DJIA 10380.43 ▼ 1.33% Nasdaq 2265.64 ▼ 2.33% Stoxx Eur 600 237.18 ▼ 3.94% FTSE 100 5123.02 ▼ 2.62% DAX 5715.09 ▼ 3.27% CAC 40 3392.59 ▼ 4.60% Euro 1.2650 ▼ 0.47% Pound 1.4680 ▼ 1.94%

For stocks, healthy pause or start of a big fall?
BUSINESS & FINANCE 17

How shale gas is going to rock the energy world
JOURNAL REPORT

THE WALL STREET JOURNAL.

VOL. XXVIII NO. 69 | EUROPE | Monday, May 10, 2010

DOWJONES A News Corporation Company | europe.WSJ.com

Merkel suffers poll setback over bailout

By Marcus Walker

BERLIN—Chancellor Angela Merkel's center-right alliance suffered a stinging defeat in a crucial regional election Sunday amid a voter backlash against German financial aid for Greece, adding to Ms. Merkel's woes as her government grapples with the mounting debt crisis in the euro zone.

Ms. Merkel's conservative Christian Democratic Union and its junior partner, the pro-business Free Democratic Party, were set to lose power in Germany's most populous state, North Rhine-Westphalia, according to projections based on exit polls and early vote counting Sunday evening. The result means Ms. Merkel's national government, which also includes the CDU and FDP, is set to lose its majority in Germany's upper house of parliament.

That would force Ms. Merkel to negotiate with left-leaning opposition parties to

European Pressphoto Agency

Germany's Angela Merkel

pass important economic legislation, hitting her government's ambitions of pushing through overhauls such as tax cuts.

It wasn't clear late Sunday whether the center-left Social Democrats, or SPD, and their allies the Greens had won enough vote to form a governing majority in the state legislature of North Rhine-Westphalia, which is home to Germany's industrial heartland. The CDU was widely expected to lose votes in the regional election, but outright victory for the center-left is a surprise, and suggests rising voter anger in the past few days over Ms. Merkel's decision to grant aid to Greece may have played a decisive role.

The CDU won 34.3% of the vote in North Rhine-Westphalia, according to preliminary results—worse than expected and about 10 percentage points less than in the state's last election in 2005. The SPD also won around 34.5%, but the Greens' strong support of around 12.4% was set to give the center-left a slender majority in the state legislature.

"The SPD is back," Hannelore Kraft, the party's leader in North Rhine-Westphalia, told her cheering supporters in Düsseldorf on Sunday.

■ Germany's slow change of mind about Europe 7

Reuters

A police officer guards No. 10 Downing Street on Sunday in London. The Conservatives and the Liberal Democrats will meet again Monday to try to forge a power-sharing agreement.

EU scrambles ahead of markets opening

By Stephen Fidler
And Charles Forelle

BRUSSELS—European Union finance ministers met Sunday to agree on a bailout fund they hoped would stem an intensifying crisis in the euro zone that threatens the stability of financial markets around the world.

With a self-imposed deadline to reach agreement before Asian markets opened on Monday morning, ministers from all 27 EU nations aimed to assemble a package impressive enough to arrest worries about the debt problems of euro-zone governments such as Portugal, Spain and Italy.

Facing a fast-deteriorating mood in markets late last week, euro-zone leaders meeting in Brussels late Friday to set the seal on a €110 billion ($145 billion) bailout for Greece convened the ministers' meeting Sunday to provide what President Nicolas Sarkozy of France called a "systemic response" to a "systemic crisis."

In an indication of gathering world-wide concern, the White House said President Barack Obama on Sunday spoke with Mr. Sarkozy and German Chancellor Angela Merkel to urge "resolute action to build confidence in the markets." Leaders of the Group of 20 major economies scheduled a telephone call late Sunday to discuss the cri-

Please turn to page 7

The Quirk

Children gone, empty nesters now ferry their pets from activity to activity Page 29

World Watch

A comprehensive rundown of news from around the world Pages 30-31

Editorial & Opinion

Victor Davis Hanson on Greek tragedies—past and present. Page 12

U.K. coalition talks inch ahead

A weekend of deal-making failed to create a new government in the wake of Britain's inconclusive general election, as the difficulty of striking a workable coalition underscored the fact that any resulting alliance may leave the U.K. with a fragile government for some time to come.

By Alistair MacDonald, Laurence Norman And Neil Shah

Britain last week woke up to its first "hung parliament" since 1974, after the Conservative Party won more seats than Prime Minister Gordon Brown's Labour Party and the Liberal Democrats, but fell short of securing a majority, meaning they are reliant on outside support to form a government. But for the Tories and their leader, David Cameron, striking such a deal isn't coming easy, and the weekend ended with Mr. Brown still in place as prime minister.

The thrust of this weekend's efforts focused on talks between the Conservative and Liberal Democrat parties, which together would have a firm majority.

After a seven-hour session of "positive and constructive discussions" on Sunday, those two parties will meet again over the next 24 hours to try to forge a power-sharing deal, said William Hague, the Conservative Party's top foreign-affairs official.

Acknowledging that the lack of a resolution could spook financial markets worried about the U.K.'s record deficit, Liberal Democrat negotiator Danny Alexander said "any agreement made will have deficit reduction and economic stability at its heart."

Labour still hopes that if the Conservatives' negotiations break down they can form a coalition with the Liberal Democrats and other smaller parties.

Liberal Democrat leader Nick Clegg met with Mr. Brown, even as his party negotiated with the Conservatives. Later Sunday, Mr. Clegg also met with Mr. Cameron in Parliament.

But Mr. Brown faced increased speculation about his future, as several Labour lawmakers called for him to step

Please turn to page 4

■ There are no real winners in this vote 14-15
■ British markets face a rollercoaster ride 4

£1.50
Bahrain BD 1.50 - Egypt $1.75 (C/V) Jordan JD 2 - Kuwait KD 1 - Oman OR 2 Qatar QR14 - Saudi Arabia SR 14
THE WALL STREET JOURNAL.

PAGE TWO

For euro land, first comes the pain, and then the hard work will follow

[Agenda]

By Irwin Stelzer

Germany is the new China.

China keeps its export machine rolling by pegging its yuan to the dollar, so that America cannot devalue its currency relative to the yuan, and instead must live with a large trade deficit. Which Americans can't afford. So China lends America the money with which to buy Chinese goods.

Germany keeps its export machine rolling by in effect pegging its currency, the euro, to the currencies of its European trading partners, who share that currency. So Greece, to which Germany sells lots of goods, can't devalue, and must live with large trade deficits. Which it can't afford. So Germany is setting about lending money to Greece—other countries to follow shortly —so that Greeks can continue to buy Mercedes cars and other products of the efficient German manufacturing and service sectors. And for good measure, it benefits from the falling euro, driven down by the Greek tragedy or comedy, take your pick, to increase its sales to non-euro countries.

Which tells us something about how all of this is going to play out. In the short term, Greece's euro-zone partners and the International Monetary Fund will cover its needs. Fathom Financial Consulting reckons that the €110 billion ($140 billion) bailout package will cover the €50 billion in Greek debt due to mature by mid-2012, plus deficits the government will incur this year and next. That assumes the Greek government sticks to its austerity program in the face of continuing riots. Then it will have to restructure, the polite term for a partial default, with unpleasant consequences for the balance sheets of German and French banks, which hold €63 billion out of €290 billion of outstanding Greek government bonds.

Associated Press

Containers loaded in Hamburg. Germany would like a few to still go to Greece.

The hope is that the European Commission's forecasts will prove excessively gloomy, and that the European economies will grow more rapidly than the commission expects, producing at least some additional tax revenues that might, only might, make the transition from red to black ink less socially disruptive. The commission is guessing the EU and euro zone will grow at annual rates of only 1% and 0.9%, respectively, this year, and that both will grow at 1.5% in 2011. But it expects the economies of Greece, Ireland and Spain to contract, and Portugal's to grow at less than 1% in 2010 and 2011. Such contractions, and even the anemic growth predicted for Portugal would, of course, make it even more difficult for these countries to reduce their deficits to close to the 3%-of-GDP target, and even more likely we will see restructurings.

Greece can't devalue its currency, and must live with large trade deficits. Which it can't afford.

The economists at Goldman Sachs think this an unduly pessimistic outlook. They have raised their euro-zone forecasts from 1.25% and 1.9% for 2010 and 2011, respectively, to 1.7% and 2.2%, based on expectations that stronger global growth and a weaker euro will stimulate exports, and the inventory build-up will continue.

Reports that Spain's economy grew a bit in the first quarter, and data compiled by Markit, seem to lean in Goldman Sachs's direction. The EU's private manufacturing and service economies expanded in each of the last nine months, and Markit's index of such activity now stands at its highest level since August 2007. New orders for manufactured products are at close to a ten-year high, and order backlogs are rising. All of this despite ash from street fires in Athens and from a volcano in Iceland.

Such higher, but still modest, growth rates can ease, but not eliminate, the crisis on euroland's periphery. Euro-zone policy makers will have to be more specific about the "stabilization mechanism" they agreed in the early hours of Saturday morning if markets are to stop demanding the almost-nine-percentage premium over safe German IOUs that Portugal is now forced to pay. Austerity targets will have to be enforced. The ECB will have to overcome its reluctance to engage in quantitative easing (a.k.a. monetization), and continue to take sovereign low-rated and junk bonds as collateral for low-interest loans.

Larry Lindsey, the economic consultant who served as chief economist to George W. Bush in the successful years of that president's reign, sums it up this way. "There are three choices: major fiscal contraction, default, or monetization. Pain, pain, or pain."

Sensible emergency measures, of course, would only get the EU over this crisis.

Then there is the harder, long-term job of restoring the health of what is now the sick man of the global economy. Europe's sclerotic economies can only defuse the ticking demographic time bomb created by its aging population if Europe reins in its welfare states, reforms its labor markets, and adopts the measures necessary to unleash the animal spirits of entrepreneurs. No secret how to do that: the path is laid out in numerous commission policy documents. All that is required is the political will, one of the few things in short supply in the otherwise underutilized European economies.

