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BUSINESS & FINANCE 19

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Associated Press

Spanish Premier José Luis Rodriguez Zapatero, left, listens to Finance Minister Elena Salgado during Thursday's parliamentary session.

Spain steps up austerity

By Jonathan House
And Christopher Bjork

MADRID—Spain pushed through measures to accelerate the cleanup of its public-sector accounts and banking system, amid intense international pressure to deal with its deep economic crisis.

On Thursday, Parliament approved by a single vote the government's plan for €15 billion ($18.29 billion) of additional budget cuts this year and next. Separately, the Bank of Spain late Wednesday said it wants to force the country's banks to speed up the recognition of losses resulting from the collapse of a decadelong housing boom.

A visibly relieved Prime Minister José Luis Rodriguez Zapatero told journalists as he left Parliament that the vote was a "difficult one" but that it has "gone as expected."

Spain has moved to the center of Europe's financial crisis as investors fret over its double-digit budget deficit, 20% unemployment rate and ailing savings banks.

The Bank of Spain's takeover of small lender CajaSur over the weekend helped fan these fears, resulting in increased financing costs for Spanish banks, while also

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Obama takes tougher line on oil drilling

President Barack Obama, under pressure to step up response to the Gulf of Mexico oil disaster, vowed tougher regulations for the oil industry and said he is suspending action on 33 exploratory drilling operations in the Gulf and canceling or temporarily suspending pending lease sales and drilling in Virginia and the Arctic.

By Jared A. Favole,
Stephen Power
and Guy Chazan

Mr. Obama also said the "oil industry's cozy and sometimes corrupt relationship" with federal regulators underscores the need for more oversight. Further, he said although **BP** PLC is responsible for cleaning up and paying for the disaster, the company is running all decisions by the U.S. government.

"The American people should know that from the moment this disaster began, the federal government has been in charge of the response effort," he said.

Mr. Obama said blame for concerns about the response rest partly on his administration's shoulders and BP's. He said BP hasn't been "fully forthcoming" with video information to help understand the scope of the spill.

The president spoke shortly after Minerals Management Service Director Elizabeth Birnbaum resigned from the agency that regulates offshore drilling and that has faced intense scrutiny for leaving safety regulation up to the oil industry.

Meanwhile, a team of U.S. scientists Thursday significantly raised the estimate of how much oil has been leaking from a damaged well into the Gulf. The figures signal that the disaster is at least as big as the Exxon Valdez spill two decades ago, and could perhaps double it in size.

The Coast Guard said a maneuver, called a "top kill," to plug the well with heavy mud has stopped oil and gas so far from coming up. Still, that doesn't mean the leak has been completely plugged or that the move was successful.

Drilling down

Reuters

The White House's announcements mark the most dramatic policy response yet to the spill. The Obama administration said it was suspending consideration of any applications for exploratory drilling in the Arctic until 2011 and extending a moratorium on permits to drill new deep-water wells for six months.

Mr. Obama is under pressure from his left flank to pull back on his promises to expand offshore oil drilling, especially in Alaska, where environmentalists say a blowout similar to the current one in the Gulf would have even more serious ramifications.

The decision is a major blow to **Royal Dutch Shell** PLC, which had planned an ambitious oil-drilling program in the Chukchi and Beaufort Seas off Alaska this summer. Shell has been arguing to regulators that its operations in Alaska would face a lower risk of the kind of problems faced BP in its ill-fated Gulf of Mexico operation.

The move is sure to upset Alaska lawmakers, some of whom were briefed on it late Wednesday. Sen. Mark Begich (D., Alaska) said in a statement that it would cost Alaska jobs and cause the U.S. to "export more dollars and import more oil from some unfriendly places." He said the halt would "cause more delays and higher costs for domestic oil and gas production to meet the na-

Please turn to page 9

Prudential seeks lower price for AIA in effort to save deal

Prudential PLC is in talks with **American International Group** Inc. to cut the $35.5 billion price tag on Prudential's purchase of AIG's main Asian unit, people familiar with the matter said, amid criticism of the deal.

The deal in its current form appears to have been doomed by complaints from Prudential's shareholders that the price and the execution risk are too high to justify the $21 billion of cash they would need to put up to help pay for the purchase. Prudential needs the support of holders representing 75% of its shares to proceed with the pact.

Proxy advisory services have so far been split on the deal. RiskMetrics has recommended shareholders vote against the takeover, citing the high cost of capital, integration risks and profit targets that would be difficult to be achieved. On Thursday, however, Glass, Lewis & Co. said the financing and the deal are in the long-term interests of Prudential shareholders.

A lower price tag for AIA Group Ltd., as the unit is called, could set back AIG in its efforts to repay U.S. government aid it received in a massive bailout starting in September 2008. A lower price also would reduce the amount that AIG can repay the Federal Reserve Bank of New York, which holds $25 billion equity in AIA and another life insurance business, and to which AIG owes $26 billion under a credit facility.

Before AIG inked a deal to sell AIA to Prudential, the government-controlled insurer had been readying a plan to float part of AIA in an initial public offering in Hong Kong. AIG was aiming to raise $10 billion to $20 billion cash from the IPO. There have been discussions about reviving the IPO plans if the Prudential deal falls through, but tumultuous market conditions in Hong Kong and elsewhere could affect the valuation.

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PAGE TWO

Nobody wants to miss the cutting

[Agenda]

By Iain Martin

The spending cuts keep on coming. In fact they are becoming the height of European fashion. Spanish parliamentarians are just the latest to join in, this week approving a €15 billion ($18.4 billion) austerity package aimed at cutting the country's deficit. It was a tight squeeze for the Socialist government, winning the key vote by one. But a win is a win, and the result means cuts of 5% or more in civil-service pay, the end of the automatic payment to parents of newborn children and big cuts in spending on public projects.

In Britain, the new Conservative-Liberal Democrat coalition government declared its intentions with the first £6 billion ($8.6 billion) of savings this week—although they are really only a small down payment on serious deficit reduction. A budget and then a tough spending review are on the way.

And Chancellor George Osborne's deputy, the Liberal Democrat Chief Secretary to the Treasury David Laws, is making himself very popular with his new Tory colleagues at Westminster. So enthusiastic is he about the "age of austerity" rhetoric and belt-tightening that he is being compared, approvingly, to that sound money man and 19th century Liberal giant among prime ministers: William Ewart Gladstone.

The Irish were the early movers on the cuts front, of course, with Finance Minister Brian Lenihan slashing programs late last year.

Now Italy is suddenly keen not to be left out. The government used an emergency decree on Tuesday to impose public spending cuts of €24 billion. In response, trade unions are threatening even more strikes than usual. But Prime Minister Silvio Berlusconi was having none of it: "For years, Italy, like many countries in Europe, lived above its means," he said. "We are all in the same boat."

European Pressphoto Agency

U.K. Treasury Secretary David Laws is enthusiastic about austerity measures.

Isn't it extraordinary how a sovereign debt crisis can concentrate minds? In the rush not to be the next in line for the ire of investors, all manner of serious cutbacks that would have once been thought utterly unthinkable are now being delivered.

Borrowing even more, then taxing a dwindling group of wealth creators doesn't seem a sensible answer.

In terms of European thinking about the state and its obligations, it shouldn't be underestimated how significant the consequences of these developments are likely to be. The way large parts of Europe have liked to conduct business—with high social spending, and costs loaded on the next generation—has run smack into two roadblocks: market fears about unsustainable debts and demographic change.

For that reason, it isn't credible to view this period as just a pause before normal service resumes in Europe. Think of the adjustments not as temporary, but as the first glimpse of a dramatically altered landscape.

Perhaps the ever-increasing number of older voters will want to carry on voting for parties that promise them their benefits and generous pensions in full. Perhaps they may even decide to ignore the moral degradation involved in expecting a shrinking pool of workers from the generations of their children and grandchildren to pay for their comforts. But what is clear is that those driving the markets can now see the flaw. They seem disinclined to fund the excessive borrowing required to support such unsustainable arrangements.

This is a serious change. It is only a few years since it was thought bad manners to question the continued viability of the European approach. The post-war conceit, remember, was that the feted "European social model" would provide perpetual high standards of living, high growth, full employment and plentiful benefits for citizens. In the last respect, the European way was deemed by its adherents to be somehow morally superior to the American dream.

But the baby boomers are coming up for retirement across the continent. In the UK, for example, according to the Centre for European Reform, "the population of pensionable age will rise by 32% over the next 25 years to 15.6 million, with the number aged over 85 more than doubling to 3.3 million."

How is all this longevity to be paid for? Might recovery and strong growth take care of things?

