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North Korea fires rockets at South

BY EVAN RAMSTAD
AND JAEYEON WOO

SEOUL—North Korea fired artillery at a South Korean island near a disputed western maritime border Tuesday, killing two South Korean marines in a surprise barrage that kindled global worries about worsening relations between the countries.

A South Korean military unit on the island returned fire, while South Korean military officials scrambled fighter jets. At least 16 marines were injured, military officials said. Three civilians were injured, and the island's 1,200 residents were sent scrambling for bomb shelters.

"The whole neighborhood is on fire," said, Na Young-ok, a resident of the island, called Yeonpyeong, from a bomb shelter about an hour after the shelling began.

South Korean officials condemned North Korea and warned that it would respond in kind to further provocations, while South Korean President Lee Myung-bak convened an emergency meeting of defense and security agencies.

"The attack is a sheer act of provocation. Moreover, shooting indiscriminately on civilians cannot be forgiven," said Hong Sang-pyo, spokesman for Mr. Lee. "Our military reacted immediately according to our combat rules. We



This picture taken by a South Korean tourist on Tuesday shows plumes of smoke rising from South Korea's Yeonpyeong island after it was hit by North Korean rockets.

will act sternly against any more provocation. North Korea should take the responsibility for this."

North Korea's official media late Tuesday said South Korea's military fired artillery into water on the North's side of the maritime border while conducting a drill, and that in response it fired the artillery at Yeonpyeong.

A South Korean presiden-

tial spokeswoman said officials were exploring whether there was a link between the shelling and North Korea's earlier complaints about a large-scale exercise the South's military started this week. North Korea has complained in the past about exercises without retaliation, however, and the South's large-scale exercise wasn't taking place near the island.

The U.S. and the European Union condemned the shelling, while Russia and China called for a cooling of tensions on the peninsula. Japan's government went on high alert, with Prime Minister Naoto Kan ordering cabinet members to step up information gathering and prepare for emergencies.

"The United States is firmly committed to the de-

fense of our ally, the Republic of Korea, and to the maintenance of regional peace and stability," the White House press secretary said, referring to South Korea by its formal name. The White House said President Barack Obama plans to call South Korean President Lee Myung-bak to discuss the attack.

The U.S. will stand "shoulder-to-shoulder" with South

Korea over the incident, said White House Press Secretary Bill Burton.

Mr. Burton called the attack "outrageous." Mr. Burton
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North Korea's attack was a rational act of extortion. Page 13

Spain officials speak out to soothe contagion fears

BY SARA SCHAEFER MUÑOZ
AND JONATHAN HOUSE

Spanish officials are mounting an aggressive campaign to dismiss fears that Europe's fiscal woes—which have already leapt from Greece to Ireland and may soon spread to Portugal—will one day reach their shores.

With the estimated €80 billion (\$109 billion) international bailout of Ireland moving ahead, investors are fretting about a similar fate for other troubled European economies. Many say Portugal could be next, but if the problems then spread to the much larger Spanish economy, some say that the durability of Europe's common

currency—a theoretical concern so far—could become a real question.

That is why Spanish officials are hastening to throw up a firewall around their country with a volley of positive comments about the progress of Spain's fiscal reforms and the soundness of its banking sector. The message they are emphasizing: Spain is not Ireland.

"Due to the extraordinary measures taken, our situation is better than those of other countries, and better than it was in May," Carlos Ocaña, deputy finance minister for the budget, said.

Meanwhile, Bank of Spain Gov. Miguel Angel Fernandez Ordoñez on Tuesday said the

Spanish banking sector is relatively healthy and there should be "no comparison" between Spanish banks and many of their European peers. His words followed remarks Monday by Spanish Finance Minister Elena Salgado, who said in a radio interview that Spain has a larger, more diverse economy than Ireland and "tangible" progress was being made with Spanish reforms.

Despite the effort to calm markets, the cost of funding for Spain and other peripheral

- The story speeds up in the euro-zone debt crisis 2
- Concerns about spreading risk still dog Europe 5

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PAGE TWO

Twelve hours is a long time in a crisis —the euro-zone one is speeding up

[Agenda]

By IAIN MARTIN



Remember when all the focus was on whether or not Ireland would deign to take a bailout? That was only late last week. So much has happened since then in the fast-moving euro-zone crisis that Ireland already seems an age ago. The story is speeding up.

Portugal is next in the queue. Not so fast says EU President Herman Van Rompuy, whose running commentary is becoming unmissable for all the wrong reasons.

Here he is on Tuesday on a visit to Stockholm. "Portugal does not need any help, it is in a very different situation to Ireland. Portugal has not suffered from a housing-market bubble, its financial sector is not oversized and its banks are well capitalized."

Yes, but that is not what is exercising the markets with regards to Portugal. The country's government reported Tuesday that its deficit had worsened in the first ten months of this year, with a 2.8% increase in government spending compared to the same period last year. Remember that the Irish bailout was supposed to alleviate pressure on Portugal and others. In the event it seems to have bought those in charge of the European project only about twelve hours of improved market stability.

Already attention is shifting to Spain. Making up around a tenth of the European economy it is of an entirely different order to plucky Portugal and little Ireland. The Spanish government says it doesn't need a bailout (a statement that is now mandatory fare for finance ministers but



Irish Finance Minister Brian Lenihan in Brussels last Wednesday.

seems not to make much difference). And the central bank pointed on Tuesday to the health of Spain's powerful banking sector.

Spain is supposed to be the firewall in the euro zone. In theory, bailouts of Greece, Ireland and Portugal can be borne, but if Spain were to need a rescue then the crisis tips into the territory in which it is conceivable that the euro zone could blow up.

Can the crisis be stopped short of Madrid, the euro saved and terrible consequences avoided?

Spain is the line it is said that German taxpayers will not cross. If they balked at assisting Spain and a German government did not participate then the euro starts to break up. It is hard to see such an eventuality having anything less than horrendous implications,

including default, chaos and widespread penury.

Can the crisis be stopped short of Madrid, the euro saved and terrible consequences avoided?

It will likely require much closer integration of the euro-zone countries that goes beyond what is currently on the table. Full-scale political integration is what is being contemplated but it is unclear whether, if Germany formally demands it, it will be viable or capable of gathering support in individual countries with their fractious and soon-to-be-frightened electorates.

But it is worth remembering that it is not just individual economies and a currency that are under pressure. Several big ideas are being stress tested here.

First, the bailing out and unlimited guaranteeing of banks—a major factor in the Irish end of the crisis. The orthodoxy that established itself after the collapse of Lehman Brothers stipulated that the interconnectedness of financial institutions made it unthinkable

that major players should be allowed to fail. That was the logic of the panic of late 2008 and early 2009.

Angela Merkel, the German Chancellor, says that this has gone too far, and that eventually bond holders and institutions must take a share of the pain. But the result of her comments on the matter was an acceleration of the crisis in Ireland and eventually a giant loan to bail out the Irish banks.