What's News

■ **U.S. stock indexes** are nearing a 10% correction for the first time since their climb began last year. Analysts disagree over whether the recent declines are a healthy pause or the start of another bear market. **17, 32**

■ **Pakistan's Taliban** was behind the botched Times Square bombing, top U.S. administration officials said. **8**

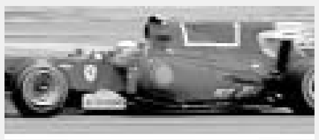
■ **Rescue workers raced** to save 83 people trapped in a Siberian coal mine after two methane explosions killed at least 12, and left both miners and rescuers trapped. **3**

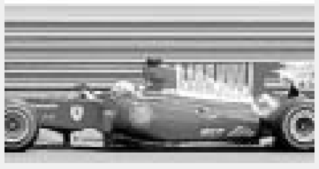
■ **Mohamed Al Fayed sold** Harrods to Qatar Holding for about $2 billion, ending the Egyptian billionaire's 25-year ownership of the British luxury-goods purveyor. **17**

■ **Air travel in Europe** and across the Atlantic is likely to face persistent disruptions in coming days as an Icelandic volcano continues to spew ash, officials said. **3**

Inside

What is cloud computing? Here's a quick guide. **27**

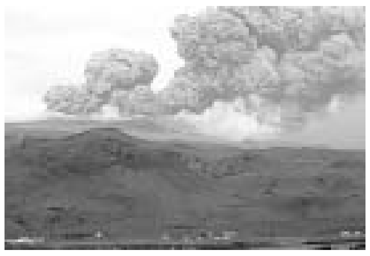




Marlboro pulls a 180 on its Ferrari sponsorship. **28**

ONLINE TODAY

Most read in Europe



1. Ash Cloud Stalls Trans-Atlantic Flights
2. Zeal and Angst: Germany Torn Over Role in Europe
3. Euroland Is Changed Forever
4. Euro Zone Pledges Bailout Fund
5. Computer Trading Is Eyed

Most emailed in Europe

1. American Parents Go to Dogs After Human Kids Leave the Nest
2. Zeal and Angst: Germany Torn Over Role in Europe
3. Opinion: The Greek Economy Explained
4. Computer Trading Is Eyed
5. Not Their Finest Hour

The Source

blogs.wsj.com/source

"Drastic cuts won't come until the markets force them on whoever ends up in charge."

David Cottle on uncertainty over how to tackle the U.K.'s vast budget gap

Continuing coverage

Follow developments as U.K. party leaders meet for coalition discussions at **wsj.com/ukelection**

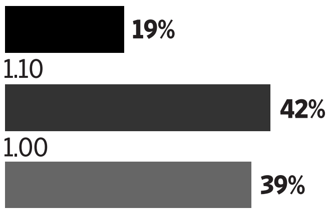
Question of the day

Vote and discuss: Which currency do you have the most faith in?

Vote online at **wsj.com/dailyquestion**

Previous results

Q: How low do you think the euro will go against the dollar this year?



THE WALL STREET JOURNAL EUROPE
(ISSN 0921-99)
Stapleton House, 29 - 33 Scrutton Street, London, EC2A 4HU

SUBSCRIPTIONS, inquiries and address changes to: Telephone: +44 (0) 207 309 7799. Calling time from 8 a.m. to 5 p.m. GMT. E-mail: subs.wsje@dowjones.com. Website: www.services.wsje.com

ADVERTISING SALES worldwide through Dow Jones International. Frankfurt: 49 69 9714280; London: 44 207 842 9600; Paris: 331 40 17 17 01.

Printed in Belgium by Concentra Media N.V. Printed in Germany by Dogan Media Group / Hürriyet A.S. Branch Germany. Printed in Switzerland by Zehnder Print AG Wil. Printed in the United Kingdom by Newsfax International Ltd., London. Printed in Italy by Telestampa Centro Italia s.r.l. Printed in Spain by Bermont S.A. Printed in Ireland by Midland Web Printing Ltd. Printed in Israel by The Jerusalem Post Group. Printed in Turkey by GLOBUS Dünya BasInevi.

Registered as a newspaper at the Post Office.

Trademarks appearing herein are used under license from Dow Jones & Co. ©2010 Dow Jones & Company. All rights reserved. Editeur responsable: Patience Wheatcroft M-17936-2003.

Registered address: Boulevard Brand Whitlock, 87, 1200 Brussels, Belgium

NEWS

Ash cuts across new flight corridors

Most European airports should be open Monday as the concern switches from crashes to eroding jet engines

By Daniel Michaels
And Andy Pasztor

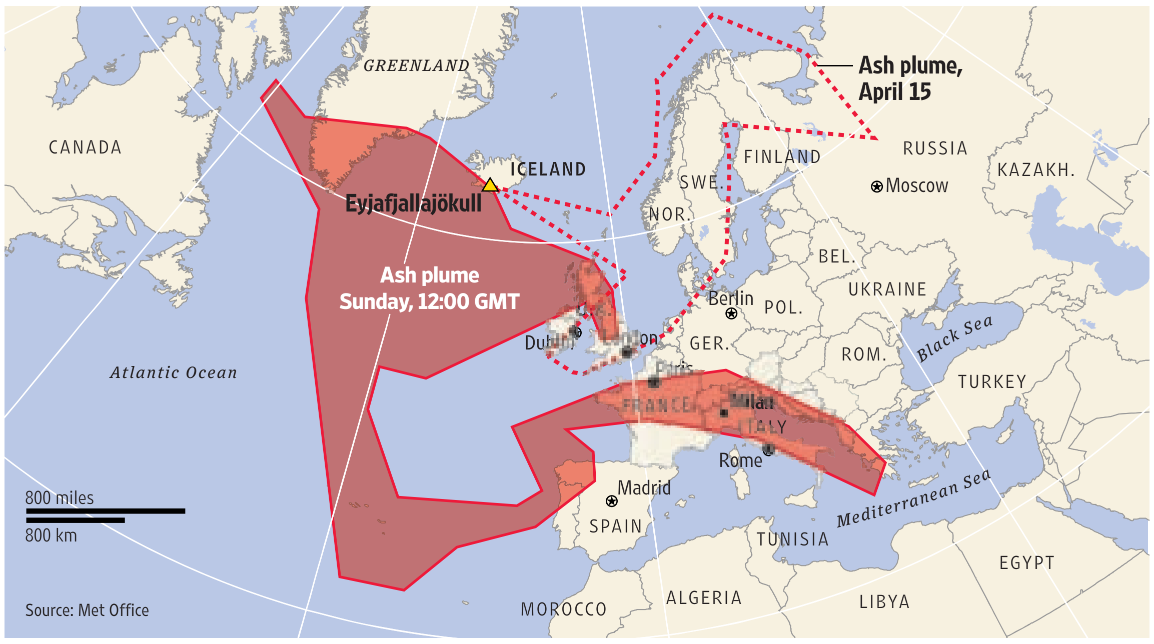
Air travel around Europe and across the Atlantic is likely to face persistent disruptions over coming days as an Icelandic volcano continues to spew ash and weather patterns push the cloud into busy airspace, aviation officials say.

On Monday, most European airports should be open but trans-Atlantic travel could face disruptions, European air-traffic officials said in a conference call late Sunday. For later in the week, the situation remains uncertain as Iceland's Eyjafjallajokull volcano continues to erupt, but less forcefully than since it first came to life on April 15, closing 80% of European airspace.

"Presently there are no indications that the eruption is about to end," Icelandic Met Office said Sunday.

Over recent days, many key trans-Atlantic corridors and European airports have faced temporary closure as plumes of ash spread south and east from Iceland. Aviation authorities are imposing the bans in areas where they determine the concentration of ash to exceed a safe threshold set by jet-engine makers last month.

For passengers, the situation resembles a protracted storm that disrupts normal air traffic. But the longer-term impact on jetliners is potentially more serious.



The persistent airspace closures are prompting pilots and airlines to call for greater study of the risk. Pilot groups on both sides of the Atlantic stress potential long-term safety and engine durability issues stemming from even relatively low-level concentrations of ash. Airlines, meanwhile, want to ensure the safety bar isn't set higher than necessary. The level of volcanic ash produced isn't enough to snuff out jetliner engines and potentially cause an accident, as several volcanic eruptions in recent decades did. But the fine, abrasive particles may cause engines to age more quickly or operate improperly, aviation officials say.

In response, meteorological offices and aviation officials around Europe have increased their analysis of both the atmosphere and airplanes. Weather forecasters are using satellites, lasers and specially equipped test aircraft to judge the ash cloud's location and density. Officials are conferring by phone at least four times daily.

On Tuesday, international aviation safety officials are scheduled to hold a meeting on contingency plans for dealing with ash.

Until last month, the industry's standard practice was to avoid volcanic ash. But under intense pressure from passengers and airlines, European officials on April 19 agreed to reopen skies and only close them when ash concentration exceeded a density set by engine makers. The compromise has upset both airlines and pilots.

European airlines criticized the lack of rigorous scientific analysis of the threat.

"There are still several areas of imprecision, all urgently needing to be refined," said Ulrich Schulte-Strathaus, secretary general of the Association of European Airlines in statement Saturday. He called on European Union air-safety officials to take a greater role in determining potential threats to safety.

General Electric Co., the largest producer of commercial jet engines, has told U.S. lawmakers the guidance last month on an acceptable level of ash was "based on industry experience and engineering judgment." GE is working with carriers to improve sampling plans and develop better methods to determine long-term engine impacts.

Mr. Schulte-Strathaus at the European airline association in Brussels pressed the same point, but from a different perspective. "Show us where the true danger is, and we will avoid it, but please demonstrate to us that decisions which damage our livelihood are being taken with the most rigorous empirical science," he said.

—Doug Cameron contributed to this article.