Perhaps, but the signs are not good. Take Britain again: The economist Tim Congdon, writing recently for the free-market Institute of Economic Affairs, is gloomy about growth prospects. Since the war the "normal" trend growth rate has been 2.5%, but Mr. Congdon calculates that in the future, it will be about 1.5% a year.

He blames the imminent slowing in labor-force growth, the large public sector, rising taxes, increased energy costs for industry associated with the U.K. government's push for "green" renewable energy as well as regulatory pressure on the banking industry for reducing the potential for borrowing and investment.

Other leading European economies have a range of similar problems, of course

In such a context, borrowing ever more in the decades to come, then taxing a dwindling group of wealth creators doesn't seem to be a sensible answer to the problems of the dying European social model. Instead, after today's cuts might come economic liberalization, increased competition and more labor-market flexibility to encourage a major increase in private-sector activity, all designed to encourage invention, innovation and growth. It is worth trying. Frankly, there isn't much of an alternative.

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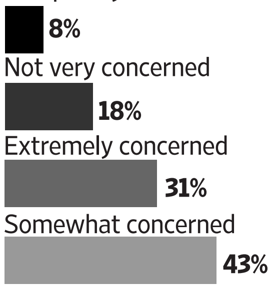

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NEWS

France targets Google on video search

By Max Colchester

PARIS—A technology consortium funded by the French government unveiled multimedia search tools Thursday, as part of a scaled-back attempt to challenge the dominance of U.S. search engines.

Quaero, which was set up two years ago, showed off software that converts spoken language into written text; a program that synchronizes electronic books to audio books; and an automatic translation device that turns German into English (though not into French).

"If you want to respond to the U.S. technological invasion, then you have to master your own technology," said Pieter van der Linden, chief co-coordinator of the Quaero project. But he said the aim was to create specialist applications and encourage research in the sector, rather than replace existing search engines. "Quaero is not about creating a single search engine with a name like Quaero.com. It's about sharing resources."

The project was started four years ago by the French and German governments, and France's then-President Jacques Chirac said they would "take up the global challenge posed by **Google** and **Yahoo.**" The venture was christened Quaero—Latin for "I seek."

The thinking was that Internet users would increasingly search audio and video clips for content, much as they now search for words. In keeping with the French "dirigiste," or government-directed, approach to business, the government, not the private sector, spearheaded the project. Mr. Chirac even saw it as similar to the Airbus project in that it encompasses both French and German input.

However, Germany quietly pulled out of the project in 2007 because it disagreed with the French plan to push for a multimedia search system, rather than focus on a better text-based search system. France set up the consortium in 2008 with a five-year budget of €199 million ($242.6 million), half from the French state and the other half from private partners, including **France Télécom** SA and media-technology group **Technicolor** SA.

Quaero groups some 26 partners, mostly French businesses and universities, which share research. The government hopes Quaero will nurture smaller French technology companies. So far, the software is aimed at the French market.

"We support it because it promotes skills within France," said Dominique Dubuisson, the deputy head of industrial strategic innovation at the government investment fund Oseo. "The aim is to accelerate collaboration and development."

For example, **Exalead** SA, a French software provider and a member of Quaero, used its partners' expertise to create a program that searches for keywords in a video. It then turns the sounds into text, which can be searched for a keyword. This technology is now being used on the French president's Web site.

Many other programs are still being developed, and some will be available for commercial use.

Google launched a similar project called Google Audio Indexing two years ago but hasn't yet come out with an application. A spokesman couldn't immediately comment.

"It's hard to grow in Europe," said Jean-Marc Lazard, the head of strategic projects at Exalead. "The project helped speed our development and grow abroad." The company has just opened an office in San Francisco, he said.

Ms. Dubuisson said that she doesn't know if Oseo will get back any of the €99 million it invested, but hopes some of the smaller companies will generate profit in 2011.

As for challenging Google, as the French government wanted to do, Quaero's current managers have more modest ambitions than Mr. Chirac. When the former president said France was going to take on Google, Mr. van der Linden said, he and other politicians "oversimplified the message."

Yacast (L); www.elysee.fr (R)

Quaero technology transcribes voice into text, as seen, left, on France 24. It also can search for the word "Carla" in videotapes of the French president's speeches.

French protest plan to raise retirement age

By David Gauthier-Villars

PARIS—French labor unions used a nationwide protest on Thursday to voice opposition to government plans to increase the minimum retirement age from 60.

Tens of thousands of workers, including teachers, air-traffic controllers and museum wardens as well as some private-sector workers, joined rallies in spite of heavy rain. Rallies took place from Marseille in the south to Caen in the north.

"We're seeing the highest mobilization since the start of the year," said François Chérèque, head of the umbrella union CFDT, during a rally in Paris. "The government must revisit its plan."

President Sarkozy, for whom pension overhaul is a priority, says French people can't afford to retire earlier than their European neighbors.

Government spokesman Luc Chatel said the turnout at the demonstrations was "low."

President Nicolas Sarkozy says French people can't afford to retire earlier than most of their European Union neighbors, who have cut pension benefits or raised future retirement ages in accordance with rising life expectancies.

The annual deficit of France's state-run pension funds could exceed €100 billion ($122 billion) by 2050, from an estimated €10 billion this year, according to a council advising the French government.

Targeted by Mr. Sarkozy as a national priority, the proposed pension overhaul is regarded as a key test of France's ability to preserve a generous social welfare system without piling up debt.

Although the government hasn't yet released details of a plan, it has made clear it wants people to work longer and retire later to help finance the pension system's growing shortfall. A pension bill could be drafted in July and presented in September to Parliament, where Mr. Sarkozy's ruling UMP party has a majority.

"The main response to demographic imbalances should be demographic," Labor Minister Eric Woerth said last week.

Economists say that raising the retirement age and the number of years workers contribute to the state-run system would only halve its shortfall. A rise in payroll taxes is inevitable, they say, unless pensioners agree to receive significantly lower pensions.

Most union leaders, including Mr. Chérèque, say the 60-year mark is "non-negotiable."

France reduced the minimum retirement age to 60 from 65 in 1983 under Socialist President François Mitterrand. The move was seen by unions as a major social victory, ranking with five-week holidays, a minimum wage and the 35-hour workweek.

Socialist Party leader Martine Aubry has said that, if Mr. Sarkozy raises the retirement age, she would bring it back down again if elected president in 2012.

European Pressphoto Agency

A band of musicians in Paris takes part in national protests, called by labor unions, against a planned pension overhaul.

EUROPE NEWS

Geithner urges coordinated reform

U.S. Treasury Secretary calls on Germany and Europe to 'balance' measures on financial rules and budget cuts

By Ian Talley
And Patrick McGroarty

U.S. Treasury Secretary Timothy Geithner, above, held a news conference Thursday in Berlin, where he met with German Finance Minister Wolfgang Schäuble.

BERLIN—U.S. Treasury Secretary Timothy Geithner called on Germany and Europe to support global economic growth by cutting budget deficits judiciously, and to avoid uncoordinated steps on financial regulation that undermine fragile confidence in financial markets.

Mr. Geithner, meeting with German Finance Minister Wolfgang Schäuble Thursday, said leading economies' policies on deficit-cutting and on regulation need to be "balanced."

"We all understand that part of recovery, part of growth, is to make sure that we make clear and credible commitments to restore gravity to our fiscal positions over time," Mr. Geithner told reporters. "But we're also working to make sure our economies are growing," he said.

Germany has faced U.S. criticism recently for pressing much of Europe to pursue austerity policies, which U.S. officials fear could undermine an already weak recovery in a key region of the global economy.

However, Mr. Geithner and his German counterpart appeared to move closer on managing the global crisis at Thursday's meeting, as the U.S. delegation acknowledged that Germany has done more than is often recognized abroad to prop up economic demand in Europe.

Mr. Schäuble told reporters that the debt crisis in Greece and investor fears of contagion to other weak euro-zone economies make it imperative that members of the currency bloc sign on to tough debt limits, even though the economic recovery is in its early stages.

The German finance minister said his country, with its aging population and rising associated long-term costs, has less room for fiscal maneuver than the U.S. But he also said deficits "must be reduced in a measured way," acknowledging the danger of choking off recovery.

The Berlin meeting was held at the end of a two-day trip through Europe for Mr. Geithner as he encouraged officials here to push forward on a measured restructuring of the financial system and to encourage growth while cutting deficits through fiscal reform.

Mr. Geithner met U.K. Chancellor of the Exchequer George Osborne in London Wednesday before dining in Frankfurt with European Central Bank President Jean-Claude Trichet. He had earlier met with Chinese officials in Beijing.