It seems that once you start bailing out banks it is difficult to stop, and if you accept the theory of inter-connectedness then is there anything large and financial you won't rescue to buy a bit of stability, even if it is for half a day?

Then there is the late 20th-century idea of closer European integration itself, or more specifically the Mitterrand-Kohl idea of Europe that emerged from the rubble of the Cold War. The European political class has invested heavily in what started out as a co-operative exercise in the 1950s but in time has become something else: a great cause to unite a continent say its supporters, a political grand project that was always going to collide with market realities say its critics.

Sometimes big ideas fail. And history suggests that right up until the moment that they do, very large numbers of people will maintain that failure is unthinkable.

Perhaps that is not about to happen in terms of European togetherness, and the crisis will slow down with order restored. But what is holding together the euro zone together today? It is now no longer the dreams of an elite determined to construct a rival to the U.S. that could parley on equal terms with the emerging powers. Today it is being held together by simple fear of the alternative.

What's News

■ **Belgian police arrested** seven members of what they said was an Antwerp-based Moroccan terror network whose alleged aims were steering recruits to Islamic rebels in Chechnya, and plotting an attack in Belgium. 6

■ **Sky Deutschland said** Germany's market regulator found that the pay-TV company overstated its profit and underestimated some risks in 2007 and part of 2008. 19

■ **The U.S.'s largest banks** are recovering from the financial crisis at a faster pace than their smaller rivals, an FDIC report said. 19

■ **The British government** detailed rules that will set a permanent cap on the number of workers allowed to enter from outside Europe. 6

■ **The scientific quest** to prevent AIDS is gaining momentum, with a new study showing that an existing antiretroviral drug can ward off infection with the virus. 9

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'Once a country is in, it hardly matters how fiscally reckless it is, there's no way it can be thrown out.'

David Cottle on euro-zone membership



Continuing coverage



As tensions rise on the Korean peninsula, follow the latest in our new blog at wsj.com/korearealtime

Question of the day

Vote and discuss: Will Portugal be the next member of the euro zone to need financial help?

Vote online at wsj.com/polls

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NEWS

An eclectic art fraud in Portugal

Some 130 paintings, together with forged certificates attesting to their authenticity, were recently seized

BY DALYA ALBERGE

A recent raid in Portugal has uncovered a large hoard of fake pictures, with police seizing works that were claimed to have been painted by Modigliani, Matisse and Monet among other noted artists.

Some 130 paintings, together with forged certificates attesting to their authenticity, were seized by officers last month. Police suspect that the forgers have been selling the fakes for some years, but police say they have yet to discover whether the forgers were collaborating with dealers. Previous forgers have had middle-men involved.

The Portuguese Judiciary Police have established a special investigation called "Caverna do Tesouro," or Treasure Cave, to deal with the case, because of the range of faked artists and the specialist knowledge required.

João Oliveira, the criminal investigation coordinator running the probe, said in an interview: "Picasso, Miró, Munch, Toulouse-Lautrec... it's amazing. This is the biggest [hoard of fakes] in Portugal and one of the most important in Europe."

Other 20th-century masters in the hoard include Chagall and Kandinsky. Such was the forgers' confidence that Old Masters like Leonardo da Vinci, whose work needs knowledge of how to artificially age pictures as well as artistic skill, are among the fakes.

Mr. Oliveira described some of the forgeries as "very good," showing a "superior technique."

The fakes could have been sold to unsuspecting buyers for "upwards of €15 million (\$20 million)" total, said one London dealer.

The hoard was found at a house described by police as "small but expensive" in Cascais, a fashionable



Portuguese Judiciary Police (2); Agence France-Press (2)



FIND THE FAKES: At top left, the Chagall wedding scene fake, with a real Chagall painting below it. At top right, a fake reclining nude by Botero; at bottom right, a real Botero.

resort near Lisbon. A Norwegian married couple is suspected of being involved in the forgery. But, in accordance with Portuguese law, their names are still withheld.

Police said the woman, in her 40s, was initially arrested, but has been released pending further in-

vestigation. Her husband is still being sought. The woman must report regularly to the police and cannot leave the country.

The forgeries consist mostly of paintings in the style of particular artists rather than direct copies of known works, police said. A forged

Kandinsky is an exception, a copy of the painter's Yellow-Red-Blue, a 1925 abstract in the Centre Pompidou in Paris.

Expert views on the quality of the forgeries, based on photographs, were divided.

However they said that, while

leading experts would not be fooled, a secondary market of enthusiasts could have been duped by the forgeries.

On being shown a photograph of a "Leonardo," Jacques Franck, an expert advising the Louvre, said: "It's a beautiful painting. The pose of the head might derive from Leonardo's unfinished drawing of Christ's head... in the Accademia in Venice... It's really a ... handsome execution, but the style... is 18th century not 16th century."

Julian Spalding, former director of the Glasgow Museums and Art Galleries, said: "There is something odd about this hoard.... Forgers most often specialize in one area of art... This is an odd jumble of very different art. It might be the work of more than one forger. I doubt if any would have fooled a specialist. They are potpourries of familiar elements in an artist's work, not attempts to create an original, unknown conception... much more difficult."

Looking at photographs, John Myatt, a British artist who was sentenced to a year in prison in 1999 as a forger of Monet, Matisse and Giacometti, described a Portuguese Modigliani as "quite convincing"—"I'd have gone for that," he said.

He also thought the Botero looked "quite credible."

But he dismissed a Chagall as missing "the essence" of the artist—"he wasn't that untidy," he said—and a Leonardo as a "pastiche of an 18th century painting."

Mr. Myatt observed that it was foolhardy to forge Leonardo: "There has been an accepted body of his work with provenance and exhibition history over 400 years. To come along with a new Leonardo is just stupid... A new Kandinsky at least makes some sense."

Student ran a wartime resistance movement

[Remembrances:
Gaston Vandermeerssche
1921-2010]

BY STEPHEN MILLER

Shortly after German troops invaded Belgium in 1940, Gaston Vandermeerssche, a Belgian university student, bicycled 800 miles to the south of France and became a spy.

Mr. Vandermeerssche, who died Nov. 1 at age 89 in Milwaukee, joined the resistance and ferried microfilm documents over the Pyrenees to Spain, where intermediaries sent the information on to London.

Later in the war he helped organize the Dutch underground, which came to comprise hundreds of agents and safe houses. After his network was penetrated by the Germans, he was arrested near the Spanish border. He spent 24 months being interrogated, but by his own account never broke.

His wartime exploits are in few history books, but espionage experts and Belgian state archives

corroborate his account.

Mr. Vandermeerssche was born in Ghent, the son of a furniture maker. He was a student at Ghent University when war broke out, and immediately joined the Belgian army. When the Germans occupied Belgium, he worked for the resistance, distributing an underground newspaper.