Conditions hold up rescue of 83 miners

By Gregory L. White

MOSCOW—Rescue workers raced to save 83 people trapped in a Siberian coal mine after two methane explosions over the weekend killed at least 12, and left miners and rescuers trapped.

Concentrations of highly flammable methane remained too great late Sunday night to allow the crews to return, leaving them scrambling to restore ventilation and pump fresh air into the mine shaft.

"The rescue efforts will resume once the atmosphere is restored in the mine," said local governor Aman Tuleyev, the ITAR-TASS news agency reported.

Sergei Shoigu, minister of emergency situations, said conditions were dangerous. "Now, we have to do everything possible to avoid a third explosion," Russian news agencies quoted him as telling miners' families.

"There is still hope," Sergei Sharov, deputy head of the Mine-Rescue Unit, told anxious relatives in the town of Mezhdurechensk, the Interfax news agency reported.

The first explosion struck the Raspadskaya mine in the Kemerovo region just before midnight Saturday, when 359 people were working in the mine. A second, more powerful blast came about four hours later, destroying air shafts and reducing most of the mine's aboveground facilities to rubble, officials said.

Of the 83 still trapped some 500 meters underground, 19 were rescuers, according to officials. The twin blasts injured 71 people.

Prime Minister Vladimir Putin set up a commission to coordinate rescue efforts. Mr. Putin dispatched top officials to the disaster site to manage operations. Mine-rescue specialists and equipment came from all over Russia, news agencies reported.

Company officials told local media that there had been a sudden build-up of methane inside the mine, and that safety alarms had sounded, but the miners had no time to escape before the first blast. Authorities opened a criminal investigation into possible failure to follow safety procedures.

Concentrations of highly flammable methane remained too great Sunday to allow crews to return.

The Raspadskaya mine, owned by **OAO Raspadskaya Coal** Co., is Russia's largest underground coal mine. It opened in 1973, and in recent years had been equipped with modern, automated safety equipment, local officials said.

Raspadskaya Coal is part-owned by Russia's **Evraz** Group, a steelmaker whose major shareholders include Roman Abramovich, an owner of the U.K.'s Chelsea Football Club.

U.K. pound, bonds remain at risk

Inconclusive election results leave investors worried new government will be too weak to quickly fix budget deficit

By Neil Shah

Britain's financial markets may face another roller-coaster ride this week after swinging wildly in the wake of Thursday's inconclusive U.K. election.

Investors are anxious for Britain's political parties to quickly form a working government amid the country's first so-called hung Parliament—where no party has a majority—since 1974. The fear: Britain's next government will be too weak to quickly fix its budget deficit, which ranks among the biggest in the industrialized world.

British politics won't be the only thing pressuring U.K. markets this week. Much depends on efforts by European leaders to contain the region's growing sovereign-debt crisis, which has fueled fears of renewed troubles for European banks, analysts say.

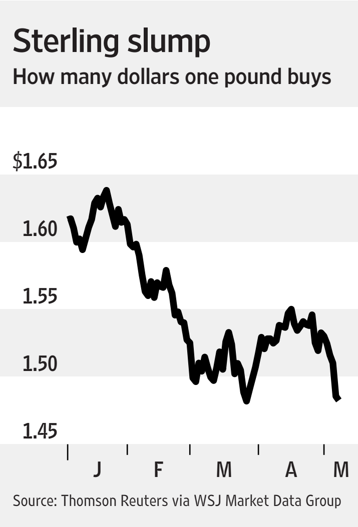
But investors in London are keenly watching the U.K. situation. Sunday afternoon in London, the opposition Conservatives, which won the most parliamentary seats and votes in the election, were locked in talks with the No. 3 Liberal Democrats. A Conservative spokesman said it was "unlikely" that any type of deal would be reached before markets opened Monday morning.

That could unnerve some investors, sparking selling of the U.K. pound and pushing down prices of U.K. government bonds and smaller U.K. stocks. A large-scale selloff of U.K. assets on Monday, however, is unlikely, analysts say.

"I think the markets will give the parties the benefit of the doubt" for now, but investor jitters could push sterling as low as $1.45 against the dollar in coming days, says Simon Derrick, a currency analyst at Bank of New York Mellon. The pound stood at $1.4821 late Friday in New York.

The Conservatives and the Liberal Democrats likely have about a week to establish a new government, either through a minimalist pact or a more binding coalition, Mr. Derrick says.

That may not be easy: The Conservatives oppose the biggest item on the Liberal Democrat agenda: voting reforms that would effectively undermine the dominance of Britain's two biggest parties. If the political uncertainty drags on for many days, financial markets may start to assume Britain's next government will be a weak minority government—one that may try to consolidate its power by holding another U.K. election. Such a scenario, investors fear, could mean putting off fiscal reforms and risking a cut to Britain's triple-A credit rating.



Major ratings firms have said they will wait for a new government to present a plan before weighing in on the U.K. credit rating.

The combination of election-driven worries whipsawed U.K. markets late last week, while concerns about Europe's debt crisis made the battering even worse.

On Thursday, the U.K. pound slumped from $1.51 against the dollar to $1.4833 as investors worried about contagion from Europe's debt crisis. Once exit polls were released in London at 10 p.m., the pound slipped again, before shooting higher to $1.49 on hopes of a clear-cut Conservative majority. The pound then fell again, dropping below $1.45, in the early hours of Friday morning while prices of U.K. government bonds also slumped dramatically. By the end of Friday, however, the pound had largely recovered its losses, returning to $1.48, after Conservative leader David Cameron offered an alliance to the Liberal Democrats and credit-ratings firms said the hung Parliament wouldn't automatically mean a downgrade to Britain's rating. Moody's Investors Service has expressed confidence that British politicians are capable of coming up with a tough deficit-cutting plan even amid a hung Parliament.

The blue-chip FTSE 100 skidded 7.8% on the week, including a 2.6% drop Friday, although the declines largely were because of worries sparked by fears that Greece's woes would spread to other countries and to banks. It was the index's fourth consecutive weekly decline, putting it at its lowest close since Feb. 9.

The U.K.'s Bank of England makes its monthly decision on short-term interest rates Monday, and analysts expect no major change, keeping interest rates at 0.5%. Yields on 10-year government bonds fell for the week, although they rose Friday.

Weekend talks fail to create a U.K. government

Continued from first page

down. One cabinet minister, who declined to be named, said it isn't the time for such conversations, given the political system is in flux.

"It's a game of poker, in which none of them know their opponents' hands because they don't know if they will be able to get their parties on board," said John Curtice, professor of politics at the University of Strathclyde. "This is high-stakes stuff, and it could drag on into the following weeks."

The three-way discussion demonstrates how shaky nearly any resulting alliance would be as it attempted to move forward and govern.

The Tory-LibDem talks could produce a solid Parliamentary majority, but are weighed down by the fact that the parties disagree on many issues, most importantly electoral reform, which is a core issue for the Liberal Democrats but which is widely resisted within the Conservative Party.

Investors are anxious for the political parties to quickly form a working government, fearing that the next government will be too weak to fix its massive deficit.

At the same time, any Labour--Liberal Democrat coalition would be hampered by the fact that, even together, they don't form a majority. Regardless, in their talks with the Liberal Democrats, both Labour and the Conservatives are wary of giving away too much.

As he attempts to become prime minister, Mr. Cameron—whose party won 305 seats on Thursday, 21 short of majority—could seek to operate as a minority government, or in some kind of informal partnership with the Liberal Democrats. But such an arrangement could fuel the unhappiness within Mr. Cameron within the party's own ranks, where there is an undercurrent of discontent over his inability to lead the Conservatives to a big win in an election where that once seemed a foregone conclusion.

Mr. Cameron knows he has to persuade his party. Seeking to win their backing, Mr. Cameron held meetings and took calls from Tory members of Parliament on Sunday evening, a spokeswoman said.

Mr. Cameron will hold a meeting with the Conservative Party on Monday evening.

Britain's financial markets may face another rollercoaster ride this week after swinging wildly in the wake of last Thursday's result.

Investors are anxious for Britain's political parties to quickly form a working government to fix its massive budget deficit, which is the largest deficit among the major economies. Fears of a weak government could spark selling of the U.K. pound and push down prices of government bonds and smaller U.K. stocks.

Howard Archer, chief European and U.K. economist at IHS Global Insight, said that with markets already nervous, the absence of a deal would "leave sterling, the FTSE and gilts vulnerable to a major sell-off on Monday."

Simon Derrick, a currency analyst at Bank of New York Mellon, added that "I think the markets will give the parties the benefit of the doubt" for now, but investor jitters could push sterling as low as $1.45 against the dollar in coming days.

Mr. Derrick said that the Conservatives and the Liberal Democrats likely have about a week to forge some sort of agreement, whether a bare-bones pact to keep the government going or a stronger coalition government.

That may not be easy. The Conservatives may struggle to agree on one of the biggest items on the Liberal Democrat agenda: an electoral system based on proportion of the vote rather than the number of seats, which typically works against smaller parties.

Agence France-Presse/Getty Images

Conservative Party foreign affairs spokesman William Hague, center, with Shadow Chancellor George Osbourne, right, and policy chief Oliver Letwin, left, shown after meetings with representatives of the Liberal Democrats on Sunday.

Other sticking points include whether the Conservatives will agree to Liberal Democrats' taxation demands, aimed at reducing the burden for the poorest in a manner that some Conservative members of Parliament find unpalatable.

Many Conservatives believe such a move would weaken their party's position in a country they have ruled on and off for almost two centuries.

Proportional representation would likely award more seats to the Liberal Democrats, who in the past two elections have won nearly a quarter of the vote but only about 10% of the seats.

That could allow the two center-left parties—Labour and Liberal Democrats—to form a long-term alliance depriving the Tories of power for years to come.

Mr. Clegg received the go-ahead from his party to talk with the Conservatives on Saturday, but will need backing for any kind of deal from three-quarters of the party. Many members see themselves as closer to Labour than Conservative ideology.

One senior Liberal Democrat official, Simon Huges, said on Sunday that the case for a new electoral system was "unarguable."