The Treasury Secretary's tour came ahead of talks between finance chiefs of the Group of 20 leading economies in South Korea next weekend, and a summit of G-20 leaders in Canada in June. Both meetings are due to discuss the global economy and financial-sector regulation.

Thursday's meeting in Berlin was a conspicuous show of harmony. "I have enormous respect for Germany and enormous confidence" in its leadership of Europe's financial restructuring, Mr. Geithner said. "We share a common interest in making sure we're working closely together to reinforce this global recovery and to work together to put in place a strong framework for global reform."

He said the U.S. and Europe are in broad agreement on "putting in place more conservative constraints on [financial-sector] risk taking, more conservative capital requirements, and bringing transparency to derivatives markets," but he acknowledged that "we're going to have slightly different approaches."

Mr. Geithner warned that reform should be "designed carefully in a way that makes the system more stable in the future but doesn't create financial headwinds to recovery."

In recent days U.S. officials have privately criticized Germany for its surprise move last week to ban some kinds of financial betting against euro-zone government bonds, including so-called naked short-selling. The move sparked concern in Washington that uncoordinated intervention by governments could damage market confidence and spook investors.

Mr. Schäuble said Thursday that Europe and the U.S. need to work more closely to tighten financial regulation, but that their solutions won't necessarily be identical. He defended Germany's short-selling restrictions and its plan to pursue a broader ban on naked short-selling of all German stocks. "I know the American approach is somewhat different," he said.

German officials privately say they were under domestic political pressure to clamp down on financial speculation against euro-zone governments, in order to secure German parliamentary approval for the European Union's nearly $1 trillion bailout fund for struggling euro members.

Mr. Schäuble added that Germany needed to move faster than the European Union, which plans to review short selling regulations in October, and that Germany's new restrictions could eventually be incorporated into wider EU regulations.

Spain cuts budget, steps up pressure on banks

Continued from first page
weighing on the euro. The Wall Street Journal reported Tuesday that banking giant Banco Bilbao Vizcaya Argentaria could face difficulty in refinancing $1 billion in commercial paper.

Earlier this month, as the financial crisis that started in Greece spread, European Union leaders put together a giant euro-zone financial backstop designed in part to ease investor concern toward Spain and Portugal. In return, it asked these countries for new budget cuts.

Thursday's vote underlined the political cost for Mr. Zapatero's minority government of measures that include a 5% cut in public-sector wages and a freezing of pensions next year. The measures passed by just one vote, with Mr. Zapatero's Socialist Party voting in favor and all others against or abstaining.

In the parliamentary debate that preceded the vote, Mariano Rajoy, leader of the Popular Party, said Mr. Zapatero was Spain's biggest problem and he couldn't support him or his economic policies.

Outside Parliament, Spain's two largest unions, Comisiones Obreras and Union General de Trabajadores, huddled to discuss the austerity measures as well as an overhaul of labor laws they are negotiating with business groups. The government has given the two sides until May 31 to reach an agreement, signaling it will impose reform if they don't.

After their meeting, union leaders said they would call a general strike if the government passes an overhaul that undermines workers' rights. They have already called a public-sector strike for June 8 to protest the austerity measures.

Raj Badiani, economist at IHS Global Insight, applauded the government for pushing through its austerity measures despite strong opposition.

"The government needs to demonstrate a strong control of the situation, helping to ease market fears that the current administration will be unable to deliver better fiscal discipline or implement effective labor-market reform," he said.

The International Monetary Fund said earlier this week Spain's labor market needs "radical" overhauls to stimulate growth and to lower its historically high unemployment rate.

Likewise, the Bank of Spain's proposals also won kudos from investors. The central bank said it wants Spanish lenders to set aside provisions for the full value of each bad loan one year after it has soured. Banks currently have to provision gradually over a period of between two and six years. It also raised provisioning requirements for real-estate assets that lenders hold on their balance sheets.

Analysts said the move may provide much-needed transparency to a sector that is under intense scrutiny from international investors who are worried about a fallout from the restructuring of fragile savings banks. Mutually owned and with close ties to local communities, these institutions are bearing the brunt of the collapse of Spain's housing boom.

Bankers also suggested that the move may accelerate merger activity among these lenders, many of which were unprofitable in the last quarter of 2009.

The government has said around two-thirds of Spain's 45 savings banks are so weakened that they should merge with strong peers. The central bank is threatening to take over those that don't.

"These changes of regulation are, if implemented, one of the most important points related to Spanish banks we have seen in years," said Santiago Lopez Diaz, a bank analyst at Credit Suisse. "The measures could be the last straw for several institutions in terms of profitability, which is going to accelerate consolidation in the sector."

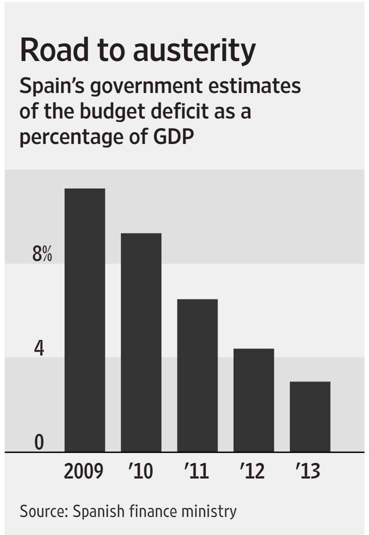
—Leire Barrera contributed to this article.

Coming clean

New rules will require the banks to recognize losses on delinquent loans in 12 months compared to 24 to 72 months currently

Period of delinquency	Percent of value that must be provisioned
Up to 6 months	25%
Between 6-9 months	50
Between 9-12 months	75
More than 12 months	100

Source: Bank of Spain



EUROPE NEWS

Europe banks remain exposed to U.S. funds

BY STEPHEN FIDLER
AND DAVID ENRICH

Sipa Press

A Granada branch of CajaSur, which the Bank of Spain took over last weekend.

Intensified financing pressures on European banks this week show how dependent they remain on short-term dollar lending by U.S. money-market funds, a strong suggestion that some important lessons from the financial crisis haven't sunk in.

Meanwhile, the U.S. funds are heavily invested in Europe's banks at a time when they face increasing challenges because of Greece's sovereign-debt crisis and worries that it could spread to other countries in the euro zone, such as Portugal and Spain.

The crisis has weighed heavily on the euro zone's banks. Many are heavily exposed to the debt of the three governments, and austerity measures being promoted to ease debt concerns across the region promise weak growth for years. This is raising more questions about private-sector borrowers.

A report this week by a Royal Bank of Scotland Group economist estimated that more than €2 trillion ($2.45 trillion) of debt issued by governments and companies in Greece, Spain and Portugal is held by financial institutions outside those countries.

"Make no mistake: This is big," said Jacques Cailloux, RBS's chief European economist and the report's author. "We're talking about systemic risk." He said the situation is comparable to the subprime-mortgage crisis that originated in the U.S. but quickly engulfed financial institutions world-wide due to their holdings of mortgage-linked securities.

Such analysis shows that the euro zone's financial system is more interconnected than people had recognized and shows how problems in one part of the 16-nation bloc can spread to banks elsewhere.

The reliance by banks on short-term dollar funding helped intensify the financial crisis, because it is potentially unstable and unreliable. Some European banks need substantial dollar funding to carry out trading activities, but others may need it to fund dollar assets that they didn't write down after the financial crisis.

On Thursday, Spain moved—belatedly, say some analysts—to force its banks to recognize loan losses more quickly.

Worries about the knock-on effects of the Greek crisis have encouraged U.S. funds to retreat from financing European banks, analysts say, though a swap line from the Federal Reserve making dollars available to European central banks has eased worries about a funding crisis.

Figures from Moody's Investors Service show nearly a third of the top funds' $2 trillion in assets were held at the end of last year with just 16 European banks. Analysts at Bank of America estimate that 40% of prime money funds' holdings are in European banks. The Moody's figures show **BNP Paribas**, which needs dollars for a lot of its trading activities, had roughly $70 billion in funding from U.S. money funds at the end of 2009. That would be equivalent to roughly 2.8% of BNP's year-end total liabilities. Another French bank, **Société Générale**, has around $59 billion from U.S. funds, which would represent about 4.8% of its total liabilities as of Dec. 31.

To be sure, some of the retreat from European banks is technical: A new regulation from the U.S. Securities and Exchange Commission that goes into effect Friday has forced the funds to hold 30% or more of their assets in short-term paper.

During the financial crisis, European banks piled into government bonds, believing they would be the safest assets. Banks were further encouraged to hold them because regulators didn't require them to use up scarce capital to protect them against losses.