Frustrated and in danger, he fled Belgium via bicycle and joined the resistance in Toulouse, France. He became a courier, making weekly trips from Brussels to Toulouse to Barcelona. The last leg involved trudging over snowy passes in the Pyrenees by moonlight. The microfilms he carried bore information collected by the underground on shipyards, gun emplacements and the like. On the return trip, he carried money to fund the resistance.

Mr. Vandermeerssche began setting up safe houses and clandestine mail drops, delving deeper into espionage. His contacts included Britain's MI6, which dropped him by parachute on a mission to organize the Dutch underground, according to Nigel West, a World War II

espionage authority.

Mr. Vandermeerssche told an interviewer that he found a nascent underground in place in the Netherlands. "They had groups—twenty, thirty, forty people organized—and they couldn't send the messages. They had no radio. At that time, the British were using pigeons," Mr. Vandermeerssche said in the 1999 oral history "A Time To Speak."

But much of the Dutch underground was compromised by German infiltrators, to the point where dozens of intelligence agents were apprehended while parachuting into the Netherlands.

Mr. Vandermeerssche was arrested in Perpignan, France, in 1943 with a cache of microfilm stuffed into butter tubs. His German interrogators suspected his role in the Dutch underground, but couldn't prove it.

"I was so young, the Germans did not believe that this kid was the head of that large network," he said in the oral history. "And I told them, 'Are you crazy? I couldn't have done this.'"

Months of brutal interrogation and solitary confinement failed to



Gaston Vandermeerssche with Ghent University's electron microscope.

break Mr. Vandermeerssche's will. He was betrayed by another underground member and sentenced to death. But he was freed by American troops near the end of the war.

Although shattered by his experiences in prison—he said he couldn't eat or sleep normally for a decade—Mr. Vandermeerssche resumed his studies, earning a Ph.D. in physics. He ran Ghent

University's electron-microscope department. In 1965, he moved to the U.S. and joined the Joseph Schlitz Brewing Co. He specialized in tribology, the physics of surface abrasion, a topic that interested brewers whose can labels were damaged during shipping.

Mr. Vandermeerssche seldom spoke about his wartime experiences, even to his family. He was decorated by five countries and in 1980 was named honorary French consul for Milwaukee.

In the 1980s, he began visiting Europe to reconstruct his wartime activities, and recounted them in a 1988 book, "Gaston's War." He came to believe that his spy networks had been purposely exposed by his masters in London, as a diversion to convince the Germans that D-Day invasions were planned for the Low Countries instead of Normandy. He called it "le grand jeu"—the great game—in his memoir.

"I'm not bitter," he said in the oral history. "It was an honor that I was used for the big purpose."

—John Miller
contributed to this article.
—Email remembrances@wsj.com

EURO-ZONE CRISIS

Winds of change? | The financial crisis may have an outsize impact on Ireland's political landscape



Brian Cowen

Fianna Fail

Ruling party in coalition. Led by Prime Minister Brian Cowen, it adopted probusiness policies in the mid-1990s. Its popularity fell when the property bubble burst. Has been in power for 53 years of its 84-year existence.

70 of the 166 seats in the Irish parliamentary lower house or Dáil



Enda Kenny

Fine Gael

Ireland's other main political party, now expected to form the next government. Barring a period between 1994-1997, it has been out of power since 1987. Its leader, Enda Kenny, has sometimes been accused of lacking charisma.

51 seats in the Dáil



John Gormley

Green Party

Formed in 1981, the Green Party formed a coalition with Fianna Fail after the 2007 general election. Its decision to quit the coalition in January is set to trigger a new general election in early 2010.

Six seats in the Dáil

Note: There are 10 seats held by independents and one



Gerry Adams

Sinn Fein

Known for its role in the Northern Ireland peace process, the party is turning its focus on becoming a political force in the Republic. Resolutely anti-big business, it hopes to capitalize on the fallout from the economic crisis.

Four seats in the Dáil

by the Speaker. There are four current vacant seats.



Eamon Gilmore

Labour Party

Once regarded as a potential minor coalition partner, Labour is now challenging the hegemony of Fianna Fail and Fine Gael. Opinion polls this summer put it ahead of both parties for the time in the Republic's history.

20 seats in the Dáil

Source: Irish parliament

Press Association (Cowen, Adams); AFP (Kenny); Reuters (Gormley); AP (z)

In Ireland, bailout triggers anger

BY GUY CHAZAN
AND NEIL SHAH

DUBLIN—The people of Ireland struggled to come to terms with an international bailout that many see as a humiliating loss of sovereignty, while pressure piled up on the government ahead of a crucial vote on next year's budget.

As Ireland's political turmoil intensified Tuesday, much of the anger among its citizens was aimed not at the European Union and the International Monetary Fund—which pressured the country to take the aid—but at the Irish government that created the mess necessitating it.

"If they force us to clean up our act, they're welcome," said Josephine Luibhéid, a retiree here. "The government is incompetent. It believed everything the banks told them and then wrote them a blank check."

At the same time, Ireland's efforts to cut its budget are also caus-

ing pain among voters.

Anger at the government escalated as opposition parties continued to call for immediate elections, a day after Prime Minister Brian Cowen's governing coalition began to unravel.

The international bailout, widely seen as a huge blow to national pride, has prompted a round of soul-searching. Ireland treasures the independence it won from Britain 88 years ago after a long and bitter struggle, and there are real fears the country may now lose some control over its affairs. Speculation Ireland may have to give up its low 12.5% corporate tax rate hasn't disappeared though the government has said it stands behind the tax rate.

"The true ignominy of our current situation is not that our sovereignty has been taken away from us, it is that we ourselves have squandered it," a recent editorial in the Irish Times said.

Mary Comer, a civil servant, said the bailout "makes us look like we're

begging." But international scrutiny of Ireland's finances might not be a bad thing, she added.

She reserved most of her scorn for the government. "I just don't believe them. All these politicians are only in it for the money," she said since the recession started, her salary has been cut three times, and she expects there will be more cuts.

The Sinn Féin party, which holds just four seats in Ireland's 166-seat parliament, on Tuesday called for a no-confidence vote in Mr. Cowen, though it is unlikely to win the support needed to push it through. Frustration also mounted among members of Mr. Cowen's Fianna Fail party, with chatter growing that he should resign despite lacking an obvious successor.

Mr. Cowen has resisted these calls and instead urged lawmakers to pass his 2011 budget, which Irish and European officials say is a key precondition of the estimated €80 billion (\$109 billion) bailout Ireland is negotiating with the IMF and the

EU.

But he was forced to promise an early election next year after his junior coalition partner, the Green Party, said Monday it will quit the government. On Wednesday, Mr. Cowen's government is to unveil a controversial four-year budget plan expected to cut another €15 billion from public finances that have already been aggressively tightened. That comes ahead of a Dec. 7 vote on a specific budget for 2011.