Both parties also must decide whether they will agree to a formal coalition government, in which the Liberal Democrats take cabinet positions, or an informal agreement in which the Liberal Democrats back a Conservative minority government in return for policy concessions. In this high-stakes game, the Conservatives can't risk driving the Liberal Democrats into Labour's arms. Nor do they want to govern as a minority government pushing through unpopular public spending cuts and risk losing out in an election that past precedent suggests follows soon after a hung parliament.

Labour lawmakers also don't want to get into bed with the Liberal Democrats if it means electoral reform.

Labour's own platform has promised reform, but stopped short of promising full proportional representation.

One cabinet minister, who declined to be named, asked why the Liberal Democrats performed so poorly if electoral reform was so important to the British voters. Some Labour lawmakers believe a period in opposition wouldn't be so bad, given that a period of minority rule for the Tories in which they have to force through budget cuts won't endear them to voters.

EUROPE NEWS

How Cleggmania got, and lost, momentum

By Paul Sonne

LONDON—So much for "Cleggmania."

Just days ago, the rollercoaster British election appeared to herald the arrival of a potent new player in U.K. politics—the Liberal Democrats, who rode party leader Nick Clegg's TV debate performances to an apparent surge in popularity.

Election night brought a rude surprise: The party not only performed far worse than expected, but it actually lost five seats since the last election.

It was small consolation that the party won 23% of the popular vote, compared to the 29% won by Labour and the 36% won by the Conservatives.

"We simply haven't achieved what we had hoped," Mr. Clegg said in his home district of Sheffield early Friday.

Patrick Dunleavy, a professor of politics and public policy at the London School of Economics, blamed the party's fall on missteps by Mr. Clegg.

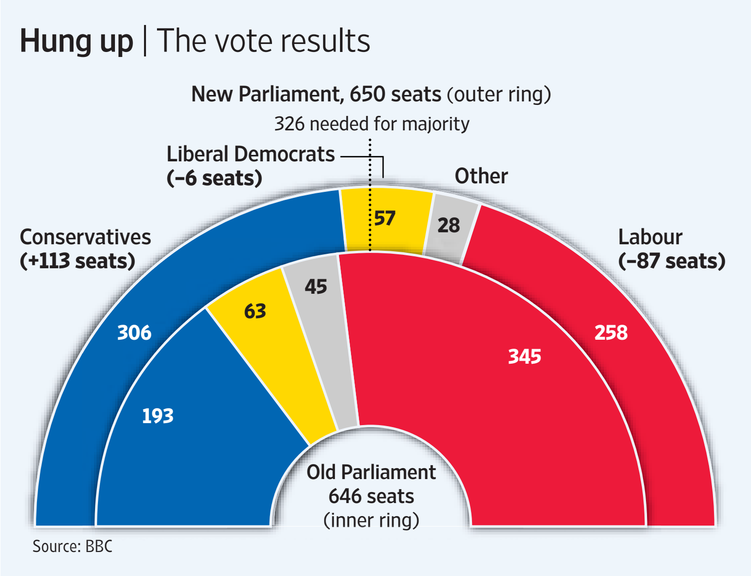
"They had this huge, rock-star moment after the first debate—and at that point the connection with reality got a bit weak," Prof. Dunleavy said. Mr. Clegg, he said, alienated potential supporters by crucifying the Labour Party and casting doubt over the possibility of a partnership with Gordon Brown.

"Why do you think so many rock bands have a great first album and then crash out?" he said. "Because they believe their own hype."

The Liberal Democrats, a center-left party that champions issues such as civil liberties, also found itself steamrolled by richer and more established Conservative and Labour party machines.

Ruth Polling, a Liberal Democrat councilor in Islington, said the Labour Party bussed campaigners and canvassers into the district in large numbers. She also said the two major parties, feeling threatened by the rise of a third, ganged up to squeeze the Liberal Democrats in the final days.

The economy was also a factor. Of the three top candidates, Mr. Clegg has advocated the closest ties to Europe.



Many Britons seized on that as a negative, particularly in light of the recent debt turmoil in Greece and Spain.

In a statement released Friday, Mr. Clegg said British voters turned out to be too scared to vote for a lesser-known third party in these times of economic uncertainty.

The Conservatives persuaded voters that a hung parliament would bring instability and economic decline, leading many to vote against the Lib Dems in areas where they were going head-to-head with the Tories, according to Geoff Juby, who just made his third unsuccessful bid for parliament on the ticket in Kent.

Many say the media also dealt a blow. Sue Doughty, a Liberal Democrat candidate who failed to oust the Conservative incumbent in the borderline constituency of Guildford, said Britain's politically aligned newspapers went after the party with an unprecedented ferocity and influenced Britons to vote against the third party.

"Before we had the Cleggmania moment, we hadn't had the full glare of the newspapers on us, for the positive or for the negative," Ms. Doughty said. "Elections are very much controlled by what people read on those newsstands the last day."

—Jeanne Whalen and Alistair MacDonald contributed to this article.

BETWEEN TODAY AND TOMORROW, OPPORTUNITY IS FOUND.

Investing happens in the here and now. But we don't let short-term thinking impact what really matters to clients: results. Our performance is measured daily and looked at over the long term. Which is why our 1,500 investment professionals worldwide bring a consistent and analytical approach to investing. Adding value for clients on five continents in over 100 countries through a world-class risk-controlled process that reveals what are real opportunities for investors and what aren't. As always, investors should remember that all financial investments involve an element of risk, and your initial investment amount cannot be guaranteed. Look to BlackRock. **Opportunity Found.**

INVESTMENT MANAGEMENT | MUTUAL FUNDS | iShares® ETFs | RISK MANAGEMENT

BLACKROCK

iShares® is a registered trademark of BlackRock Institutional Trust Company, N.A. All other trademarks, service marks or registered trademarks are the property of their respective owners. Issued by BlackRock Investment Management (UK) Limited (authorised and regulated by the Financial Services Authority). Registered office: 33 King William Street, London, EC4R 9AS. Registered in England No. 2020394. Tel: 020 7743 3000. Issued in Switzerland by the representative office, BlackRock Investment Management (UK) Limited (London), Zürich Branch, Claridenstrasse 25, P.O. Box 2118, 8022 Zürich, Switzerland. For your protection, telephone calls are usually recorded. BlackRock is a trading name of BlackRock Investment Management (UK) Limited.

EUROPE'S DEBT CRISIS

Germany is torn over role in region

Turmoil could force the country to choose between its twin ideals: financial stability and euro-zone unity

BY MARCUS WALKER AND MATTHEW KARNITSCHNIG

LUDWIGSHAFEN, Germany—Helmut Kohl, frail and confined to a wheelchair, returned to public view last week, imploring his countrymen not to abandon the goal he spent his political life pursuing: a united Europe.

"Today, I am convinced more than ever that European unification is a question of war and peace for Europe and for us, and the euro is part of our guarantee of peace," the former chancellor, his voice uneven and raspy, told guests at a celebration for his 80th birthday.

As Chancellor Angela Merkel looked on, Mr. Kohl issued a thinly veiled critique of her reluctance to help Greece, saying he couldn't understand "people who act as if Greece doesn't matter." Of course the situation is difficult, but Germany must pull out all the stops, he said, drawing applause from the crowd.

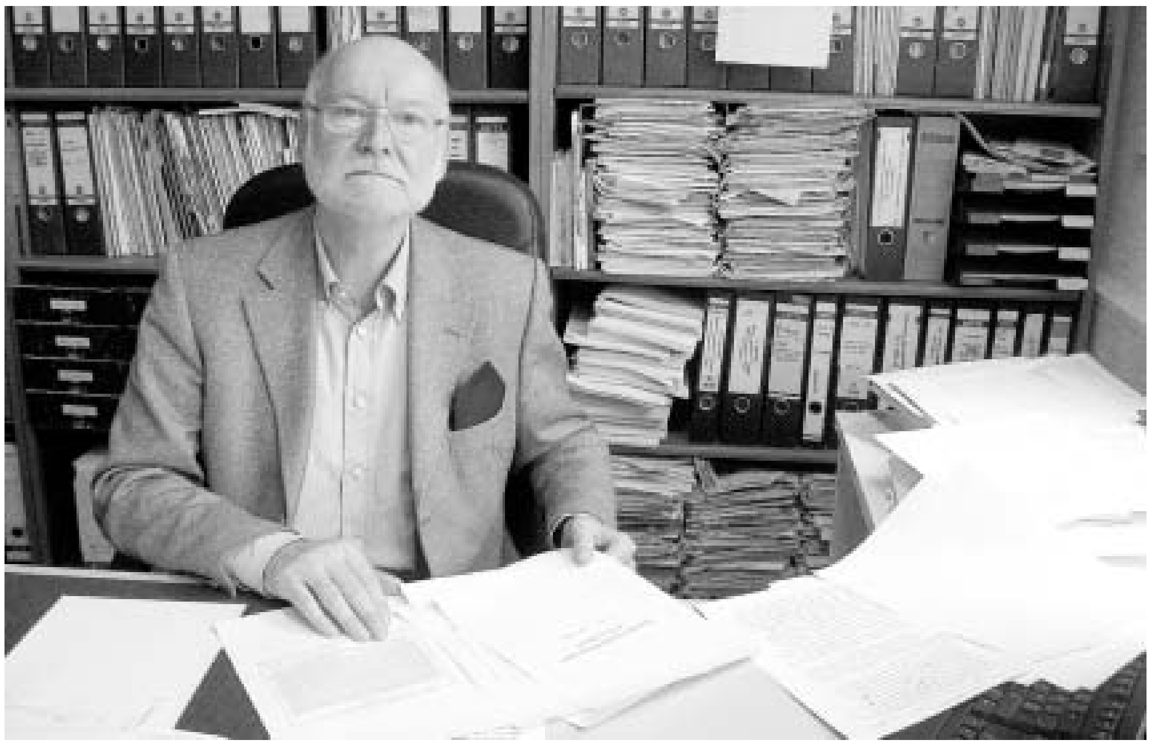
The scene underscored the threat Greece's turmoil poses to monetary union, the grandest expression of the European continent's drive toward integration. Mr. Kohl led the unification drive two decades ago. Now the increasingly disruptive debt problems in Greece and elsewhere post the question: What price is Germany willing to pay to save Europe?

