three or for years ago, people complained that things had gotten too expensive. Companies were trading at higher multiples. Clearly, that's no longer the case."

U.S. NEWS

Lawmakers cite 'shortcuts' by BP

Letter to Hayward mentions 'five crucial decisions' on well's design; CEO to face tough questions before Congress

By Neil King Jr.

WASHINGTON—Congressional investigators say documents uncovered as part of their inquiry into the Gulf of Mexico oil spill have raised "serious questions about the decisions made by **BP** PLC in the days and hours before the explosion on the Deepwater Horizon" drilling rig.

In a letter sent Monday to BP Chief Executive Tony Hayward, the Democratic leaders of the House Energy and Commerce Committee say that in the days and hours leading up the April 20 explosion, BP appears "to have made multiple decisions for economic reasons that increased the danger of a catastrophic well failure."

The letter amounts to a warning to Mr. Hayward that he will face tough questioning Thursday when he testifies for the first time before Congress.

BP declined to respond to the specifics raised in the letter. "Tony Hayward will be testifying on Thursday before the full committee, and we would expect that the committee will raise these issues in the hearing," said a BP spokeswoman, Anne Kolton.

The letter, written by committee Chairman Henry Waxman and oversight subcommittee Chairman Bart Stupak, advises Mr. Hayward to bring other officials and technical experts to answer an array of pointed questions under oath about specifics of the well's design, safety measures, and operations on the Deepwater Horizon rig.


Reuters
President Obama walks with Coast Guard Rear Adm. Allen in Gulfport, Miss. Mr. Obama will meet with BP Wednesday.

The letter cites evidence that "at the time of the blowout, the Macondo well was significantly behind schedule" and says those delays appear "to have created pressure to take shortcuts to speed finishing the well."

The letter quotes from an email message sent between two BP engineers six days before the explosion in which one drilling engineer calls the project a "nightmare well which has everyone all over the place."

The lawmakers then cite what they call "five crucial decisions" that BP made in designing and completing that may have led to vulnerabilities in the well's design. "The common feature of these five decisions is that they posed a trade-off between cost and well safety," the letter says.

Meanwhile, BP, under U.S. pressure to contain the spill, has outlined plans to capture all of the oil currently estimated to be flowing from the well. In a letter sent Sunday to U.S. Coast Guard Rear Admiral James Watson, BP said it expects to have the capacity to capture between 40,000 and 53,000 barrels of oil a day by the end of June. That compares with 15,000 barrels a day now, out of a flow of 20,000 to 40,000 barrels scientists estimate are coming from the well.

BP, which said further enhancements will increase the collection capacity to as high as 80,000 barrels a day by mid-July, submitted its latest plan after Mr. Watson, the federal government's second-in-command for the spill response, told the company Friday its previous plan was insufficient and gave BP a 48-hour deadline to come up with a revised approach.

Mr. Watson said in a statement Monday that "BP is now stepping up its efforts to contain the leaking oil," noting that the new plan's call for collecting 50,000 barrels of oil by the end of June is two weeks earlier than the previous timeline.

"Their revised plan also includes methods to achieve even greater redundancy beyond the month of June, to better allow for bad weather or unforeseen circumstances," Mr. Watson said.

On Monday, U.S. President Barack Obama made his fourth trip to the Gulf Coast since the April 20 sinking of the BP-leased Deepwater Horizon rig. On Wednesday, the president plans to tell BP officials in a meeting at the White House that the company should create a special reserve to pay for damages caused by the spill.

Senate Democrats on Monday asked BP to set aside $20 billion in a special account to be used to pay for economic damages and cleanup costs. BP is also under pressure in Washington to suspend its dividend.

The company said it has collected 134,500 barrels of oil since the containment process began.

—Susan Daker and James Herron contributed to this article.

Fed weighs options should U.S. recovery falter

Continued from first page

near zero and signal no inclination to change that for a long time. But behind-the-scenes discussions could include precautionary talk about what happens if the economy doesn't perform as well as expected.

"If events in Europe evolve so that they have a more severe and broad impact on financial markets, then the scope of the problems for the U.S. could be magnified," Charles Evans, president of the Federal Reserve Bank of Chicago, said in a speech last week.