One of the key arguments being marshalled by Mr. Cowen's opponents: By being forced to accept international aid, the government has lost all legitimacy.

"We've had a loss of sovereignty here for the first time since the foundation of the state," Enda Kelly, leader of the center-right Fine Gael, said in a television interview.

The irony is that Mr. Cowen's party, Fianna Fail—or "Soldiers of Destiny"—has long been seen as the trusted guardian of Irish self-determination. The party was a product

of Ireland's long struggle for independence from Britain, and its founders instigated a civil war because they considered the peace deal struck with Britain in 1921 a betrayal of Irish independence.

In power, Fianna Fail was credited with helping to transform Ireland into a "Celtic tiger," one of Europe's fastest-growing economies.

But the party was also accused of being too cozy with the property developers and bankers many hold responsible for fueling Ireland's economic boom and subsequent burn-out. The party's ratings have fallen to 17% in recent polls.

"It's a sorry state to be in when a very successful economy was effectively destroyed in a very short period," said Blair Horan, general secretary of the Civil Public and Services Union and a political independent. But he said he didn't feel Ireland was losing its independence by accepting the bailout. "Sovereignty in the euro zone is shared anyway," he said.

Spain tries to ease concerns

Continued from first page
eral European countries soared Tuesday, as investors worried the heavily indebted nations could run into problems like those buffeting Ireland.

Spain's risk premium—as measured by the spread on its 10-year bonds over the German equivalent—hit its highest level since the creation of the euro in 1999. The country's stock market closed down 3.1%. Spain has yet to meet its funding needs for 2010 and has further debt sales on the calendar.

Meanwhile, the cost of insuring the debt of Spain's two largest, healthiest banks—Banco Santander SA and Banco Bilbao Vizcaya Argentaria SA—reached its highest level in more than a month, according to data provider Markit. In another sign of bank stress, midsize bank Banco Sabadell SA has recently begun offering a high rate of 5% on some savings accounts in a bid to attract deposits.

Spanish officials acknowledged Tuesday that lawmakers must keep

up deficit-cutting measures if they are to quell investor concerns.

"The international financial and economic community and our European partners are going to be very demanding," said Mr. Ordoñez, who is also a member of the European Central Bank's governing council.

According to data Tuesday, Spain's central government deficit fell by almost half in the first 10 months of the year to €31.26 billion, or 2.96% of gross domestic product.

The government has pledged to lower its overall budget deficit to 9.3% of GDP this year from 11.1% last year.

Like Ireland, Spain saw its economy grow rapidly over the past decade thanks to a housing boom, in which its banking sector expanded.

Both countries' economies hit the skids when the asset bubble began to deflate, though Spanish banks have held up better than many of their peers in Ireland and elsewhere, thanks in part to tighter oversight and government rules that required them to set aside extra buffers to

absorb losses.

In Ireland, bank losses were so severe that the government needs financial aid from the European Union and the International Monetary Fund even after putting €50 billion into the sector.

Spain has injected €11 billion through its Fund for Orderly Bank Restructuring, although many analysts question whether Spanish banks have recognized the full extent of their losses.

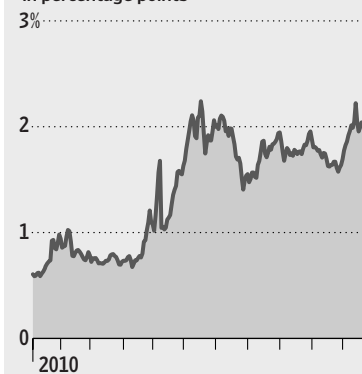
A key difference between Spain and Ireland, says Joaquin Maudos, a professor of economics at the University of Valencia in Spain, is that the total assets in Spain's banking system are 328% of Spain's GDP, while Ireland's reached 998% of that country's GDP; putting Spain in a much better position to absorb problems in its banking sector.

"There are elements that are comparable between Spain and Ireland, but they are not the same," said Mr. Maudos.

However, the banking sector could be dealt a fresh blow by prob-

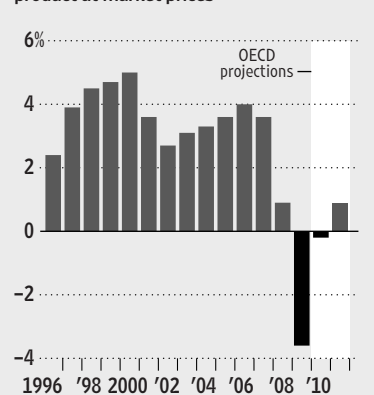
Climbing costs | Spain's funding expenses and GDP growth

Spread between 10-year Spanish government bonds and German bonds, in percentage points



Sources: Thomson Reuters; WSJ Market Data Group; OECD, Spanish government

Annual change in gross domestic product at market prices



lems in neighboring Portugal.

Analysts and economists say that Spain's ability to reassure markets now hinges on the speed at which further public- and private-sector changes are made.

Earlier this year, Spain forced a wave of mergers among local lenders, which are heavily exposed to the country's property bust. While the mergers have been agreed to on

paper, about half have been bogged down in disputes over governance and structures of the new entities.

The government needs to swiftly pass legislation to overhaul the country's generous pension system, said Luis Garicano, a professor of Economics and Strategy at the London School of Economics.

—Emese Bartha
contributed to this article.

EURO-ZONE CRISIS

Contagion remains Europe's worry

BY STEPHEN FIDLER

Financial-market jitters took a tighter hold on Europe amid selloffs of the euro and the debt of some of the euro zone's most indebted countries, confounding hopes that an international bailout for Ireland this past weekend would relieve pressure on other governments.

German Chancellor Angela Merkel underlined the grave situation, calling Ireland's crisis "very worrying" for the region. "We're in an extraordinarily serious situation as far as the situation of the euro is concerned," Ms. Merkel said in a speech Tuesday.

Traders said the comments added to pessimism about Europe's debt crisis, which shows increasing signs of spreading despite efforts to stem it by propping up Ireland. The euro slid below \$1.34 for the first time in two months, though the weakness followed an apparent "flight to safety" after North Korean attacks on South Korea.

In Portugal and Spain, investors dumped shares. Portugal's main stock market index fell 2.2%, and Spain's fell 3% as bank shares there were battered. The gap between yields on Spanish and Portuguese government bonds and those on low-risk German debt widened, suggesting market confidence continued to erode. The yield premium for 10-year Portuguese bonds rose 0.2 percentage points to 4.47 percentage points, while that for Spain gained almost 0.3 percentage points



German Chancellor Angela Merkel, pictured Tuesday, says the euro is in "an extraordinarily serious situation."

to 2.37 percentage points, the highest since September 1996, before the euro was created.

The selloff in Spanish stocks and bonds came as the government's short-term borrowing costs rose sharply at an auction of three-month and six-month bills even as officials insisted that their deficit-cutting measures were on track.