Germany's parliament gave approval Friday to a contribution of €22.4 billion ($28.3 billion) toward a joint European Union-International Monetary Union aid package for Greece. Even as it did so, critics of the euro sought a court injunction to block the aid.

Ms. Merkel's center-right alliance suffered a defeat in regional elections Sunday in Germany's most populous state, North Rhine-Westphalia, amid rising voter anger over the bailout of Greece. Center-left opposition parties were set to win power in the region, according to exit polls and early vote counts.

The result means Ms. Merkel's conservatives will lose control of the upper house of German parliament, forcing the chancellor to negotiate with left-leaning opposition parties in order to pass economic legislation. That effectively means her government is unlikely to be able to cut income taxes, a key conservative aim.

Germany, still scarred by the economic disarray that fueled Hitler's rise in the '30s, is widely seen as the euro zone's fiscal scold, demanding Teutonic frugality from other members. The country receives less attention for the role it has played in driving European integration over the past 60 years, especially under Mr. Kohl, often putting its own interests behind those of what Germans sometimes call "the European project."



DPA/ZUMA Press

Joachim Starbatty of the University of Tübingen sued to block a euro-zone bailout of Greece.

Now, Europe's debt crisis could force Germany to choose between its twin ideals: financial stability and European unity. Berlin's contribution to rescue loans for Greece is less than 1% of Germany's gross domestic product. But similar bailouts for Spain and Portugal, in case these too prove necessary, could require Germany to lend the equivalent of more than $200 billion.

Though this is well under the €500 billion the government put up to bail out its own banks in 2008, Germany's willingness to pay for profligate neighbors is being stretched. The burden of helping nations besides Greece could force Germany to cut its own budget, at a time when it's already asking its people to endure more belt-tightening.

"A second bailout like Greece will hardly be politically possible," says Michael Hüther, director of the Institute for the German Economy, a think tank. "The political consensus in Germany won't tolerate this endlessly."

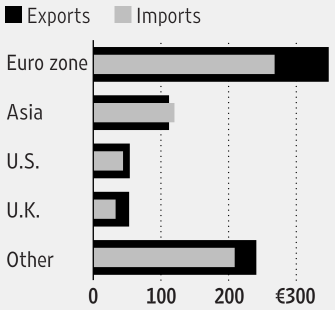
The mounting credit crisis on the euro zone's fringe has hardened skepticism about a currency that a majority of Germans were reluctant to adopt in the first place. More than a decade after its introduction, over 60% of Germans still say the euro has brought more disadvantages than gains, according to pollsters Infratest Dimap. A similar percentage opposes extending financial help to Greece.

The tabloid newspaper Bild has assailed the bailout plan in blaring headlines for the past two weeks. "What Will It Costas?" a headline said recently, making a play on a common Greek name. "Euroland is Burning," said German news magazine Der Spiegel. "What will Happen to Our Money?" asked the highbrow weekly Die Zeit.

Friday's front page of the Frankfurter Allgemeine Zeitung, an influential voice of German conserva-

Deutsche mart

Germany's trade in goods, 2009, in billions



€1 billion = $1.28 billion
Source: German Federal Statistics Office

tism, said Europe's usual method of papering over cracks with German money "has reached its limits now that the issue is the bankruptcy of whole states and the clash of cultures."

The Greek aid plan faces a court challenge filed Friday by a university economist, Joachim Starbatty, and by other prominent critics of the euro. On Saturday Germany's highest court rejected the critics' demand for a temporary injunction to block aid payments immediately, but the court hasn't ruled yet on the aid's legality. The challenge is taken quite seriously, because the EU treaty that created the euro outlaws bailouts except under extraordinary circumstances.

Prof. Starbatty, who in the 1990s tried to keep Germany out of the euro, says wages and other business costs have for decades risen faster in Southern Europe than in Northern Europe.

Southern countries such as Italy, Greece and Spain used to let their currencies sink to compensate for their higher inflation, but the arrival of a common currency ended that, and the countries instead borrowed to sustain their expensive habits.

"There is a deep fissure across the euro zone" separating the disciplined North from the more-lax South, says Prof. Starbatty, sitting in his cluttered office in the medieval university town of Tübingen.

For Germany to shoulder some of its neighbors' debt burden, Prof. Starbatty says, is incompatible with the strong, stable euro Germany promised its citizens. He says a country like Greece can escape its bind and resume growth only if it quits the euro, restores the drachma and devalues it, and reaches a deal with lenders to restructure debts. He advocates a shrunken euro bloc with just the healthiest economies, such as Germany, Austria, the Netherlands, Finland and possibly France.

"Economically, you can imagine anything," responds Hans-Werner Sinn, a prominent German economist, about the idea of contracting the euro zone, which now comprises 16 nations. "Politically, it would mean the breakup of the European Union. Southern European countries would see it as such as affront that there would be further consequences."

A North-South schism would undermine decades of effort by Germany to overcome Europe's divisions. A majority of Germans still share former Chancellor Kohl's conviction that only a Europe whole and friendly can deliver the peace and security they yearn for to escape a history of war, tyranny and collapse.

That yearning for harmony even led to the sacrifice of the German mark, the symbol of West Germany's postwar prosperity.

Mr. Kohl committed to European monetary union when, as he set out to reunite Germany upon the fall of the Berlin Wall, he was dismayed to see the hostility and suspicion shown him by leaders of France and other European countries. Mr. Kohl reassured them by saying that he wanted both a united Germany and a united Europe.

The promise of a single currency was the centerpiece of the 1992 Maastricht Treaty on European union. The treaty failed to achieve the cohesive political union Mr. Kohl wanted, however, creating an awkward hybrid: an economic zone with a single currency and central bank, but no federal government.

The inception of the euro in 1999, and of euro coins and notes in 2002, divided Germans. A majority resented losing the mark.

Corporate Germany, however, had come to see the mark's strength as a problem. Its periodically rising exchange rate priced German goods out of export markets, especially during economic downturns, when other European currencies such as the Italian lira, Spanish peseta or French franc sagged.

The mark's appreciation "gave us a massive competitiveness problem in the 1990s," says Peter Bofinger, a member of the government's council of economic advisers. "If the good fairy came and gave us back the mark, it would immediately rise by 20% and all of our gains in competitiveness in the last 10 years would be gone" he says.

Most of Germany's growth in the past decade has come from exports, and trade with Southern Europe has played a major role. German car makers, engineering companies and the like have won rising market shares by keeping a tighter lid on wages than did rivals in some countries. With the euro, German business no longer had to worry about Southern Europeans devaluing their currencies to become more competitive.

Today, Europe's sluggish recovery from recession means euro-zone markets are losing some of their importance for German business. Companies such as Siemens AG and Volkswagen AG expect much of their future growth to come from China and other developing economies.

Still, German companies see bailouts as a price worth paying to preserve the euro zone. Karl-Ludwig Kley, chief of pharmaceutical company Merck KGaA of in Darmstadt (no relation to the U.S.'s Merck & Co.), says, "Europe will remain a key market" for his company.

The official line in Berlin is that European unity and financial rectitude still go hand in hand. Greece will turn itself around under heavy pressure from the International Monetary Fund, German politicians say, adding that the fiscal strains in Portugal and Spain aren't comparable to Greece's.

The crisis could become a defining moment for Ms. Merkel, a risk-averse politician who prefers to manage problems with small steps rather than leap boldly forward as Mr. Kohl did 20 years ago. Ms. Merkel has been criticized throughout her political career as lacking vision and a sense of historic purpose.

Leo Dautzenberg, a lawmaker in Ms. Merkel's Christian Democratic Union, says the bonds that hold together the euro must be strengthened. He says the goal is not a "transfer union" in which Germany subsidizes others but "a stabilizing system that intervenes earlier" when countries stray from fiscal and economic responsibility.

The result could be a Europe in which Germany, through EU institutions, imposes controls over welfare states, labor markets and other policy areas in other euro-zone countries. But that would require an end to Germany's shyness about throwing its weight around, which runs deep in today's political culture. "It's a tall order," says Josef Joffe, a German newspaper publisher. "It's not part of the German postwar character," he says.

—David Crawford and Vanessa Fuhrmans contributed to this article.

A Special Advertiser Feature

How big do you have to be to enter a partnership in France?

wsj.com/france

Presented by

Invest in France Agency

IMF approves big Greece bailout

Unprecedented loan totaling $38 billion is expected to help placate markets and investors

By Ian Talley

WASHINGTON—The International Monetary Fund on Sunday approved a three-year, €30 billion ($38 billion) loan to help pull Greece out of an economic quagmire.

The unprecedented IMF loan, the largest financial commitment the institution has ever made to a single country, is part of a €110 billion IMF and European Union package that includes conditions requiring Athens to tighten its fiscal belt and raise taxes.

The IMF said around €20 billion in financial support would be immediately available to Greece from the joint package. The IMF will contribute €10 billion as part of the package total of €40 billion for 2010. IMF's total funding represents 32 times Greece's IMF quota, its share of contributions to the fund.

IMF Managing Director Dominique Strauss-Kahn acknowledged the road ahead for Greece would be difficult, but he called the reform program credible and achievable.

"Today's strong action by the IMF to support Greece will contribute to the broad international effort under way to help bring stability to the euro area and secure recovery in the global economy," said Mr. Strauss-Khan. "Implementation is now the key." Under the terms of the deal, Greece will cut its budget deficit from a record 13.6% of GDP last year to 8.1% this year, and below an EU ceiling of 3% by the end of 2014, translating into €30 billion in combined spending cuts and higher taxes.

IMF officials have said they're confident the measures are enough to bring the Mediterranean country back from the brink. Although the fund expects Greece's real GDP to decline 4% this year, it forecasts growth of 1.1% in 2012.