Now, however, with markets growing increasingly worried about the solvency of Greece and other debt-laden countries, the banks' bond holdings are threatening to blow holes in their balance sheets. The once-unthinkable, a government default, strikes the markets as increasingly plausible. In one sign of that shift, the cost of buying insurance on Spanish government bonds has soared more than 250% in the past year, according to data provider Markit Group. Banks and other financial institutions across Europe together are sitting on hundreds of billions of dollars worth of debt issued by European governments.

The U.K.'s **Barclays** PLC, for example, holds more than £4.9 billion ($7 billion) of Spanish government bonds. France's two biggest banks have €8 billion of Greek sovereign debt. German banks also hold tens of billions of euros of Greek government bonds.

Such "sovereign bonds" were long considered virtually risk-free, and regulators encouraged banks to invest in such assets as a way to keep their risk profiles low.

"Many European financial institutions find themselves holders of hundreds of billions of euros worth of risk assets (e.g. Greek government bonds) that they had held as riskless assets," wrote Nazareth Festekjian, a managing director at Citigroup Inc., in a letter this week urging European policy makers to protect banks from having to write down the values of their bond holdings to market prices.

Even if governments don't default on their debt, the banks' bond holdings are nonetheless shedding value in the wake of ratings downgrades and mounting market jitters. The situation has parallels to the recent credit crisis: As subprime-mortgage-related instruments lost value, banks world-wide had to write down the values of the securities, saddling them with crippling losses.

Banks' vulnerabilities might be deeper than they appear.

Some analysts and investors believe that certain European banks are masking their exposures to troubled countries like Greece by relying on a type of derivative called credit-default swaps. The instruments are designed to serve as an insurance contract; if Greece defaults on its debt, for example, the policies pay out.

The problem is that the CDS might not provide as much protection as the banks are hoping. For example, if Greece were to voluntarily restructure its debt, banks could suffer losses on their bond portfolios, but the CDS contracts might not be triggered, according to a recent report by analysts at RBC Capital Markets.

In addition to government debt, financial institutions are holding about €1.1 trillion of bonds and other debt issued by the private sectors in Greece, Spain and Portugal, according to the RBS study. The outlook for this debt has also deteriorated as prospects for a strong economic recovery have weakened, because of austerity programs and government debt troubles.

Meanwhile, Spain's banks fueled the country's real-estate boom by generously doling out loans to developers and home buyers. The banks financed those loans borrowing heavily themselves. Today, foreign banks and other investors are holding €770 billion of Spanish banks' debt, said RBS's Mr. Cailloux.

That is one reason why the Bank of Spain's seizure last weekend of a midsize regional lender, CajaSur, fueled the panic among European banks and investors.

The arithmetic adds up to an unspeakable word

[Brussels Beat]

BY CHARLES FORELLE

There is one word that must not be uttered in this town: Restructuring.

When it comes to the €110 billion they've pledged to Greece, officials of the European Union and the International Monetary Fund insist that a debt default by the bedraggled country is beyond contemplation.

"Let's be very concrete and precise," EU President Herman Van Rompuy said last week. The Greek package "does not include any provisions for debt restructuring."

But even if Mr. Van Rompuy won't talk about it, private economists sure will.

"At this point, it is very clear that restructuring is the only option," says Lena Komileva of Tullett Prebon in London.

"Almost certainly, the Greek debt will have to be restructured in 12 to 24 months," says Eswar Prasad, a former IMF official now at Cornell University.

And Josef Ackermann, the chief executive of **Deutsche Bank**, said earlier this month he thought it "doubtful" that Greece would be able to repay all its borrowings.

Why all the dour faces?

The Greek government had €273.4 billion in debt at the end of last year, equivalent to 115.1% of the country's gross domestic product. That ratio will rise sharply through 2012, since a yawning budget gap adds more to the tab each year. There are few signs that the stagnant Greek economy will grow anywhere near fast enough to catch up.

The EU and IMF's plan, which involves €80 billion in loans from the 15 other euro-zone countries and €30 billion from the IMF, is enough to keep Greece afloat for a few years while the country enacts giant cuts and fiscal changes. Those, it is hoped, will make Greece more attractive to private creditors, and the country can be eased back into capital markets.

If Greece's efforts can pare the budget gap enough, "then the debt-to-GDP ratio will start to recede and there won't be questions of sustainability," said John Lipsky, the IMF's No. 2 official, in a conference call the day the bailout was announced.

The private sector is more pessimistic, for two main reasons.

First, the cuts are brutal, and it may be difficult for Greece's leaders to sustain them. The plan, particularly this year and next, calls for big hikes in taxes and sharp cuts in wages and payments for the many civil servants.

Second, even if everything goes well, the sobering math favors a restructuring.

Greece in 2009 ran a primary deficit of €20 billion, which is to say that even excluding interest paid on its debt, the government was €20 billion in the hole. Like a consumer with living expenses greater than his salary, Greece needed to borrow just to keep the lights on—stopping credit-card payments wouldn't solve the problem.

A default now "would be a recipe for significant disorder," Mr. Lipsky said. But the EU-IMF program trims the primary deficit. By 2012, according to IMF estimates, the primary deficit will have turned into a surplus of €2.4 billion. At that point, Greece is borrowing only to deal with existing debt.

The cost of that debt is soaring. In 2012, Greece will be spending €17.1 billion on interest, up from €11.9 billion last year. In 2014, when Greece's debt is projected to peak at €353.8 billion, it will pay €20.4 billion in interest to creditors. That's not far off what it will spend on government wages.

But that strengthens the Greek case to reduce the interest burden. High interest payments and no primary deficit "are the exact circumstances," wrote **Citibank**'s Willem Buiter in an analysis earlier this month, "that make a default individually rational for the debtor."

In 2012 or 2013, with debt nearly 150% of GDP, "the notion of paying off banks in Western Europe is not going to go off very well" in Greece, says Cornell's Mr. Prasad. Especially since "you are going to have to squeeze social expenditures so much."

Ms. Komileva says Greece faces a "crisis of solvency." That's made clear by investors' ho-hum reaction to the European Central Bank's pledge to purchase Greek and other sovereign debt from the markets. The yield on Greek 10-year bonds Thursday was 7.82%, down from pre-bailout levels but still more than five percentage points above Germany's yield.

Insolvent borrowers, Ms. Komileva says, have three options: get capital from a lender of last resort, improve their own performance or reduce their liabilities through restructuring. Greece has already tried the first two, she says, but they "haven't resolved the cause of the insolvency: lack of growth" and dire public finances. Another issue posed by Greece's mounting debt: It will, eventually, still need access to large amounts of private financing. Of course, that's what triggered Greece's present problem.

In 2014, after years of painful cuts, the IMF projects Greece will need to borrow €70.7 billion and will have €265 billion in debt to the private sector—about where it was in 2009. Except that it will also owe €85 billion to the EU and the IMF.

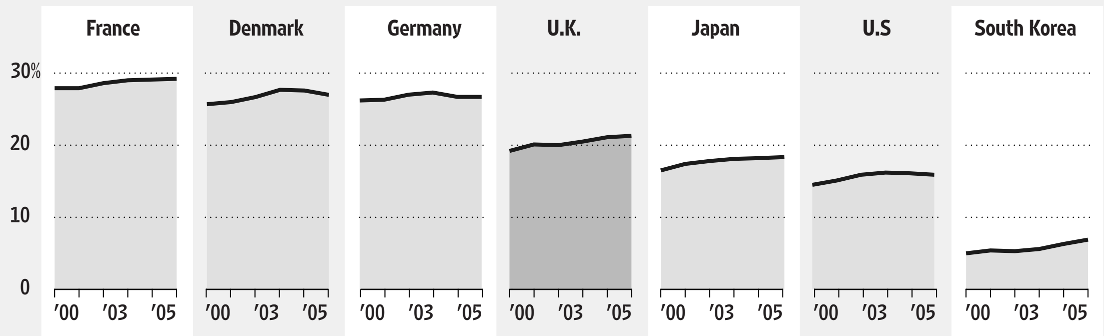
Mr. Prasad, who worked at the IMF for 16 years, says the Greek program has bought the country a year before restructuring. But that year is "very important," he says.

For one, it forces the Greeks to make serious reform steps toward reform. It gives creditors time to prepare for a default. And it gives other weak euro-zone countries time to work on their finances.

"Spain and Portugal," Mr. Prasad says, "have been given a very clear signal that they have a year."

Benefits Cost

The costs for governments of 'social protection,' from unemployment benefit to state pensions, have been rising but differ greatly across the globe.