The Ireland bailout followed huge government capital injections over the past two years to prop up banks that suffered big loan losses, in turn causing the government's debt burden to balloon. This has turned the spotlight to banks in Spain and Portugal, analysts said. "The contagion risk, at this stage, in part lies in the lack of trust in those

two nations' banking sectors," says Vincent Chaigneau, a Société Générale strategist.

Spain, like Ireland, has suffered a collapse in house prices that has hit its banks. Portugal hasn't, but its private sector is highly indebted, the economy hasn't been growing and unemployment is high, raising questions about people's ability to

repay their debts.

Economists say contagion, in which a loss of confidence in one economy transmits to others, can occur through trade connections, economic similarities or financial linkages.

An economic downturn can hit a trading partner's exports or reduce tourism revenues. A collapse in value of financial assets in one country can hit confidence about banks in another if those banks hold a lot of those assets. One reason cited for the fall in Spanish bank stocks: their exposure to Portugal.

Contagion also can happen when investors look across from a troubled economy and see similar problems elsewhere. While Portugal doesn't have banking problems of the scale of Ireland's, or a budget deficit as big as Greece's, it does have an unhappy combination of budget deficits, high government debt and low growth.

A third transmission mechanism for contagion is through investor portfolios, where price falls in one asset class cause investors to sell other assets. This can happen because investors such as mutual funds need to preserve liquidity to fund redemptions. Bond markets on the euro zone's geographic periphery have seen investors, such as pension funds, run for the exits because price swings have undermined the stability that they seek.

—Bernd Radowitz and Marcus Walker contributed to this article.

The case for default to keep debt in check

BY BOB DAVIS

As another European country edges toward a multibillion-euro bailout, a number of economists say there is only one way to make creditors share the pain: default.

In Dublin, officials from the International Monetary Fund, European Union and United Kingdom are negotiating a rescue package that is likely to require the Irish government to further squeeze pensions and paychecks but pay off bondholders of Irish banks, whose debts the government guaranteed.

Such a lopsided outcome—which has been repeated since the Latin America debt crises of the 1980s—enrages many voters and signals to investors that there is no price to pay for risky lending because international institutions will always bail them out.

Instead, say economists, lenders should be required to take hits on their investments as a way to reduce a government's bills and to force lenders to be more careful about where to invest their money next time because they will realize the IMF and others won't guarantee they will be paid in full.

"The most important effect is that [a country's] debts won't build up so much," said Harvard University economist Kenneth Rogoff, who has chronicled centuries of sovereign defaults.

German Chancellor Angela Merkel tried to move in that direction last month. She persuaded fellow EU members to consider forcing

investors in sovereign bonds to take losses as a condition of future rescue plans. But the effort backfired when it prompted a sharp rise in borrowing costs for weaker euro-zone governments. Critics say that made an Irish bailout even more likely.

At the Group of 20 summit this month, Germany, the U.K., France, Italy and Spain tried to calm markets by issuing a statement that any new mechanism wouldn't come into effect before mid-2013, after the expiration of a €750 billion bailout fund that Ireland will likely access. Germany is seeking to make sure the "permanent crisis mechanism" that replaces it punishes bondholders as well as taxpayers.

Still, the negative market reaction illustrates the difficulty of making such a change. During times of crisis, any talk of punishing creditors drives up interest rates and makes the situation worse.

After the Asian financial crisis of 1997 and 1998, the IMF proposed an institutionalized default program. Under the program, the IMF would have judged a country's ability to pay its debts and the policies it needed to pursue. Another institution would have acted like an international bankruptcy court. The proposal withered in 2003 under opposition from the U.S. Treasury and emerging markets, which didn't want to cede power to an international body.

—Matthew Karnitschnig and Stephen Fidler contributed to this article.

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EUROPE NEWS

U.K. to cap foreign workers

BY CASSELL BRYAN-LOW

LONDON—The British government on Tuesday detailed new rules that will for the first time set a permanent cap on the number of workers allowed to enter the country from outside Europe.

But because the rules don't address significant migrant groups such as students or workers who arrive from Europe, they will have little impact for now on Prime Minister David Cameron's goal of reducing overall immigration figures, a key part of his election platform earlier this year.

Mr. Cameron's Conservative Party has argued that high immigration levels have put pressure on public services and led to tensions in communities. The government, in unveiling the new rules, to take effect in April, also pledged to tighten the rules for other categories of immigrants, including students.

The government Tuesday said it would limit the number of skilled and highly skilled workers entering the U.K. to 21,700 a year, representing a reduction of about a fifth from last year's levels of 28,000. The move follows a temporary cap imposed by border authorities in June while they determined details of the permanent limit.

A number of companies—including large international firms in sectors such as finance and pharmaceuticals—had lobbied the government, concerned that thresholds set too low would hinder their ability to hire talent.

To help address those concerns, Home Secretary Theresa May on Tuesday said the government would exclude from the total cap current employees that a company transfers to the U.K., as opposed to outside hires. Existing employees account for the largest category of worker permits. However, transferred employees earning less than £40,000, or about \$64,000, annually won't be able to stay longer than a year, on the theory that lower-paid workers are less skilled.

"Generally, business is fairly happy that the government has listened to it," said Nicolas Rollason, a



Prime Minister David Cameron and Home Secretary Theresa May view passports on a visit to Heathrow Airport on Tuesday.

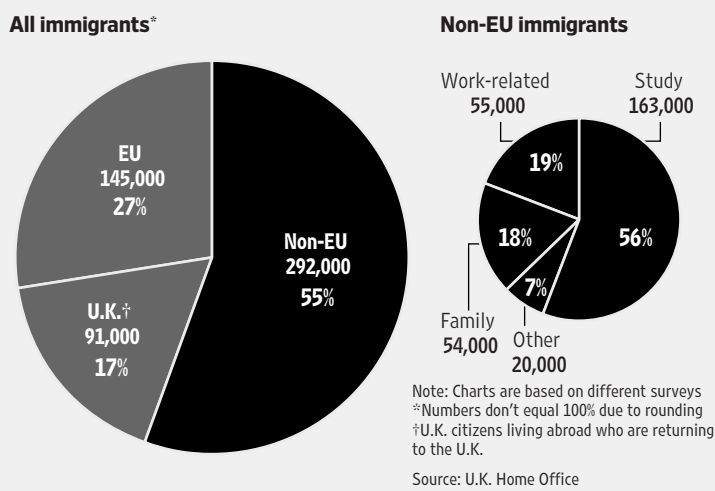
London-based partner at law firm Kingsley Napley LLP whose clients include multinational firms in finance and other industries. "The question is now, going forward, how quickly the U.K. government can respond to the increased demand for non-EU workers when there is an upturn in the economy."