Markets remain skeptical that Greece will have the discipline to see the required reforms through and that its economy will be able to grow enough to repay their loans.

EU scrambles for agreement before markets open on Monday

Continued from first page

sis.

The strains in financial markets have grown along with disappointment among investors over how European officials have handled the crisis in the months since it became clear that Greece was having trouble refinancing its debts.

Last week, pressures also began to build on European banks, where worries about their investment and loan exposure to Greece led to rising borrowing costs. It also sent the euro, the common currency of 16 EU countries, to its lowest levels since last March.

According to European officials, two mechanisms were under discussion by ministers.

The first would extend to euro-zone nations a facility that has been used to provide financial help for non-euro countries such as Hungary, Latvia and Romania. An expansion of that from €50 billion to €110 billion was under discussion, one official said.

The second, potentially more controversial, proposal was aimed at providing debt guarantees for euro-zone governments.

The European Central Bank was also expected to make an announcement, possibly to avert concerns about funding difficulties at European banks, analysts said.

Meanwhile, Spain and Portugal have decided to make additional spending cuts to bring down towering budget deficits more quickly, government spokespeople said.

The measures being discussed in Brussels make clear how far the financial crisis is stretching the founding principles of the common currency. Those principles emphasize that each euro-zone country is committed to managing its own fiscal affairs.

This fiscal independence, however, has been one of the principal causes of the current crisis, allowing Greece to generate budget deficits and build up government debts to levels that many investors view as unsustainable.

In an effort to correct that fatal flaw, euro-zone governments are becoming more dependent on one another, a step that seems likely to require much closer coordination over fiscal policy and penalties for spendthrift governments. Until now, governments have resisted this interference with their independence to tax and spend as they choose.

Thus the EU treaties contain a so-called no-bailout clause, which forbids the bloc itself or any member to "be liable for or assume the commitments of" another EU country. The treaties also prohibit the European Central Bank from either extending credit to countries or purchasing their debt directly.

To work around these obstacles, European officials appear to be relying on vaguer parts of the treaties, or on novel interpretations.

One complication Sunday was that, while the mechanisms were being designed for the 16 countries of the euro zone, they also needed agreement from at least some of the other 11 EU countries that don't use the common currency, such as the U.K.

—Adam Cohen, Tom Lauricella and Laurence Norman contributed to this article.

Associated Press/NBC

U.S. Attorney General Eric Holder, on a Sunday talk show, said Faisal Shahzad didn't act alone as previously thought.

Attack linked to Taliban

U.S. says Pakistani militants aided in New York bombing attempt

By Evan Perez

WASHINGTON—Pakistan's Taliban militants were behind the botched May 1 Times Square bombing in New York, top administration officials said, reversing earlier U.S. claims casting doubt on such a connection.

Attorney General Eric Holder told ABC News's "This Week" talk show, one of two Sunday shows on which he was scheduled to appear, that ''We've now developed evidence that shows that the Pakistani Taliban was behind the attack," according to an excerpt of the show's transcript.

The excerpt didn't detail what possible evidence might have led U.S. authorities to change their view from last week that the suspect, Faisal Shahzad, had likely acted alone. Mr. Shahzad, a 30-year-old, Pakistani-born U.S. citizen, has admitted to investigators that he built the bomb and rigged it to explode in a 1993 Nissan Pathfinder in New York City's bustling Theater District packed with tourists, U.S. officials say. He at least initially claimed to have acted alone, according to authorities, and the unsophisticated nature of the bomb led them to give that claim credence.

If proven to be true, the link to the Pakistani Taliban would demonstrate a new reach by the militant group, which is known to be behind bombings inside Pakistan. U.S. and Pakistan authorities had believed that the group didn't have the capability to carry out operations much beyond the country.

"We know that they helped facilitate it," Mr. Holder said. "We know that they probably helped finance it. And that he was working at their direction."

U.S. investigators' view of Mr. Shahzad's alleged links to established terror groups began to change late in the week after investigators gathered other proof, including electronic evidence from his computer and information gleaned by investigators in Pakistan, where at least one alleged contact was detained by authorities in the aftermath of the bombing attempt, U.S. law-enforcement officials said.

Investigators are now focusing on the financing of the attack, which cost approximately $2,000.

Investigators are now focusing on the financing of the attack, which cost approximately $2,000, plus how Mr. Shahzad covered his living expenses as he allegedly plotted the attack in recent months.

The initial investigation has found that Mr. Shahzad hand-carried into the U.S. and declared cash totaling $82,500 in increments of about $20,000 between Jan. 16, 1999 and April 24, 2008, a U.S. official familiar with the matter said. The U.S. government recorded Mr. Shahzad's cash cargo in the Treasury Department's Treasury Enforcement Communications System, a database used to store information on people who might otherwise not trigger law-enforcement suspicion.

The cash is likely explained by the fact that Mr. Shahzad came to the U.S. as a student, and people from developing countries often prefer to use cash instead of banks, U.S. officials said. They said investigators don't believe that the money was used in the New York bombing attempt.

Instead, officials are focused on other sources of cash, including couriers commonly used in immigrant communities to carry cash to and from the U.S., officials said. So far investigators haven't found evidence that anyone else in the U.S. was involved with Mr. Shahzad's plot, the officials said.

John Brennan, President Barack Obama's homeland security and counterterrorism adviser, said in a separate interview on CNN on Sunday that Mr. Shahzad apparently "was working on behalf of the Tehrik-e-Taliban Pakistan, the 'TTP.' That's the Pakistan Taliban. This is a group that is closely allied with al Qaeda."

Mr. Brennan told Fox News that TTP trained, funded and met extensively with Mr. Shahzad to plan the attack. Mr. Brennan said both al Qaeda and the Pakistani Taliban groups are operating with degraded capabilities, which means that attacks on American soil and in other areas are smaller in scope.

On Friday, Pakistani and U.S. investigators questioned four alleged Islamist militants who may have had contact with Mr. Shahzad, according to people familiar with the matter.

The overseas portion of the investigation was focusing on Karachi, a southern port city of 18 million people where police last week detained the four alleged militants. The men are believed to belong to Jaish-e-Muhammad, one of several Pakistani extremist groups active in the border regions near Afghanistan.

Police and intelligence officials said at least one of those arrested, Mohammed Rehan, was a conduit who took Mr. Shahzad to Pakistani Taliban training camps in the northwest of the country. "We are directly looking at who did he have contact with while in Pakistan, what did he do, who is supporting him and why," U.S. State Department spokesman P.J. Crowley said.

Mr. Rehan was picked up last Tuesday at the Bathha Mosque in a middle-class suburb of Karachi, where Mr. Shahzad's father-in-law and his family also live, according to Pakistani authorities.

—Tom Wright and Siobhan Gorman contributed to this article

THE WALL STREET JOURNAL.
EUROPE
Executive Travel Program
Guests and clients of 320 leading hotels receive The Wall Street Journal Europe daily, courtesy of
THINK MEDIA OUTDOOR
www.thinkmediaoutdoor.be

U.S. real estate's far reach to continue to hurt recovery

[THE OUTLOOK]

By Conor Dougherty

Highflying property prices drove the most-recent U.S. economic boom, and a collapse in real-estate values hammered it back down. Now, as the economy struggles to regain its strength, real estate is expected to continue to act as a brake, rather than a accelerator.

Despite clear signs of revival in the larger economy, including upturns in manufacturing and consumer spending, the nation's market for homes and office buildings remains mired in foreclosures and oversupply. That imbalance will be worked out over time, but in the meantime, it is slowing the recovery in myriad ways.

Here's how it breaks down:

Less construction means fewer jobs. Construction is a big employer and one of the better-paid sectors for men who lack a college degree. The sector has shed 2.1 million jobs from its peak in March 2007 to April 2010. The 5.6 million construction jobs that are left comprise 4% of U.S. jobs, down from 6% when employment peaked in December 2007.

With the glut of houses, offices and malls already pressuring the real-estate market, many of these jobs will not come back for a while, putting added pressure on unemployment even as growth resumes. Indeed, construction spending is running 13% below its year-ago level and about 25% below the boom-year peak.

Home owners who once felt rich are feeling poorer. Throughout the boom, consumers used their home equity to borrow and spend as they watched housing prices soar. The ratio of dollars taken out of homes to total personal income—a gauge of how much consumers are pulling out of their homes relative to how much they make in wages and other income—fell the last three quarters of 2009. During the boom years, that ratio got as high as 9% nationwide, according to Moody's Analytics.

While real-estate prices have stabilized, they are unlikely to regain prerecession values for years. That has left many consumers with a pile of debt but not much home equity to be used for investment or spending, a big reason why economists believe recent gains in consumer spending aren't sustainable. "The housing market, since it was the epicenter of the crisis, is also central to the feeble recovery," says Ethan Harris, an economist at Bank of America Merrill Lynch.

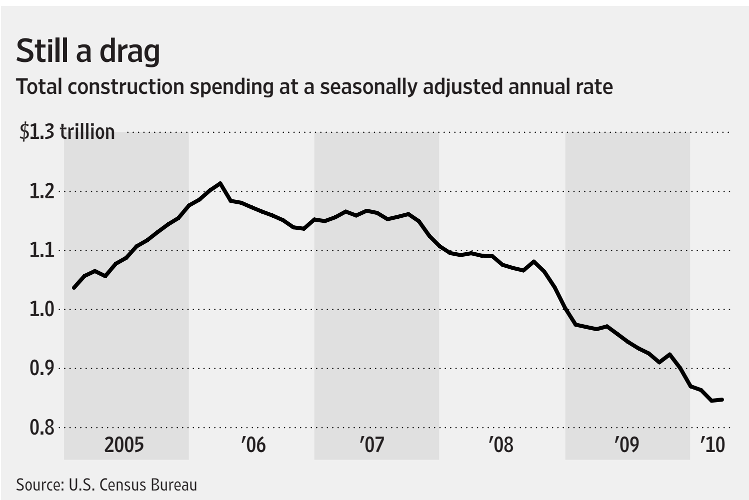
Small businesses aren't borrowing as much. While bigger companies can access the now-recovered market for bonds and other debt, many smaller companies—which are key job generators—use the value of their own property to secure bank loans. As the value of those holdings has fallen, so too has their ability to get loans, crimping investment and hiring at a time when the recovery is gaining steam.