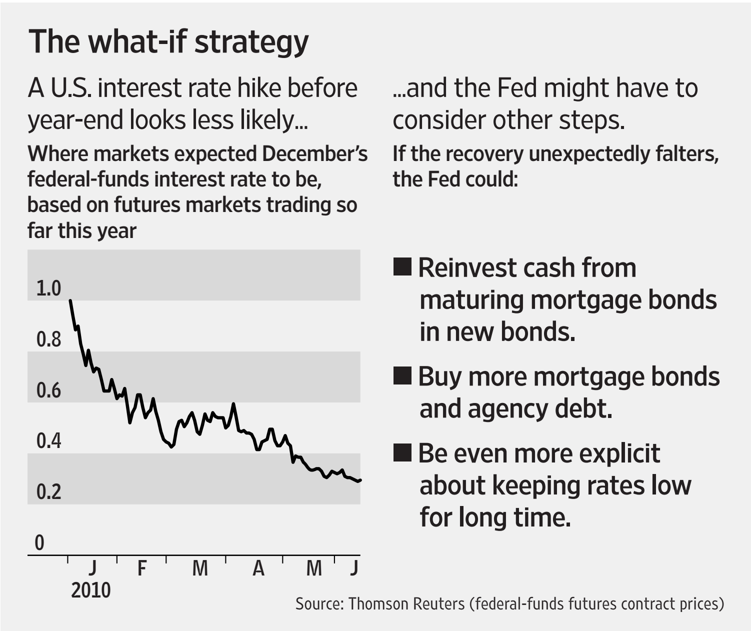
New York Fed officials have begun talking about "two-sided" risks to the economy—in other words, the risk that growth and inflation could come in lower than expected as well as higher.

Some of the Fed's "hawks," who tend to worry most about an increase in inflation also have noted risks on the economic horizon.

"The European sovereign-debt situation is serious and there are many unanswered questions about how events will unfold," James Bullard, St. Louis Fed president, said in Tokyo on Monday.

Mr. Bullard said he expected the recovery to remain on track, echoing the cautiously reassuring comments by Fed Chairman Ben Bernanke last week. By September, Mr. Bullard noted, the nation's output of goods and services is likely to have recovered to prerecession levels.

But high unemployment is another widespread concern. "I would be surprised if the national unemployment rate were to fall below 9% before the end of 2010 or below 8% by the end of 2011," Narayana Kocherlakota, Minneapolis Fed president, said Friday.



Fed officials have been planning an exit from easy money policies for months. They have allowed several emergency programs to expire. Discussions at recent meetings have been focused on such issues as selling some of the mortgage-backed securities the Fed bought during the crisis.

Officials don't rule out the possibility that markets could settle and the economy could produce a few months of strong job growth and solid consumer spending and business investment, prompting them to proceed toward raising interest rates sooner than markets expect, which is early 2011. One Fed bank president, Thomas Hoenig of Kansas City, wants to start moving toward tightening this summer.

But if the recovery falters, or inflation slows much further and deflation threatens, there are at least two avenues the Fed can take.

The first is asset purchases. During the financial crisis, the Fed purchased $1.25 trillion in mortgage-backed securities on top of buying debt issues by Fannie Mae, Freddie Mac and the U.S. Treasury. Mr. Bernanke has said the steps helped to lower long-term interest rates, including those on mortgages.

The Fed could resume such purchases, though it isn't clear they would have as powerful an effect as they had in 2008 and 2009, because long-term rates are already low. Rates on 30-year fixed-rate mortgages are about 4.7%, down from 5.2% in early April.

The Fed could also take an intermediate step. Right now, it is not reinvesting cash it gets when mortgage-backed securities are paid off by borrowers. If the Fed reinvested that cash—projected to be about $200 billion through 2011—in mortgage bonds or Treasurys, it would help keep the financial system awash in money and could hold interest rates down.

The Fed also could alter the words it uses. Since March 2009, the central bank has said it planned to keep short-term interest rates low for "an extended period." If the Fed strengthened this reassurance, that could help to keep longer-term interest rates from rising.

A new report by the Federal Reserve Bank of San Francisco, based on projections for inflation and unemployment, suggests that the Fed may not need to raise short-term interest rates to curb growth or inflation until early 2012, later than is commonly expected on Wall Street.

The report cites a rule of thumb that the Fed tends to lower the federal-funds rate by 1.3 percentage points if inflation falls by one percentage point and by almost two percentage points if the unemployment rate rises by one percentage point.

Based on that rule, the federal-funds rate—now near zero—would be minus 2.9% under today's conditions and wouldn't need to move higher until the first half of 2012, according to San Francisco Fed economist Glenn Rudebusch. The analysis factors in the stimulus the Fed has provided with its mortgage purchases.

"It seems likely that the Fed's exit from the current accommodative stance of monetary policy will take a significant period of time," the report said.

WORLD NEWS

Kyrgyzstan clashes threaten region

About 100,000 refugees flee to neighboring Uzbekistan; government requests Russia's help in restoring order

BY KADYR TOKTOGULOV
AND ALAN CULLISON

BISHKEK, Kyrgyzstan—Ethnic violence racked this strategically important Central Asian country for a fifth day Monday, threatening to destabilize what has been a conduit for troops and supplies for the U.S.-led war in Afghanistan.