The government has previously indicated that the cap could be subject to review if needed. On Tuesday, it said the system is designed to reduce net migration while still attracting the best and brightest workers.

In 2009, 196,000 more people came to the U.K. than left, a 20% increase from 2008. The government has said it aims to reduce net migration to the tens of thousands a year.

The new rules will make little difference to the overall immigration numbers, for now. The limit applies only to non-European workers,

U.K. immigration breakdown in 2009



but nearly a third of all people arriving in the U.K. are from Europe. And they also have no bearing on other large groups of migrants such as students, which account for the majority of those arriving from outside Europe, and dependents.

Ms. May said the government would be looking at ways to tighten rules for other groups, including students and family members.

She said she will shortly be conducting a review of the student-visa system.

Eleven arrests in antiterror sweep

BY JOHN W. MILLER
AND DAVID CRAWFORD

BRUSSELS—Belgian police Tuesday arrested seven members of what they said was an Antwerp-based Moroccan terror network whose alleged aims were steering cash and recruits to Islamic rebels in Chechnya, as well plotting an attack on Belgian soil. As part of the sting, three men in the Netherlands and one in Germany also were arrested.

The 11 men were scheduled to appear Tuesday afternoon before a special antiterror investigating judge in Mechelen, a city near Brussels. The judge will decide by noon Wednesday how many of the men will be charged.

Possible charges include belonging to a terrorist organization, money laundering and recruitment for a foreign military, a person familiar with the matter said.

The spokesman for the prosecutor's office in Aachen, Germany, said the German suspect was arrested

for "membership in a terrorist organization and other charges." He declined to name the other charges, and instead referred the question to the Mechelen court.

German security officials have monitored at least three of the suspects, a person familiar with the investigation said, without providing details.

Lieve Pellens, a spokeswoman for the Belgian prosecutor's office, said further details would be released on Wednesday. "This has nothing to do with the threat in Germany," she said, referring to German warnings that Islamist terrorists were planning attacks there soon. "It's really a Moroccan group based here that was being used by the Chechens."

Of the men, six hold Belgian and Moroccan passports, and three hold Dutch and Moroccan passports. Two are Chechens who hold Russian passports. They came to the attention of antiterror authorities via a website, identified by police as "Ansar Al Mujahadeen," that they used to try to recruit Islamic radicals for

terrorism, Mrs. Pellens said.

If the judge charges them, the men will face a pretrial hearing before the end of the month. The trial would take place some time next year.

Lors Doukaiev, the Chechen man arrested in September for detonating a bomb in a Copenhagen hotel, was a resident of Liege in eastern Belgium. Mr. Doukaiev was plotting to blow up Jyllands-Posten, the Danish newspaper that printed cartoons mocking the prophet Mohammad in 2005, Danish police said. However, Mr. Doukaiev, who was injured in the blast and is still being held, was working on his own, with no connection to the men arrested Tuesday, Belgian police said.

Chechen gangs are known in Belgium for petty-crime sprees, not for their political violence, says a Brussels police officer whose job doesn't allow him to be quoted by name.

However, the struggle of Islamic Chechnya to win independence from Russia has long been a favorite cause of Islamist terrorists, and Bel-

gium is considered one of the their European hubs.

Before Tuesday's arrests, only one previous prosecution has alleged attempted attacks on Belgian soil. Two days after Sept. 11, 2001, Nizar Trabelsi, a former soccer star from Tunisia, was arrested for allegedly plotting to blow up a military base. In 2003, he was sentenced to 10 years in prison.

Since then, Belgian authorities have arrested and sentenced dozens of Islamist terrorists based in this small kingdom, whose population of 10.6 million includes some 650,000 Muslims, mostly Moroccans and Turks.

Alleged "shoe-bomber" Richard Reid once bought a fake passport near the Brussels south station. Mr. Reid was convicted of trying to blow up a U.S.-bound airliner in 2001 with explosives hidden in his shoe.

In 2005, Muriel Degauque, a 38-year-old Belgian woman from the rust-belt city of Charleroi, blew herself up in Iraq after being converted to Islam by a terror network.

France and Germany lift growth in euro zone

BY ILONA BILLINGTON

LONDON—Growth in the euro-zone's private sector accelerated sharply in November, boosted by a strong expansion in France and Germany, despite heightened concern about the rising debts of some euro-zone member states, particularly Ireland.

The preliminary composite purchasing-managers index for the euro zone rose to 55.4 in November from October's 53.8, financial-services company Markit said Tuesday. The November services PMI for the euro zone also rose by more than expected, to 55.2 from 53.3 a month earlier, while the manufacturing PMI jumped to 55.5 from 54.6 in October. A PMI level above 50 signals an expansion in activity, while a level below 50 signals a contraction.

Economists had forecast the composite measure would rise just marginally, to 53.9. The services PMI was forecast to fall to 53.1, while the manufacturing PMI was seen a little stronger at 54.7.

"The flash PMI readings for November indicate that the euro zone regained some of the growth momentum that had been lost since July's peak," said Chris Williamson, chief economist at Markit. "However, growth remains very unbalanced, led by a renewed surge of output and employment in Germany—which is driving economic growth at almost twice the euro-area average—while the periphery continues to struggle with extremely tough conditions."

Ireland on Sunday formally requested financial aid from the European Union and the International Monetary Fund to protect its banking sector. "Ireland's woes appear to have done little so far to affect the economic recovery elsewhere in the euro zone," said Martin van Vliet, euro-zone economist for ING Bank.

"The unexpected increase in the euro-zone composite PMI is encouraging, especially given the resurgence of the sovereign-debt crisis. With the weakening in global trade set to slow exports, however, there remains a risk that the pace of recovery in core euro-zone economies will slow down."

Other data released Tuesday from Germany and Italy were also upbeat and showed that consumer confidence in the larger economies of the region had improved.

German growth in the third quarter was confirmed at 0.7%, compared with the previous quarter, and 3.9% in annual terms in the more detailed breakdown of gross domestic product figures published Tuesday. The GDP data showed that private and public spending were key to the brisk pace of growth last quarter, while November's PMI suggested a pickup in growth is likely in the fourth quarter.

Results of the forward-looking German GfK consumer-confidence survey for December, released Tuesday, also reflected continued buoyancy in the largest euro-zone economy, for the remainder of the year at least, with the index rising to 5.5 from November's 5.1.

—Emese Bartha in Frankfurt contributed to this article.

U.S. NEWS

Centrist group draws Bloomberg's support

By MONICA LANGLEY

An alliance of centrist Republicans and Democrats is seeking to organize a grassroots effort aimed at the "middle" of American politics, a political sphere depopulated by the midterm elections.

The advocacy group, dubbed "No Labels" for eschewing either major U.S. party affiliation, has drawn the support of New York City Mayor Michael Bloomberg, the country's most powerful independent politician.

Mr. Bloomberg will be the group's keynote speaker at the Dec. 13 launch.