Note: The OECD uses a broad measure of government benefits that takes into account cash benefits and so-called benefits in kind, including some forms of state supplied health care and accommodation.
Source: OECD

Welfare will be target of U.K. benefit crunch

By Alistair MacDonald

> 'Your income may not be high, but it is guaranteed,' says onetime benefit-recipient Lee Page. He took a job five years ago but was reluctant to stick with it when he saw he was clearing little more than he had received in state aid.

Britain's new government on Thursday promised a "radical reform" of public benefits such as unemployment and disability. This bid is a key part of the U.K.'s efforts to trim a worrisomely large budget deficit—and it depends, to a large extent, on its ability to rein in payments to families like the Sussocks.

Emma Sussock, an unemployed single mother in Liverpool in northwest England, claims about £120 a week in various benefit payments plus free housing from the government. The 21-year-old's mother hasn't worked in more than 20 years and last attended a job interview five years ago, and Ms. Sussock's step-grandfather has been receiving incapacity benefits since suffering a heart attack more than 20 years ago.

Most of the people she knew growing up were welfare claimants, and she wasn't spurred to work at school or look for a career. She says has worked just one day, behind the bar in a nightclub, since leaving school at 16.

Iain Duncan Smith, the U.K.'s new minister for Work and Pensions, on Thursday promised "radical reform" of the country's welfare system. "A system that was originally designed to help support the poorest in society is now trapping them in the very condition it was supposed to alleviate," he said in a speech.

The U.K. Treasury estimates that spending on a raft of state benefits—from unemployment compensation and worker disability to government retirement benefits, but excluding health care—will total around £200 billion ($288 billion) in fiscal 2010-2011, about 14% of the country's gross domestic product.

While spending as a percentage of GDP has been inflated by Britain's increased unemployment benefits during the recession, this budget typically accounts for up to a quarter of public spending. Different countries classify such spending in various ways, but the U.K.'s level is higher than those in the U.S. and many large Asian economies by most measures, but is by no means the largest in Europe.

Now the U.K. is in the same position as many other European governments—rushing to trim deficits to stay in the good graces of ratings agencies and creditors. The U.K.'s government, for its part, has promised to simplify a system which currently covers 51 different benefits.

The new coalition government, made up of the Conservative and Liberal Democrat parties, has already signaled that it plans to make it tougher for families to abuse welfare benefits. That could help counter mounting criticism from some politicians and media sources that government payouts for the unemployed, incapacitated and others have given some families a long-term dependency on state aid.

The government says it will reassess nearly 2 million claims filed annually by those seeking to be classified as physically incapable of working. That is almost 7% of the working population.

At the same time, the new government is expected to target some benefits that also go to more affluent residents—such as a benefit that pays parents £20.30 for a first child and an additional £13.40 for each additional child per week, regardless of the family's income.

A broader target is pensions. The government has said it will increase the age at which people can claim state pensions, among other changes, helping to address an unfunded pension liability that some analysts believe will soon exceed £1 trillion.

Welfare cuts have already been announced by several European governments, including those in Ireland, Greece and Spain. Even famously generous welfare states are looking at cuts. The Danish government recently announced changes to unemployment benefits and a cap on overall family welfare payments.

"Across Europe the financial crises will hasten a shake-up in welfare reform, particularly in pensions," said Julian Le Grand, professor of public policy at the London School of Economics.

In Britain, governments have often talked of welfare reform but never gotten very far, even as costs have risen rapidly. "It's partly because they are directed at the more vulnerable, like children and the old and the poor, and that does arouse people's sense of compassion," said Prof. Le Grand, who advised the last Labour government on welfare reform.

At the tail end of its 13-year reign, the Labour government began seeking more proof that unemployment-payment recipients were looking for work. On Thursday, Mr. Duncan Smith promised to cut benefits for those unwilling to look for employment.

Expectations of further shake-ups have been heightened by the arrival of Mr. Duncan Smith. He is chairman of the Centre for Social Justice, a think tank that argues state aid entrenches poverty by making people dependent on benefits. It argues for reducing benefits gradually when people find work.

"For too many people, work simply does not pay," Mr. Duncan Smith said Thursday.

Lee Page, who spent 18 years either on benefits or in jail, agrees. On the state dole, he received unemployment checks and the government provided for his housing and local taxes.

When he found work six years ago, Mr. Page says, after paying taxes, housing and travel costs, he was left with only 15% more than he would have earned on benefits. He contemplated returning to benefits, he says. After two pay raises, he says, he is now more secure.

"People are frightened to leave the security of benefits, where your income may not be high, but it is guaranteed," he said.

In Liverpool, Ms. Sussock says she has been facing increasing demands from benefit administrators since January. "They said to me, 'We will expect to know how you are living.'"

Ms. Sussock, who says she last took a vacation trip when she was 10 years old, says she thinks the government's pitch is a good idea and wishes she had been more motivated herself.

"I don't want to be on benefits," she said. "I want a good house and to take [my daughter] on holiday."

British retailing at 14-month low

By Ilona Billington

LONDON—Sales volume at U.K. retailers slumped in May to the lowest level since March 2009, while retailers' business confidence and investment intentions also dropped sharply, a survey by the Confederation of British Industry showed Thursday.

The monthly Distributive Trades Survey's retail sales balance dropped to a balance of -18 in May from +13 in April. The balance is the difference between the percentage of retailers reporting higher sales and those reporting lower sales compared with a year earlier.

Market participants had been expecting the balance to rise a little to +14, according to a survey of economists last week.

"These retail sales figures for the early part of May are clearly disappointing, with many sectors failing to achieve higher sales than a year ago," said Ian McCafferty, CBI chief economic adviser. "Unseasonal poor weather at the start of the month is likely to have dented clothing sales while some signs of slowing momentum in the housing market may help to account for the renewed weakness in sales of big-ticket items and other household goods."

The slowdown in spending may also reflect wider concerns about the economy and domestic politics.

"It may also be that consumers were deterred from spending by the heightened political uncertainty that resulted in a hung parliament and coalition government," said Howard Archer, chief U.K. and euro-zone economist for IHS Global Insight. "Significantly the survey was carried out between 27 April and 12 May." He was referring to the new U.K. coalition government that took five days to form after the May 7 general election because voters failed to elect a single-party majority government.

The retail survey also showed that the volume of orders placed with suppliers fell sharply to a balance of -24 in May from +1 in April.

For June, the CBI survey also showed a balance of -15 of retailers expecting higher sales. Last month, a balance of +17 were expecting higher sales in May.

The survey also included some quarterly questions that showed that retailers' confidence regarding the business situation in the three months to May fell to a balance of -5. That compares with +2 in the three months to February and is the lowest level since -8 in the three months to May 2009.

At the same time, retailers' investment intentions dropped to a balance of -13 in the three months to May from -2 in the three months to February.

While the survey was completed before the new Conservative-Liberal Democrat coalition Government was formerly agreed and announced, the weaker level of business confidence and spending plans probably reflected retailers' concerns over new government spending cuts and tax rises as well as the still fragile economic recovery.

"Although sales were quite weak, inflation remains high," said Michael Saunders, U.K. analyst for Citi Group Inc. "The balance for expected price hikes is the third-highest of the last 15 years. With the weak pound and large gains in import prices over the last 2-3 years, UK inflation is likely to remain sticky and well above target."

Russia softens on trade

By William Mauldin

MOSCOW—Russia said Thursday it has worked out a plan that would allow for the resumption of U.S. poultry trade, halted since January.

The U.S. expressed hope that exports to Russia would resume soon but said the two sides are still working on the issue, a key stumbling block in Russia's accession to the World Trade Organization.

Russia's consumer protection agency, known as Rospotrebnadzor, agreed on four guidelines for poultry trade between the two countries after talks last week, Rospotrebnadzor chief Gennady Onishchenko said, according to Russian newswires including the RIA Novosti service.

The guidelines seek to satisfy the demands of a Russian law that took effect in January, banning poultry treated with a chlorine wash common in the U.S., as well as U.S. "political issues," Mr. Onishchenko said.

Trade can resume after an exchange of "corresponding letters" between the U.S. Department of Agriculture and Rospotrebnadzor, said Mr. Onishchenko, who declined to provide a timeline.

U.S. NEWS

Arizona law is two-edged for GOP

Tough stances on immigration are likely to resonate in some states, but could hurt party in California in fall

By Jim Carlton
And Tamara Audi

EL CENTRO, Calif.—Many candidates in Republican primaries have embraced Arizona's new immigration law, but that could hurt a few of them in November.

While a majority of voters tell pollsters they support the law, and tough stances on illegal immigration are likely to resonate this fall in such states as Nevada and Florida, Republican candidates in California might face a potential backlash from the state's more liberal electorate.