Sporadic gunfire continued overnight and fresh fires raged in the south, in violence the Health Ministry said has killed at least 124 people. Officials say the death toll could be considerably higher, as the current count includes only the dead at hospitals and morgues.

Jallahitdin Jalilatdinov, the leader of the minority Uzbek community in Kyrgyzstan, told the Associated Press that more than 200 Uzbeks have been killed in the fighting. Around 100,000 people have now fled fighting into neighboring Uzbekistan, he said.

Violence abated somewhat in Osh, the southern region's largest city, residents said, although armed Kyrgyz gangs continued to roam the streets. But fighting intensified in Jalal-Abad, another southern flashpoint, where witnesses reported that a hotel, a shopping mall and at least 10 homes were on fire. Leaflets dropped there from government helicopters called for calm.

Armed Kyrgyz amassed at Jalal-Abad's central square and planned to travel to the nearby Uzbek settlement of Suzak in search of an Uzbek community leader they blame for starting the trouble, the AP said.

"It is not yet possible fully to contain the situation," Temir Sariyev, deputy head of the country's interim government, told reporters in Bishkek. "Armed groups are breaking through here and there, and this is linked to the fact that our forces are insufficient."

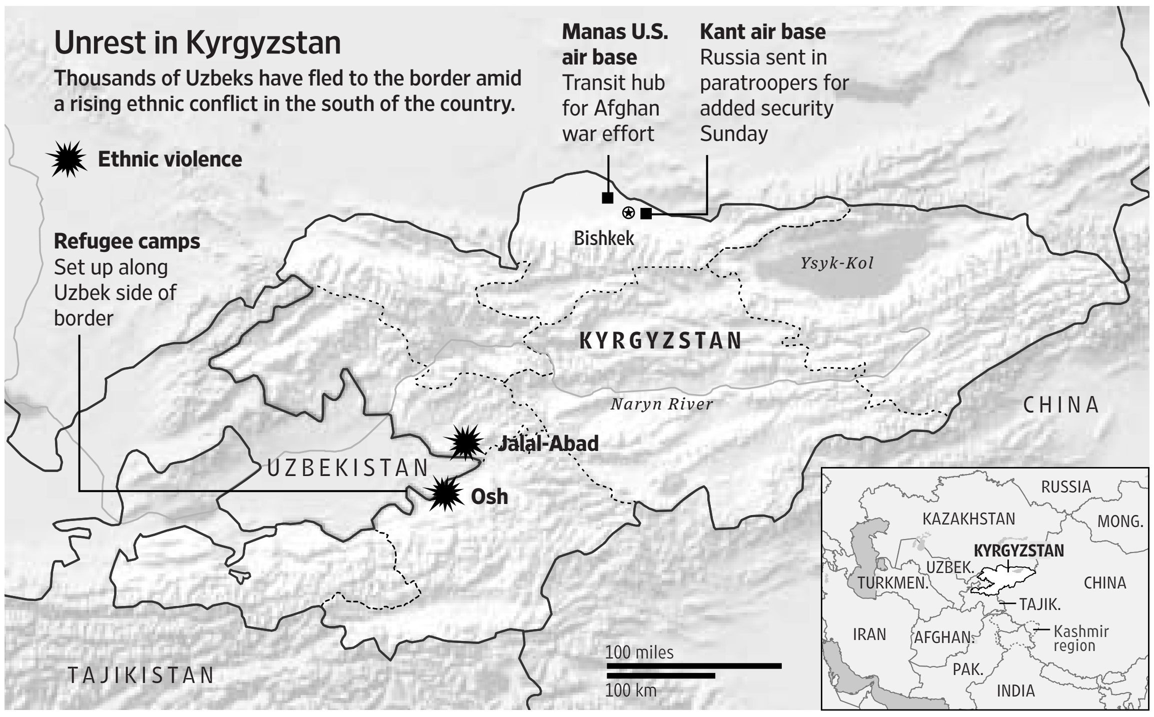
For the first time since Kyrgyzstan declared independence in 1991, the government on Saturday appealed to Russia for help in restoring order. The Kremlin responded by saying it was sending 300 paratroopers—but only to protect its own military base near Bishkek, far from the fighting in the country's south. Russia otherwise appears wary of being drawn into the Kyrgyz conflict.

For days after clashes erupted late Thursday, Kyrgyzstan's own security forces failed to contain a rising tide of ethnic violence in the south.

On Monday, however, residents reported that security forces had set up checkpoints in Osh and were stopping cars without license plates. Many such cars, suspected of carrying gangs involved in attacks and looting, had been on the streets Sunday. Security forces also escorted a busload of South Asian students to the airport in Osh, residents said.

Associated Press

Uzbek refugees walk in the southern Kyrgyz city of Osh, near the country's border with Uzbekistan.