Some 49% of small businesses own at least part of the commercial buildings in which they are located, and the majority of them have mortgages, according to the National Federation of Independent Business. But as real-estate values have fallen, so has this source of equity, limiting how much a bank can lend them. U.S. nonfinancial companies had $6.3 trillion in real-estate assets at the end of 2009, down 33% from 2007, according to the U.S. Federal Reserve. That drop is a big reason why corporations' total net worth fell to $12.9 trillion from $15.9 trillion over the same period.

With the value of collateral so depressed "the ability for many small employers to borrow will be constrained precisely as sales begin to strengthen and new investments are warranted," wrote the National Federation of Independent Business in a recent report on small-business credit conditions.

Lower real-estate values translate into lower property taxes, crimping government spending. State and local governments employ 20 million police officers, teachers and other employees, roughly 15% of the work force and more than in all of manufacturing. But much of the money to provide services and pay employees comes from property taxes, which depend on property values. Even as the economy and job market recover, local governments are cutting employees as they grapple with the worst budget deficits in a generation.

Real estate itself is but a small share of the U.S. economy, but its tentacles reach far.



Agence France-Presse/Getty Images

Relatives and friends mourn antigovernment demonstrators who were killed last month in clashes in Bangkok.

Thai peace out of reach

Hopes of settlement fizzle after fresh violence; new protesters arrive

By Patrick Barta

BANGKOK—Hopes of an imminent settlement in Thailand's continuing political crisis dimmed further after violence hit the capital again over the weekend and thousands of new antigovernment protesters arrived from rural areas.

Prime Minister Abhisit Vejjajiva, who came to power with military backing in a 2008 parliamentary vote, appealed to protesters Sunday on nationwide television to stick with a previously announced reconciliation plan designed to end the two-month impasse in which red shirt-wearing protesters have occupied key parts of the city and brought many businesses to a standstill. The plan calls for new elections on Nov. 14 and for independent investigations into recent political violence, among other steps.

Mr. Abhisit said protesters need to decide soon whether they will accept the plan's terms, which would mean vacating the large section of central Bangkok they have occupied for several weeks.

But in the Red Shirt zone, protesters gave no indication they intend to leave anytime soon. On Sunday, the area was noticeably more crowded than a week earlier, with some of the thousands of protesters playing board games and watching DVDs of past gun battles with government security forces.

Optimism had soared the week before, when Mr. Abhisit on May 3 proposed the reconciliation plan. Red Shirt leaders, who represent a large bloc of Thailand's rural poor as well as others dissatisfied with the current government, initially voiced qualified support for the initiative, which also calls for possible changes to Thailand's constitution. Some analysts say protest leaders want to wrap up a deal soon as the rainy season begins and some of their core supporters turn their attention to planting a new crop.

But talks bogged down late last week, as Red Shirt leaders demanded more specifics, including a precise date for when the government plans to dissolve parliament. That date is viewed as crucial, as it could determine who controls the government during a shuffle of top military leadership scheduled for September.

Another group of demonstrators allied with the country's royalist establishment said late last week it opposes any compromise, and pressed the government to take a harder line on the protesters. Many Bangkok residents are afraid that those known as Yellow Shirt activists, who brought down a previous government in 2008 when they occupied Thailand's main airport, could take to the streets if Mr. Abhisit reaches a deal with the latest protesters, wreaking further havoc.

Tensions escalated late Friday and early Saturday. Two policemen were killed and a dozen people wounded when unknown assailants fired guns and grenades on the outskirts of the main protest zone in Bangkok's central business district. Those battles—which both sides blamed on unnamed provocateurs possibly out to undermine the reconciliation process—brought the death tally in Thailand's political troubles over the past two months to 29, including 25 killed in gunfights on April 10. Hundreds have been injured.

On Saturday morning, an estimated five thousand new protesters began arriving in convoys from rural strongholds north of the capital, in an apparent bid by Red Shirt leaders to renew pressure on the government.

They wandered in and out of the main protest zone, which remains blocked off with barricades made from used tires and sharpened bamboo. Some slept in front of ATMs.

Speaking from the area's massive soundstage in the shadow of one of Bangkok's biggest shopping malls, leaders questioned the sincerity of Mr. Abhisit's offer. Red Shirt leaders have promised to keep negotiating on the reconciliation plan, despite the latest violence, but said they may unveil their own proposals in the next few days.

"We can't tell if we will be here only a week, two to three months, or forever," said Anand Makmoon, a 47-year-old rice farmer from Udon Thani in northeastern Thailand. He and his wife, Boonpeng Makmoon, said they came to Bangkok several days ago to join the protests because the government had shut down community radio and TV programs in their area, making it harder to get information about the movement.

Taliban threaten an Afghan offensive

By Maria Abi-Habib And Matthew Rosenberg

KABUL—The Taliban warned they would launch a major countrywide offensive in the coming days, momentarily shifting the focus from President Hamid Karzai's visit to Washington.

Afghan officials dismissed the Taliban's warning as nothing more than blustery rhetoric, and coalition officers said they, too, didn't think the militants could sow chaos on the scale suggested in a statement posted on their Web site Saturday.

But "we'll obviously be looking to see what happens Monday," the day the Taliban warned the offensive would begin, said a North Atlantic Treaty Organization officer. "Our guard is pretty high every day. This doesn't change anything."

The Taliban said their forces would begin laying siege Monday to Afghanistan's major cities and blockading Afghan and NATO bases.

The militants called their coming offensive "al-Fatah" ('to conquer' in Arabic) and warned there would be "ambushes, detonations of explosive devices, assassinations of government officials, suicide bombings and detainment of foreign invaders."

The warning appeared timed to a series of coming events. The first, Mr. Karzai's visit to Washington, starts Monday and is aimed at smoothing over the rough relations between Kabul and the Obama administration.

A series of major attacks could distract from the trip and underscore just how far Mr. Karzai's government and its Western backers have to go before the Taliban is neutralized.

Later in May, Mr. Karzai is planning to convene a so-called Peace Jirga—a gathering of politicians, elders and other prominent Afghans—to chart out a path for talks with the insurgents.

Alongside peace talks, the Karzai government and its Western backers are also planning to lure away low-level fighters with cash and jobs.

The Taliban, in a statement Saturday, offered their own version of that plan, saying it would provide "material incentives" to any Afghan soldiers or police who defected.

The Taliban also said they would take care to ensure the safety of ordinary Afghans.

Civilian casualties, especially those caused by NATO forces, are a longstanding concern among Afghans, including Mr. Karzai, who is expected to raise the matter in Washington and who is hosting a national peace assembly next month to seek a consensus on how to reconcile with insurgents and help end the war.

Many Afghans fear there will be more civilian casualties in the coming months as thousands of NATO and Afghan soldiers pour into the southern city of Kandahar and push out to the districts that surround it.

The area is the Taliban's birthplace and strategic heartland, and coalition special operations forces are already quietly hunting down midlevel commanders in the area.

Afghan officials dismissed the Taliban's warning as blustery rhetoric, and coalition officers said they, too, didn't think the militants could sow major chaos.

The Taliban are also stepping up activity in and around the city, and the offensive announced Saturday seemed to be a bid by the insurgents to counter allied efforts to win over the Kandahar's populace with promises of increased safety and better governance in the coming months.

The Taliban have already stepped up suicide bombings in Kandahar, and the militants are targeting prominent officials and tribal elders in the city and surrounding districts. The latest assassination came Saturday, when the insurgents took credit for gunning down an official and two of his bodyguards in Arghandab, a volatile district north of the city.

Despite the increasing volatility in Kandahar, Afghanistan's Defense Ministry was quick to downplay Saturday's statement, calling it a "desperate move."

"This statement is just more propaganda by the Taliban," said Defense Ministry spokesman Gen. Zahir Azimi. "The enemy is in a defensive position, not in an offensive position."

China confirms Kim's visit

By Gordon Fairclough

SHANGHAI—North Korean leader Kim Jong Il pledged to work with Beijing to "create favorable conditions" for talks aimed at shutting down his nuclear-weapons programs, China's state media reported, providing the first official confirmation of a five-day visit by Mr. Kim to his powerful neighbor and patron.

Mr. Kim's presence in China wasn't acknowledged by either government until the secretive dictator was back inside his own country Friday. During his visit, he and Chinese President Hu Jintao met and called on other countries involved in the so-called six-party talks "to demonstrate sincerity and make positive efforts," China's state-run Xinhua news agency said.

After North Korea last year conducted its second nuclear test, the U.S. and others pushed for Pyongyang to return to the talks, which in addition to the U.S., China and North Korea include Japan, Russia and South Korea. Pyongyang has resisted. Mr. Kim's stance may be softening in the face of United Nations sanctions that appear to have hurt North Korea's finances. But it remains unclear what conditions the country might seek in exchange for returning to the bargaining table.

Interest in the talks on the part of Washington and Seoul has cooled recently amid suspicions that a North Korean torpedo attack was responsible for the sinking of a South Korean naval ship in late March.

CLASSICAL
DEWITT
AUDACITY

WWW.DEWITT.CH

EVERY DEWITT IS BUILT BY A DEDICATED MASTER HOROLOGIST AND EACH INCLUDES AN AUDACIOUS TWIST ON THE CLASSICAL WATCHMAKERS ART.

INTERVIEW

Chasing growth in the east as business travelers recover

InterContinental's CEO sees a brighter future for business travel, while lamenting tax policies at home

[Andy Cosslett]

By Javier Espinoza

LONDON —-Andy Cosslett, chief executive of **InterContinental Hotels Group** PLC, is looking east to boost growth in Europe.