In California, "they risk alienating...independent voters who don't support deportations," said Mark Baldassare, chief executive of the nonpartisan Public Policy Institute of California.

Among the leading GOP candidates to succeed Arnold Schwarzenegger as California's governor, Steve Poizner has used his embrace of the Arizona law to try to convince voters in California's June 8 primary that he would represent GOP interests better than front-runner Meg Whitman, who doesn't support the law.

"Meg Whitman and I, major differences here," the state insurance commissioner said in a new television ad that began airing May 24. In the ad, he accused the former eBay Inc. chief executive of downplaying illegal immigration. Ms. Whitman's aides dismiss his ad as the flailings of a desperate candidate, and say she would be just as tough on illegal immigration as Mr. Poizner.

Mr. Poizner still trails Ms. Whitman in the polls, but the gap has narrowed significantly in recent weeks, in part because of his attacks on her immigration stance, political analysts say. In March, Ms. Whitman led Mr. Poizner 61% to 11% among likely Republican voters, but as of May 19, that lead had dwindled to 38% to 29%, according to polls by the Public Policy Institute of California.

"He has used immigration and a range of issues to make himself the most attractive conservative candidate in the race," said Mr. Baldassare. "The Arizona law is one part of it."

Mr. Poizner and other GOP candidates who support the April 23 Arizona law, which requires police to question anyone they suspect of being an illegal resident, say they don't think their backing will prove to be a drawback for them in the general election.

Meanwhile, in the GOP primary to face California Democratic Sen. Barbara Boxer, all three major candidates—Carly Fiorina, Tom Campbell and Chuck DeVore—have come out in support of the Arizona law.

In Nevada, some of the Republicans seeking to unseat Democratic Sen. Harry Reid are embracing the Arizona law to help endear themselves to conservatives in a state where tea-party activism runs strong.

"I think it's a great thing," said Danny Tarkanian, a former University of Nevada, Las Vegas basketball star running in the GOP primary on June 8 against Sharron Angle and Sue Lowden, who support the law.

Mr. Tarkanian's campaign quickly put out a radio ad praising Arizona. "Washington is so far out of touch Arizona had to pass a law just so they could enforce the law," said Mr. Tarkanian, in the ad that began running statewide on April 26.

The GOP strategy of courting the anti-immigrant vote could give Democrats a talking point against rivals in general elections outside California, too.

Anger over the Arizona law among many Latinos in Nevada has led to a spike in Democratic voter registrations. Julie Arcache, a 30-year-old nursing assistant in Las Vegas, cited her concern over the Arizona law for her move to register to vote a few weeks ago.

"They can stop me because of my color," said Ms. Arcache, who registered as a Democrat and vowed to vote for Mr. Reid. "We're not going to stand for it."

Associated Press

Members of the Los Angeles tea party and Westside Republicans rally Tuesday against the City Council's vote to boycott Arizona over its immigration law.

But a Rasmussen Reports poll last Thursday still showed the Senate majority leader trailing his top GOP challenger, former Nevada Republican Party Chairwoman Lowden, 52% to 39% among likely voters, virtually unchanged from an April 5 poll. The same survey found 57% of the voters favoring Arizona-style legislation for Nevada.

Reid campaign spokesman Jon Cummings said that the Arizona law, which the senator opposes, could help focus attention on Mr. Reid's record of helping Latinos.

California is different from Nevada, with a political landscape that makes immigration a treacherous topic for Republicans. California does have a cadre of deeply conservative voters, especially outside the metro areas, who have a huge impact on primary voting. But in general elections, liberal votes tend to shift elections in favor of moderate candidates. Republicans make up 31% of California voters; 45% are registered Democrats.

One sign that an anti-immigration stance during the primaries could backfire in general elections, according to Mr. Baldassare of the Public Policy Institute, comes from a March poll by the institute. He noted that 78% of Democratic voters surveyed said illegal immigrants should be allowed to keep their jobs and not be deported, while 46% of Republicans said they should be deported.

"They need to leave it alone, just as it is," said Marlen Baez, an 18-year-old student at Imperial Valley College, referring to immigration controls. Like many El Centro residents, Ms. Baez, a U.S. citizen, has relatives on both sides of the Mexican border and crosses back and forth weekly. "More than half the people who live [in Imperial County] are Mexican or have Mexican family," Ms. Baez said. "We shouldn't be kept apart."

But her classmate, Katherine Gonzales, is frustrated with what she sees as the lack of immigration enforcement. "It's something I think about a lot because I live so close to the border," she said. "I have a problem with all these Mexican students coming over here and getting a free and easy education, and they don't live here."

Ms. Gonzales said she is beginning to pay attention to the governor's race, and will be particularly interested in what the candidates have to say about immigration.

Profits keep rising, GDP is shaved

By Conor Dougherty
And Jeff Bater

Companies earned bigger profits in the first three months of the year, but the nation's overall economic growth was slower than originally thought as the U.S. continues to slog through recovery.

U.S. corporations saw after-tax profits rise 9.7% in the first quarter, better than the 8.2% growth in the fourth quarter, the Commerce Department reported Thursday. Earnings were 42.7% higher than in the year-earlier period.

Hibbett Sports Inc., for example reported last week that earnings for its fiscal first quarter, the 13-week period ended May 1, rose 59% on increases in shoe and clothing sales. The Birmingham, Ala., retailer, which mostly operates in midsize markets in the Southern U.S., lifted its current-year profit forecast.

The Commerce Department report also showed that the gross domestic product, the sum of goods and services produced in the U.S., expanded at a 3.0% annual rate in the first quarter, lower than the 3.2% the government previously estimated. Consumer and business spending were lower than previously estimated, while imports, which subtract from growth, were greater.

A separate report Thursday from the Labor Department showed the seasonally adjusted number of people applying for unemployment insurance decreased 14,000 to 460,000 in the week ended May 22. The number of people collecting standard, state-issued unemployment insurance fell 49,000 to 4.6 million in the week ended May 15.

When workers covered by various unemployment extensions—including those funded under the federal stimulus act—are added to the mix, there were just under 10 million people collecting unemployment insurance in the week ended May 8, the Labor Department reported.

The reports show the economy continues to recover but that a large part of that growth is a function of federal spending and moves by businesses to rebuild inventories after slashing them during the recession. Businesses increased inventories by $33.9 billion in the first quarter, instead of the previously reported $31.1 billion.

Consumer spending has improved considerably, but high joblessness and heavy debt loads continue to weigh on households. The GDP report showed consumers increased spending by 3.5%, below the 3.6% gain previously reported but more than double the 1.6% increase of the fourth quarter.

As the stimulus fades and companies are done restocking, the onus of the recovery will shift increasingly onto consumers' shoulders.

As the stimulus fades and companies are done restocking, the onus of the recovery will shift increasingly onto consumers' shoulders. Consumer purchases account for some 70% of economic activity. "The biggest debate is over the path of the labor market recovery and hence the ability of consumers to help drive real growth," said Joshua Shapiro, chief U.S. economist at MFR Inc.

The GDP report showed business spending rose by 3.1%, down from an earlier estimated 4.1%. Equipment and software outlays increased 12.7% instead of the 13.4% previously estimated.

Real final sales of domestic product, which is GDP minus the change in private inventories and therefore is considered a better reflection of actual demand, increased at an annual rate of 1.4% in the first quarter. That was down from the previous estimate of 1.6% and below the 1.7% gain in the fourth quarter.

Even though the economy is improving, many economists don't expect prices to increase much. The GDP report is unlikely to alter that view.

The government's price index for personal consumption was left unrevised at a 1.5% increase. The index rose 2.5% in the fourth quarter.

War-funding bill passes Senate hurdle

By Corey Boles

WASHINGTON—The U.S. Senate Thursday approved a key procedural hurdle on a roughly $60 billion bill to pay for the war in Afghanistan through the remaining four months of fiscal 2010, setting up a possible final vote later in the day.

By a 69-29 margin, lawmakers approved the motion, known as cloture, which seeks to shut down debate on the bill.

Earlier Thursday, Senate Democrats voted down three attempts by Republicans to bolster the U.S. and Mexico border.

The White House had tried to head off the Republicans earlier in the week by making it known they would request 1,200 troops be sent to the border and ask for $500 million to boost security.

Traditionally, Congress has not paid for the costs of fighting the wars in Afghanistan or Iraq by finding savings elsewhere in the federal budget.

U.S. NEWS

Spill fallout widens debate on government's proper role

[Capital Journal]

By Gerald F. Seib

In the messiest way possible—quite literally—America is rethinking and remaking the relationship between government and business.