One scenario gaining ground sees Mr. Bloomberg as an attractive third-party presidential candidate if the two-party polarization and economic downturn persist—and if former Alaska Gov. Sarah Palin and President Obama are the likely Republican and Democratic nominees.

"Independents are the fastest-growing group of voters in the country, and as that trend continues, they will wield more and more influence in elections," said Mr. Bloomberg, who also said he wasn't considering a presidential bid.

Efforts such as No Labels "aren't important, they're invaluable" if Mr. Bloomberg does decide to run, a top adviser to the New York mayor said. But No Labels founder Nancy Jacobson said the group had not asked Mr. Bloomberg for money and doesn't support any candidates yet.

No Labels is led by Ms. Jacobson, a Democratic fundraiser, and Republican image guru Mark McKinno, who were introduced to each other by Kevin Sheekey, Mr. Bloomberg's political adviser.

The group already has raised more than \$1 million to seed its effort against what it calls "hyperpartisanship." Backers include billionaire co-chair of Loews Corp. Andrew Tisch, Panera Bread founder Ron Shaich and Facebook Chief Operating Officer Sheryl Sandberg.

The group's goal is to start a grassroots movement for the centrist majority akin to the work of the tea-party movement on the right and Move On on the left. It comes when public support for the major parties is historically low.

"I've never seen such a wide opening for a third force in American politics," says William Galston, political historian, Brookings Institute fellow and a No Labels adviser. "And this time, Americans have a lot of skin in the game because of the tough times."

At the launch in New York, Mr. Bloomberg is scheduled to be joined by Newark, N.J., Mayor Corey Booker, as well as centrist U.S. senators Joe Lieberman, an independent, and Ron Wyden, a Democrat.

The group wanted to invite Republican Sen. Lindsay Graham, but didn't want to hurt his future election chances in his home state of South Carolina.

The group has already road-tested its message in cities across the country, most recently in New Hampshire last week.

In a living room full of politically active citizens in Portsmouth, No Labels' organizer John Avlon, an expert on independent parties, said, "This is a rebellious idea for the po-

litically homeless—and our numbers are growing."

New poll data offer support for this view. About 40% of Americans identify themselves as independents though many still vote along party lines, according to a recent Pew poll. "It's the largest single group in American politics and the only growing segment of the electorate," says Doug Shoemaker, former pollster for President Bill Clinton and Mayor Bloomberg.

But questions are being raised—both inside and outside No Labels—about the group's reach, with its focus on process rather

than a political leader or action agenda. Third-party movements in the center of the political spectrum have tended to falter, including the last presidential election's Unity '08, with the exception of a strong candidate such as Teddy Roosevelt in 1912 or Ross Perot in the 1990s.

"Kumbaya moments and puppies are great, but you need more meat to get real support," Peter Angerhofer, a Republican at the Portsmouth gathering, told the No Labels speakers. "If you want to create a third party and carve out the middle, that might work, but be clear about it."



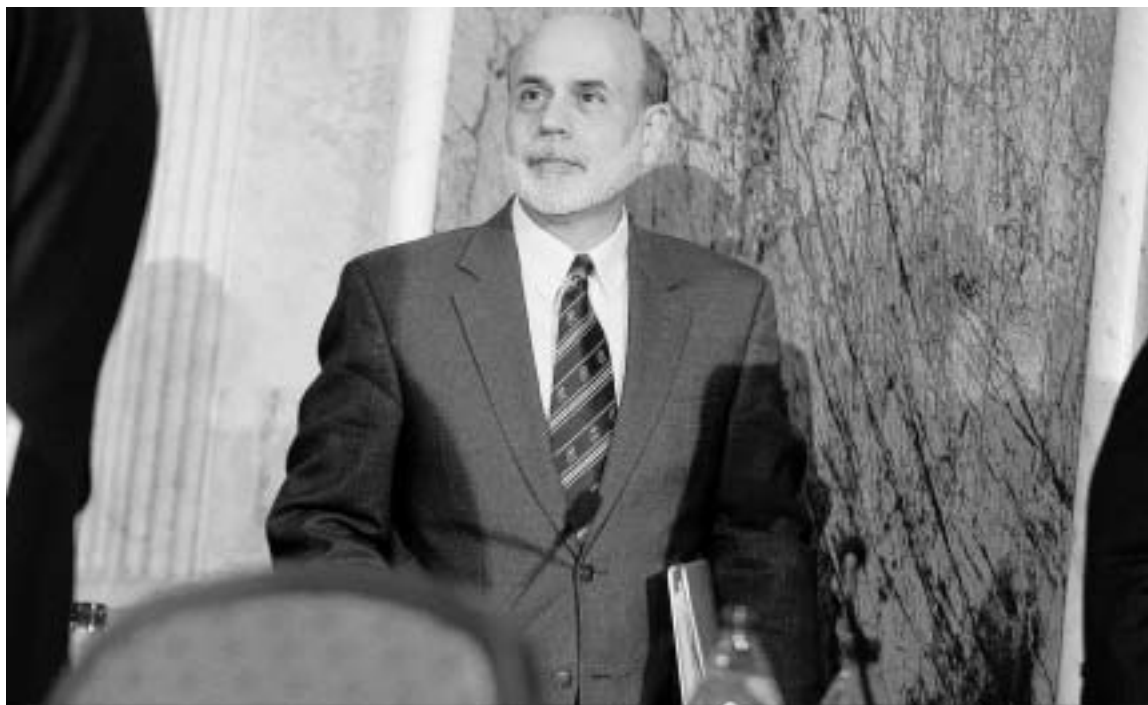
New York Mayor Michael Bloomberg will speak at the launch of No Labels.

Taking a nosedive, by TIME

When the bull market of Wall Street stumbled, we all took the fall. As the global economy struggles to find its feet, keeping up to date is more important than ever. So for breaking business news, informed articles and our dedicated business blog *The Curious Capitalist*, visit Time.com

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U.S. NEWS



Bloomberg News

Fed Chairman Ben Bernanke in Washington on Tuesday. Fed officials see unemployment staying high and inflation low.

Fed lowers forecast for growth next year

BY LUCA DI LEO
AND JON HILSENATH

Federal Reserve officials downgraded their assessment of the U.S. economy at their last meeting three weeks ago as they debated the benefits and costs of a new bold step to support the recovery.

Minutes of the Fed's latest policy-setting meeting Nov. 2-3, released Tuesday, showed officials expected the economy to grow at a moderate pace next year, with unemployment staying disappointingly high and inflation uncomfortably low.

The minutes also showed Fed officials held an unusual video conference two weeks before their formal Nov. 2-3 meeting in which they took up hot-button issues like whether to set targets for inflation or long-term interest rates.

No decisions were made during the video conference, held Oct. 15. Among the issues on the table was whether the Fed should target some interest rate that is longer in duration than the federal funds rate, an interest rate on overnight loans that

now stands at just a little bit above zero.