Munching on a sandwich at his InterContinental Hotel in Park Lane, overlooking Hyde Park, the 55-year-old Mr. Cosslett outlines his grand plans. The key, he says, is to push the region's growth by building its operations in the Middle East and Asia, and particularly China.

"We are expanding the InterContinental network in the Middle East and Asia, which will help investors bring their brand choices from those places into Europe," he says. "We are building bridges between economic powers to get a synergy."

Across continental Europe, InterContinental Hotels Group Plc, the biggest hotel chain in the world ranked by number of rooms, has already 342 hotels, and the company plans to open a further 98 over the next three to four years. This includes 36 new hotels in the U.K. and 11 in Russia, Mr. Cosslett says. Worldwide, the company has 4,400 hotels, operated as management contracts and franchise operations.

Still, it's been a rough time in the hotel industry of late. Last year, InterContinental had a 34% plunged in operating profit to $363 million, and revenue fell 19% to $1.54 billion. But hotel-industry research and consulting firm **Smith Travel Research** said in April that hotel occupancy in the U.S.— InterContinental's main market— is better than it had expected. STR predicts that occupancy will rise 1.9% this year to 55.8%, contrary to its previous forecast that occupancy would remain flat year-to-year.

"We have seen the market returning," Mr. Cosslett says of his first quarter results due Tuesday [May 11th] "We expect things will improve gradually through the year as we get into [the third quarter of 2010]."

"Rates are still down, so even though occupancy is strong and business travelers are returning, the rates are still down over a year ago," he explained. "We won't be able to say we are out of it until the rate per room is going positive."

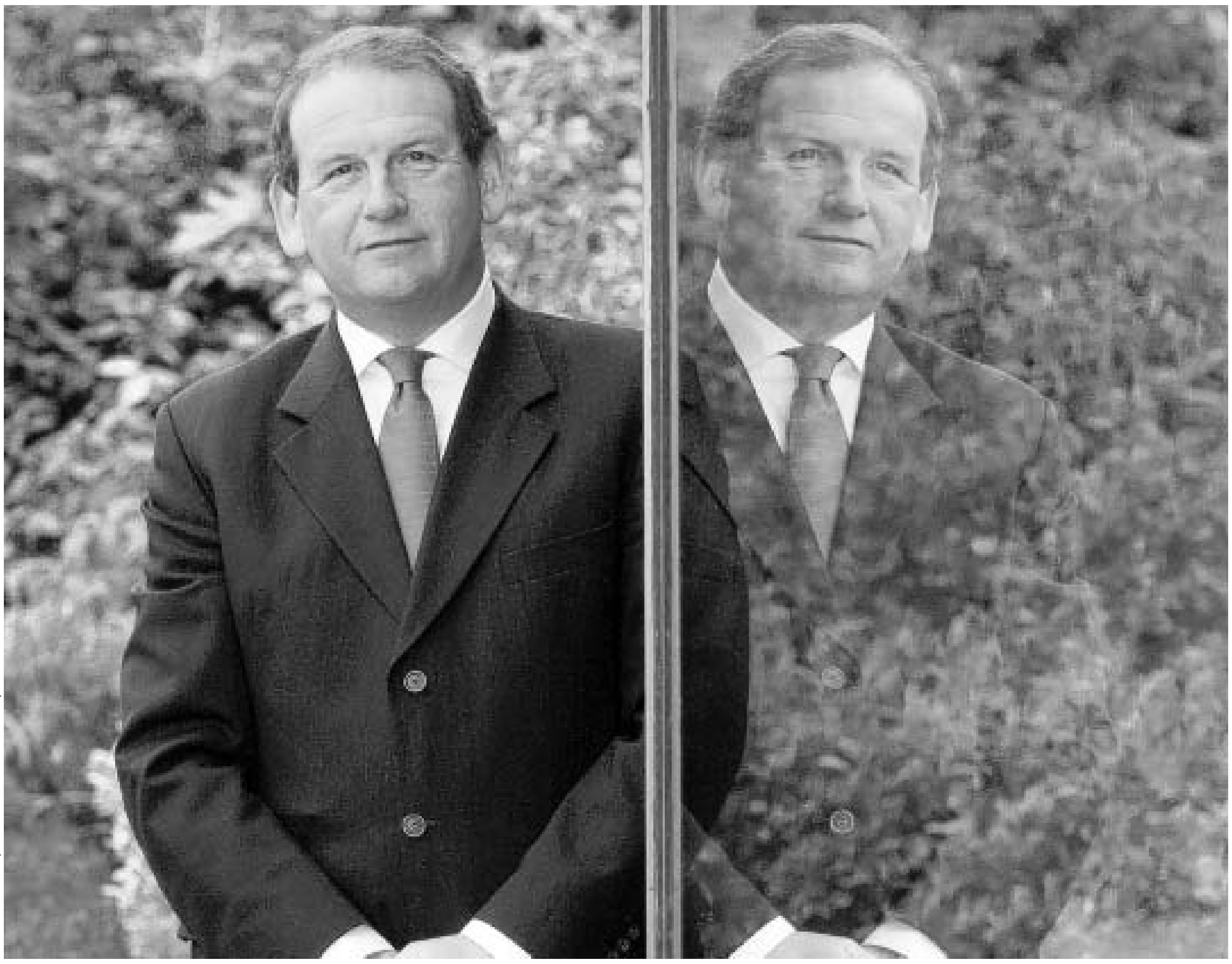
Mr. Cosslett sees positive signs as the economy recovers, however.

"The phones are ringing now more often to book conferences. We are in that moment where everyone knows business is coming back and the people who organize these conferences know it's coming back," he says. "There is no question that the world has missed meetings."

But hotels could still be missing meetings for a while. Last month, thousands of passengers were left stranded as an ash cloud from the Icelandic Eyjafjallajokull volcano forced aviation officials to shut down airspace over a wide part of Europe. The halt of air travel took a direct toll on airline balance sheets, but the problem has yet to cause major troubles for hoteliers.

"Overall the impact on business was fairly neutral - we did have some guests cancelling reservations but we also saw an increase in bookings at hotels near airports. Had the disruption gone on for an extended period of time this may have been a different story," Mr. Cosslett says.

Analysts agree. During the last volcanic ash disruption "people who didn't get here were replaced by the people who didn't," says Nigel Parson, an analyst with Evolution Securities in London. "It is very difficult to factor in the volcanic [ash disruptions] in anticipation of what might happen."



Credit Visual Media/InterContinental Hotels Group

Even amid the recession, Andy Cosslett says InterContinental managed to open 439 hotels last year, more than one a day.

To deal with the disruption, InterContinental implemented a temporary, worldwide policy that would allow guests over a limited period of time to cancel their booking or to move their booking to a later date.

Still, following further disruptions late last week, authorities are warning that trans-Atlantic air routes could take another hit following a new eruption. Hotel industry experts have warned that if the volcanic ash caused disruptions for longer, many hoteliers could suffer from cancelled bookings.

"Clearly longer term the impact could well be negative as people will be reluctant to make travel plans, whether business or leisure, if they believe there's a risk that they may be stranded or have their flight cancelled," said Robert Barnard, partner for hotel consultancy services at PKF in London.

However, there is evidence that the market for business travelers is turning. A recent report published by London-based **Ascend**, an aviation industry consulting firm, revealed that business travelers are expected to travel more often in the coming year with 35% of those polled expected to fly more on business this year compared to only 10% last year.

Talking about the return of business travelers gets Mr. Cosslett excited in the same way as talking about the expansion of one of InterContinental's key brands – the **Holiday Inn** – does.

"Holiday Inn is important because it's the biggest brand in the hotel industry," he says. Such is the importance of the brand that the group launched last month its biggest ever advertising campaign. This involved a $1 billion investment across more than 3,300 hotels worldwide. Already 2,200 hotels have been revamped, in an effort to create a more contemporary image of the mid-range hotel.

Even amid the recession, Mr. Cosslett says InterContinental managed to open 439 hotels last year, more than one a day. But he concedes growth is bound to slow down and he isn't suggesting expanding will be easy.

The lack of financing continues to be a hurdle. Mr. Cosslett says that although financing is "gradually becoming available," banks want to renegotiate all existing loans.

"The banks keep telling me that they are giving lots out -- but it's the terms at which they are giving it out. There has been a hardening in the market," he explains.

"If you want to take more money or refinance, everything has to come back on the table and that's placing some of our owners in quite a tricky spot," he adds. "We are in the middle of a tough six-month (period)."

On top of tough financing, Mr. Cosslett has also been campaigning hard to bring the "new wave" of taxes and regulations to people's attention. He believes hotels provide a quick and flexible way to get people back into work and provide a much-needed stimulus to the struggling economy.

"There is a great opportunity to stimulate the economy rapidly within months but we need to take a fresh look at the tax burden and follow the examples of countries like France and Germany where the VAT has been reduced to help the hospitality industry," adds Mr. Cosslett.

He sharply criticizes the U.K. government for not doing its part to kick-start the economy. "Ever-rising taxes are an area where small businesses get hammered the most. [In the U.K.] we are blindly pushing VAT to 17.5% and it might go up. A one-size-fits-all approach to taxes is not the answer. You can take an intelligent approach," he says

In the U.K. alone, the tourism industry is worth £114 billion, 8.2% of the national economy, according to VisitBritain. His company is asking the British government to implement concrete measures to help the struggling hospitality industry. Among several steps, InterContinental wants the U.K. to cut the VAT rate on hotel accommodation to 5% as soon as the economic environment picks up. He would also like the appointment of a dedicated Minister for Tourism to be placed within an economic industry like the Department of Business, Innovation and Skills.

Mr. Cosslett has another compelling argument as to why he thinks his industry should receive strong government support: the 2012 London Olympics, of which his Holiday Inn brand is a commercial partner.

"Just at the time when we should be investing ahead of the biggest single sporting event that we may have in a generation, we are running the risk of cutting down on training budgets, and service can deteriorate," he warns. "The last thing we want is a scenario where the Olympic experience is less than what it should be."