Even as oil laps ashore in Louisiana after leaking from BP PLC's well, souls are being searched in Washington about why regulators didn't or couldn't prevent the disaster, and why nobody had a good answer for coping with it once it occurred.

President Barack Obama's announcement Thursday of an extended moratorium on new deep-water drilling is only the beginning of a government re-evaluation of its relationship with the offshore oil industry. A presidential commission soon will put the relationship in therapy.

The risk is that the wrong question may dominate the coming discussion—namely, whether there was too little regulation of the offshore oil industry. The better question is less about quantity than quality: Were regulations smart and up to date? They almost certainly weren't.

More on that in a minute. The broader point is that the BP oil spill is just the latest in a series of traumatic events forcing a rethink of government's relationship with business. Bank bailouts, energy plans, auto-maker rescues, Toyota accelerator problems: All have forced both politicians and average Americans to rethink the proper role of government in the private economy.

The issue is hardly resolved and has been the subject of some of the capital's most vicious debates in recent months, notably during the mud wrestling over health care. To some extent, the question of government relations with business will never be fully settled, because it goes to the core of the philosophical divide between the two political parties.

Yet some pretty important points of consensus actually have been reached on this front. For example, we can now be fairly confident the U.S. isn't into nationalizing industries. If there ever was a time when the government would nationalize a bank, for instance, it would have been last year, when the financial system was in free-fall, when Great Britain took some steps toward nationalization, when serious voices here suggested the same, and when an activist Democratic administration was in place. Yet it didn't happen.

Similarly, the government bailout of General Motors, controversial as it has been, made government a majority owner of a company—a huge step, to be sure—but stopped short of a nationalization.

And we've learned anew that the country likes a bit of industrial policy, but not very much. The notion of using government to encourage and stimulate alternative energy has become a bipartisan item on the energy agenda, but not much more.

There's also agreement that, just as regulation can go too far, deregulation can go too far in key areas, and that antiquated regulatory programs can be worse than no regulation at all. Auto-safety regulators are on the hot seat for not resolving the Toyota rapid-acceleration problem, and behind the heated debate over financial regulations was a bipartisan consensus that the market meltdown showed a need for a better system to oversee financial markets.

Now the BP spill ushers in the next round of debate, over the government's role in policing offshore drilling. Everyone from the conservative Republican governor of Louisiana to the most liberal Democrat in the House agrees that the system failed.

And within that failure lie some basic factors to explore anew. For starters, the law that governs the reaction to and responsibility for an oil-pollution disaster was passed two full decades ago, and was designed mostly to handle the risk of another Exxon Valdez oil spill coming from a giant tanker. The kind of deep-water drilling that goes on now, and the pollution dangers within it, were barely imagined then.

There's agreement that, just as regulation can go too far, deregulation can go too far in key areas.

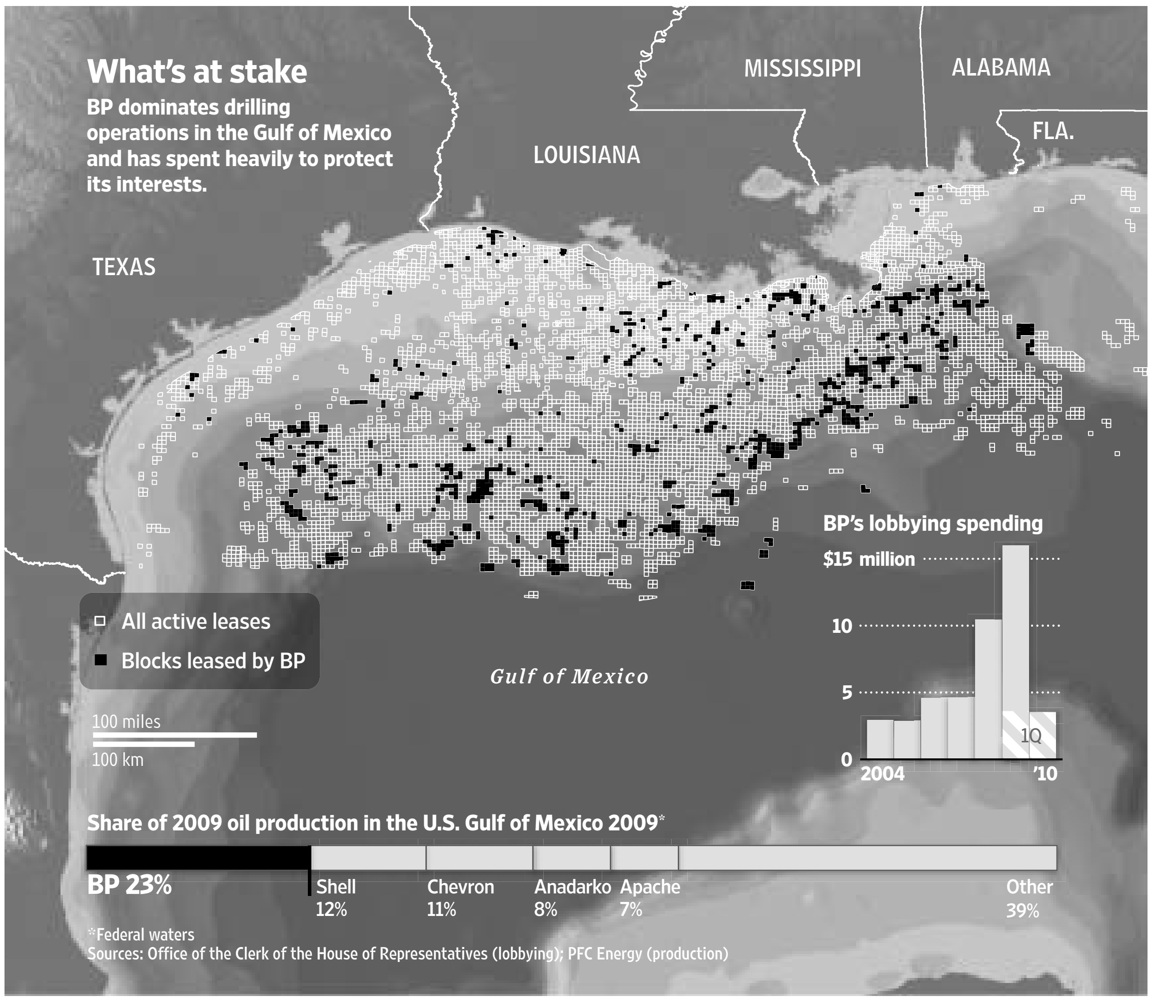
"The offshore oil technology stuff has just completely whizzed right on by" the law, said Coast Guard Adm. Thad Allen, the man in charge of containing and cleaning up the BP mess. "And maybe there's an issue about the technology moves faster than our ability to...understand." That may be "a regulatory issue that needed to be raised."

At the same time, Adm. Allen noted in a conversation with a group of columnists this week, the same system has put both the responsibility for drilling and closing in a well, in addition to the resources needed to clean up a mess if things don't go right, almost entirely in private-sector hands. The federal government, it turns out, has precious little equipment or manpower to bring to a cleanup.

"And the commission may want to look at whether or not there should be a different distribution of resources, and what the federal government is responsible" for, Adm. Allen said.

The question the cleanup effort raises, he adds, is: "How much of that should be done in the private sector, and be on call, or how much of it should be in the U.S. inventory? And I think [that is a] legitimate line of inquiry by the commission."

Put simply, the question, in this area and elsewhere, will be finding the best line between private-sector rights and government responsibilities.



BP tackles drilling curbs

Concerns over tougher industry regulation drive lobbying push

By Elizabeth Williamson

Aiming to blunt a regulatory and political backlash from the massive oil spill in the Gulf of Mexico, **BP** PLC has revved up its influence machine, relying on heavy hitters with deep Democratic roots.

BP is one of the biggest spenders on lobbying in the oil and gas industry, which as a whole has spent $625 million since 2004 to represent its interests in Washington. After the Obama administration took office in 2009, BP's annual spending grew by half, to $16 million.

During the first quarter of 2010, it spent $3.5 million on lobbying, second to ConocoPhillips, according to figures compiled by the nonpartisan Center for Responsive Politics.

Since the April 20 explosion that started the Gulf spill, BP's lobbyists and crisis communications experts have helped to shore up congressional opposition to measures punishing oil companies, and moved to position BP as an ally with the government to manage the crisis.