Some municipal services resumed in Osh for the first time since the violence erupted, and less shooting was heard.

But young Kyrgyz men wearing masks and carrying metal poles roamed streets littered with burned cars and tires.

"These young guys are aggressive," said a Kyrgyz resident who identified himself only as Azamat. "Ethnic Uzbeks aren't seen on the streets."

Mahmud, who declined to give his last name, said he and other Uzbeks had barricaded the roads to their neighborhood in Osh with cargo containers, trucks and cars. "No gangs have come to us. Last night half the male population managed to get some sleep."

An ethnic Russian woman who declined to give her name said from Osh: "It is better today, thank God. Trash was collected today by the municipality. Bread was distributed for free. There was no visible smoke in town. Some shots are being heard, but rarely. It is less tense. Military troops are seen on the streets."

The ferocity of the fighting heightens fears of wider havoc in Central Asia, whose hitherto peaceful former Soviet republics have been a base for resupply of the U.S.-led war in Afghanistan.

The U.S. State Department Sunday called for a quick restoration of peace and order, and endorsed efforts by the United Nations and the Organization for Security and Cooperation in Europe to find a solution.

For nine years the U.S. has maintained an air base in Kyrgyzstan, known for its picturesque mountains and high meadows.

Lately the country been the scene of civil strife: In April, mobs toppled its autocratic president after protests over his alleged corruption and utility rate increases. Now ethnic strife has sprung up in the vacuum left behind.

Leaders in Bishkek's interim government have blamed the ousted president, Kurmanbek Bakiyev, for inciting unrest in the south in an effort to regain power.

Speaking to reporters Monday, Mr. Bakiyev again blamed the interim government for not preventing the rioting, the AP said.

Kyrgyz security chief Kenishbek Duishebayev said Monday evening on television that Mr. Bakiyev's younger son, Maxim, was arrested in Britain when he flew into a Hampshire airport on a leased private plane, according to the AP. Prosecutors, who placed him on an international wanted list in May, alleged that companies he owned avoided almost $80 million in taxes on aviation fuel sold to suppliers of the U.S. air base. The U.K. Home Office and local police and airline officials declined to comment.

The brunt of the violence has been borne by ethnic Uzbeks, who are a sizable minority in Kyrgyzstan, mainly concentrated in the south.

Uzbek officials say that thousands of Uzbeks, many of them women and children, have fled over the Kyrgyz border into neighboring Uzbekistan, after ethnic Kyrgyz began burning Uzbek homes and looting shops in the southern Kyrgyz city of Osh. Uzbekistan's Emergencies Ministry said it was setting up refugee camps for the victims in border areas, according to Russia's RIA Novosti news agency.

Ethnic tensions have simmered between Kyrgyzstan's ethnic communities since the collapse of the Soviet Union, but have seldom broken above the surface. They stretch back to 1990, when rising ethnic nationalism and worsening economic conditions before the breakup of the Soviet Union let to a deadly conflict in which hundreds were killed before it was eventually put to a stop when Soviet troops intervened.

The Kyrgyz government dispatched troops to the city over the weekend, but that has done little to stop the fighting. On Sunday, Kyrgyz officials declared a state of emergency throughout Jalal-Abad province, which borders on Uzbekistan.

India's inflation rose above 10% in May

BY ANANT VIJAY KALA
AND PRASANTA SAHU

NEW DELHI—India's inflation rate accelerated into double digits in May as food prices remained firm and prices of nonfood items rose, adding to market expectations that the Reserve Bank of India will tighten monetary policy soon.

The benchmark wholesale price index rose 10.16% in May from May 2009, higher than April's 9.59% rise. The level was beyond market expectations of a 9.60% rise.

The government also revised March's inflation reading to 11.04% from a provisional 9.90%, showing that inflationary pressures haven't ebbed despite efforts by the federal government and central bank to bring them under control.

Kaushik Basu, chief economic adviser to the Finance Ministry, said the double-digit inflation rate is a matter of concern, adding that high iron and steel prices have contributed substantially to the figure.

"I was more or less expecting last week, seeing the little bits and pieces of data that were coming in, that this [double-digit inflation] was going to happen, but still when it happens it does not come as good news," Mr. Basu told reporters. He expects inflation to ease to 5% by the end of the fiscal year in March.

The economy remains on a strong footing, however, and Mr. Basu expects it to expand 8.9% in the April-June quarter.

It grew 7.4% last fiscal year and is projected to expand 8.5% this year. Data Friday showed a stronger-than-expected bounce in industrial output in April.

Those data may make the central bank less reluctant to raise rates before its scheduled rate-setting meeting in July, many economists say.

Inflation in India has been driven primarily by high food prices. But demand pressures have now spread to nonfood manufactured products, preventing inflation from cooling.