After the spill, the company brought on crisis communicator Hilary Rosen, former Democratic congressional staffer, former chief executive of the Recording Industry Association of America, and a current editor-at-large for HuffingtonPost.com. Ms. Rosen heads the Washington-based office of British communications firm the Brunswick Group. Public records are not yet available on the new Brunswick contract. Ms. Rosen declined to be interviewed on the record.

BP expects a dramatic and expensive tightening of rules governing offshore drilling. But the company wants to avoid curbs on new drilling, say its lobbyists.

So far, most action in Congress has focused on raising the limits on civil liability under federal law from the current $75 million. Maintaining that focus could in itself prove a victory for BP, say people involved in the debate. A higher liability cap could hobble small independent oil companies, easing competition for their bigger rivals.

Earlier this month, BP assured administration officials it planned to shoulder all costs associated with stopping and cleaning up the spill, expected to run into billions.

Even before the Gulf disaster, BP has faced tough scrutiny from federal regulators, starting in the aftermath of a 2005 explosion that killed 15 workers at a Texas refinery, a 2006 oil spill in Alaska and allegations of safety lapses at a Toledo, Ohio, refinery.

Before the spill, Mr. Obama voiced support for expanded offshore exploration in some geographic areas. But on Thursday, Mr. Obama, under pressure to step up response to the disaster, vowed tougher regulations for the oil industry and said he is suspending action on 33 exploratory drilling operations in the Gulf and canceling or temporarily suspending pending lease sales and drilling in Virginia and the Arctic.

Obama takes harder line on oil drilling

Continued from first page

tion's energy needs."

Shell officials appeared resigned to the decision. They acknowledge that Mr. Obama can't halt oil production in the Gulf of Mexico, which is crucial to U.S. energy security. But he can stop oil companies drilling in virgin areas if they haven't started.

But the decision will be hugely frustrating for the Anglo-Dutch major, which won a slew of legal challenges from environmental groups. It has already started moving equipment up to staging areas in Alaska, ready to commence drilling in July.

In the wake of the Gulf disaster, Interior Department officials said they would subject Shell's drilling plans to a new safety review before deciding whether to issue final permits. Subsequently, Shell sought to reassure nervous regulators that its Alaska plans would meet the "highest and operational and environmental standards."

In a letter sent earlier this month to the MMS, it stressed there was a much lower risk of the kind of blowout that destroyed the Deepwater Horizon April 20, since the wells it planned to drill in Alaska were in much shallower waters and at much lower pressures. It also said it would heighten safety measures, including testing a critical piece of safety equipment, the blowout preventer, every seven days instead of every fortnight, the industry standard.

Shell also argued it would have much more backup plans in place than BP had when the Deepwater Horizon exploded.

But environmental critics of Shell's plans said the company still had not addressed how it could ensure a rapid oil-spill response. They say cleanup equipment and personnel would have to be transported thousands of miles by barge or helicopter to the spill site.

It's still unclear what caused the oil rig operated by BP to explode and sink in April off the Louisiana coast. Mr. Obama was scheduled to receive a report Thursday from the secretary of the Interior Department following a 30-day investigation.

—Angel Gonzalez and Neil King Jr. contributed to this article.

WORLD NEWS

Japan toughens North Korea stance

Lawmakers tighten restrictions on Pyongyang and drops its recent acrimony with the U.S. over troop deployments

By Yuka Hayashi
And Yoree Koh

TOKYO—Japanese lawmakers moved Thursday to tighten restrictions on North Korea, signaling Tokyo's desire to remain a strong and reliable U.S. partner following months of acrimony over U.S. troop deployments.

Japanese officials are also considering other steps that could affect a group of about 600,000 North Koreans in Japan—a legacy of Japan's domination of Korea more than 60 years ago.

A Japanese parliamentary committee passed a bill Thursday to authorize the nation's coast guard to inspect North Korean cargo ships in international waters. The bill is expected to pass the main chamber of Japan's upper house of parliament Friday

Japanese government officials are also considering other measures such as tightening reporting requirements for fund remittance and physical shipments of funds from Japan to North Korea. The Public Security Intelligence Agency, Japan's main government intelligence agency, ordered its officials stationed across Japan to strengthen information gathering related to North Korea.

In particular, Japanese officials are focusing on a group called the General Association of Korean Residents in Japan, the de-facto North Korean embassy in Japan that is also known by the name Chongryon. Mikinao Kitada, head of the Japanese intelligence agency, said in a speech to the heads of its regional bureaus and broadcast on television that the agency will keep a close eye on Chongryon as it was "deepening subordination to North Korea."

Input from Japan | Remittances sent from Japan to North Korea, In billions of yen*

*By person via aircraft or boat; excludes bank and postal transfers
Note: Years shown are through March except 2010 which is through February
Sources: Japan's Ministry of Finance; Associated Press (photo)

North Korean soldiers monitor the Yalu River on Thursday in Sinuiju, at the border with China.

An official at Chongryon said the group didn't have comment Thursday on Mr. Kitada's remark.

The moves suggest that the government of Japanese Prime Minister Yukio Hatoyama wants to put months of bickering with the U.S. behind it. The two longtime allies were at loggerheads over where to move U.S. troops in Okinawa. Citing the importance of the U.S.-Japan alliance and the rising tensions in Asia, Mr. Hatoyama on Sunday changed course and accepted an existing military relocation accord with the U.S. That broke a campaign promise with Japanese voters not to allow a new military facility in Okinawa.

The bill that passed through committee Thursday allows Japanese coast guard officials to board North Korean ships suspected of carrying banned items such as weapons, nuclear materials or narcotics, or order rerouting into Japanese waters where the Japanese police can order the submission of banned items.

While Japan isn't nearly as prominent a supporter of North Korea as is China, Japan's large North Korean community complicates its interactions. Taking aim at North Korea's vulnerable economy, Japan is also considering further lowering the ceiling on the amount of remittances the Japanese government require be reported to authorities. The government's current policy requires remittances that exceed 10 million yen, or about $111,000, be reported to the Ministry of Finance.

Remittance payments have already dropped off in recent years after the Japanese government imposed similar punitive measures. The government discontinued a ferry service between North Korea and the Japanese city of Niigata after Pyongyang launched rockets and detonated its first nuclear device in 2006. The move crippled the ability to transport funds and goods to the country, a bulk of which is sent to relatives there by ethnic Koreans living in Japan. The total sum of remittances sent by boat or plane fell to 191 million yen in 2007 from 1.61 billion yen the previous year, according to Japan's Ministry of Finance.

Mexico arrests mayor of Cancún

By David Luhnow

MEXICO CITY—Mexican police have arrested a prominent gubernatorial candidate for alleged links to organized crime, amid growing concerns that drug gangs are buying off politicians to get the Mexican government to back off in its war against the cartels.

Gregorio Sánchez, mayor of Cancún and candidate for governor in the state of Quintana Roo for the leftist Party of the Democratic Revolution, or PRD, was arrested at the Cancún airport late Tuesday by agents from the Mexican federal Attorney General's Office.

Mr. Sánchez, 47 years old, was arrested on charges of organized crime, conspiring to traffic drugs, and money laundering, the Attorney General's Office said in a statement.

"I've been illegally detained here at the airport," the candidate wrote on his Twitter account (@gregqroo) moments after being arrested. His campaign manager has since been sending updates via the same account, denying the charges against Mr. Sánchez.

While Mexican governors have been charged with similar crimes before, Mr. Sanchez's arrest marks the first time a gubernatorial candidate has been arrested during a campaign. The PRD lashed out at the arrest, which it said was politically motivated ahead of the state's July 4 vote.

"This is a blatant attempt to prevent Greg from being candidate and eventually governor," Jesús Ortega, the PRD president, told Mexican television following the arrest.

Mexican officials said Mr. Sánchez has links to the notorious Los Zetas cartel, which is believed to control most illegal activities in the area around Cancún. Mr. Sánchez's bank account had multimillion-dollar transactions far above his public-servant salary, officials said.

Mr. Sánchez has been in the spotlight since last year, when a retired army general sent at the request of the governor's office to clean up state and local police forces in Quintana Roo was tortured and murdered by suspected hit men from Los Zetas.

During a subsequent investigation, three of Mr. Sánchez's aides were jailed for alleged ties to Los Zetas, including the Cancún police chief and the city's prison director. The men, who have denied the charges, remain in jail.

Mexico's Interior Ministry said it told the PRD about the investigations into Mr. Sánchez in January, before he became the party's official candidate.

Mexico holds 12 gubernatorial contests on July 4, including in five northern states where drug cartels are particularly strong and where drug-related violence is problematic.

There are growing concerns that cartels have paid off candidates in various states and threatened candidates in other races. Despite the scandals, voters are likely to put many such candidates in office anyway, analysts say.