Some officials noted that targeting the yield on a term security could be an effective way to reduce longer-term interest rates and thus provide additional stimulus to the economy, the minutes of the meeting said. However, they also worried that targeting a longer-term interest rate could force the Fed to buy undesirably large amounts of bonds to keep the interest rate at the target.

Although the Fed didn't take action in this direction, the discussion suggests the idea could reappear if the economy weakens again. The Fed kept a target for long-term interest rates of around 2.5% in the 1940s and early 1950s as the U.S. emerged from war and depression.

Low prices and a stubbornly high jobless rate led Fed officials this month to resume a bond-purchase program that was used to combat the financial crisis. The step was attacked by Republican lawmakers and foreign government officials, who said it could hurt the U.S. dollar and usher in high inflation.

The minutes showed that, even

though Fed officials voted with an overwhelming 10-1 majority to support the move, several worried about its consequences.

"Some participants noted concerns that additional expansion of the Federal Reserve's balance sheet could put unwanted downward pressure on the dollar's value in foreign-exchange markets," the minutes showed. Several officials saw a risk the move could "cause an undesirably large increase in inflation."

The Fed projects U.S. gross domestic product, the broadest measure of economic activity, will rise at an annual rate of between 3.0% and 3.6% in 2011 after growing by around 2.5% this year. That compares with a previous June forecast that GDP would increase between 3.5% and 4.2% next year.

The economy grew at an annualized rate of just 2.5% in the third quarter, government data showed Tuesday, after rising by 1.7% in April to June.

The slow recovery should keep the unemployment rate, currently at 9.6%, around 9% at the end of next year, Fed officials predicted.

GDP growth is revised higher

BY LUCA DI LEO
AND JEFFREY SPARSHOTT

The U.S. economy expanded at a slightly faster pace than previously thought in the third quarter and corporate profits rose, but growth is still too weak to cut unemployment.

Separately, home resales dipped in October after two months of increases, with a weak economy and worries about flaws in foreclosure documents keeping buyers away.

Gross domestic product, the value of all goods and services produced, rose at a seasonally adjusted annual rate of 2.5% in July through September, the Commerce Department said Tuesday. In the government's first report, released Oct. 29, GDP was estimated to have risen 2%

in the third quarter, following a 1.7% growth rate in the second quarter.

The economy has expanded for five straight quarters, but unemployment remains high at 9.6%. Economists polled by Dow Jones Newswires expected GDP would be revised up to a 2.4% growth rate in the July-to-September period.

The report also showed companies, especially in the financial sector, posted higher profits in the third quarter. After-tax earnings rose by 3.2%, compared with the second quarter's gain of just 0.9%.

The GDP breakdown showed spending by Americans, accounting for about 70% of demand in the U.S. economy, rose at a 2.8% rate in July through September, compared with a previously reported 2.6% rate.

Top private forecasters believe growth will be sluggish in 2011, weighed down by high public debt and unemployment.

Exports rose 6.3%, up from the 5% increase estimated in the previous release and following a 9.1% second-quarter rise. Imports, which subtract from GDP, rose 16.8% in the quarter, lower than the previous estimate of a 17.4% increase.

Sales of previously occupied homes decreased by 2.2% to a seasonally adjusted annual rate of 4.43 million, the National Association of Realtors said. Economists surveyed by Dow Jones Newswires had expected home sales to drop 0.7% to an annual rate of 4.5 million.

—Jeff Bater and Alan Zibel
contributed to this article.

Tilt at unemployment puts Fed's mandate in spotlight

[Capital]

BY DAVID WESSEL



With unemployment at 9.6% and inflation below the Federal Reserve's working definition of "price stability," this seems a strange moment for Congress to contemplate instructing the Fed to focus exclusively on fighting inflation.

But Sen. Bob Corker (R., Tenn.) wants to revive that notion, which has lain dormant for more than a decade because there has been so little inflation. "I am concerned about inflation down the road," he explains. "The time is right for us to bring clarity to the Fed." In the House, Paul Ryan (R., Wis.) and Michael Pence (R., Indiana) agree. Mr. Pence argues that the Fed's quest to combat unemployment by buying \$600 billion in U.S. Treasuries is a failure and threatens to "monetize our debt and trigger inflation."

The implication is that the Fed has lost its moorings. Has it really? For more than 30 years, Congress has charged the Fed with aiming at "maximum employment, stable prices and moderate long-term interest rates." That wording has long made some Fed officials and academic economists uneasy because it is rooted in a now-abandoned view that the government could dial up a little more inflation to get a little less unemployment and vice versa.

The current consensus is that the Fed can—and, indeed, is now attempting to—reduce unemployment in a recession, but in the long run can deliver only price stability. What Fed Chairman Ben Bernanke calls "the longer-run sustainable unemployment rate" is determined by demographics, job-market rules and other factors beyond the Fed's control. In this view, if the Fed tried to push unemployment too low now, it could create too much inflation later, the mistake the Fed made in the late 1970s.

But it is not the 1970s. Even though the Fed has been holding short-term interest rates near zero for nearly two years, prices rose at only a 1% annual rate in the third quarter, the Commerce Department said Tuesday. No measure of inflation expectations foresees anything like the 8%-plus inflation of the '70s. And it's hard to find a single Greenspan or Bernanke decision that would have been different if they had an inflation-only mandate. So why all this now?

Reason One: Politics. After the Bush-Obama bank bailouts, the Obama fiscal stimulus and all of Mr. Bernanke's bond-buying, the economy still stinks. People are frustrated. Voters are angry at what they perceive as the government's failure. The Obama-Bernanke line is: It could have been worse. The Republican response: Everything that the White House, the Treasury and the Fed have tried has failed. Attack it.

After Sarah Palin, a likely Republican presidential candidate, launched a surprise attack on Mr. Bernanke's bond-buying—indelibly branded QE for "quantitative easing," over Mr. Bernanke's protests—some other Republicans moved to avoid ceding the Fed-bashing turf to her. And then Bernanke lieutenant Kevin Warsh, a former Bush White House staffer, decided to go public with his unease about QE2, making Mr. Bernanke look vulnerable. All of a sudden, the Fed and the Democrats seem to be on one side and prominent Republicans on the other.

Reason Two: The stormy seas into which the Fed's QE2 is sailing. Mr. Bernanke would prefer to cut short-term interest rates by another three-quarters of a percentage point, but he can't. Rates are at zero. So in his mind, he's doing the next best thing, buying Treasury bonds to nudge down long-term interest rates.

The maneuver started well. After Mr. Bernanke advertised it in an August speech, markets did what the Fed expected: Stocks rose, bond-market yields fell, the dollar slipped. Then the Fed made it official on Nov. 3, and it has been overwhelmed by the backlash ever since from foreign governments unhappy about the impact on their currencies (which the Fed anticipated), from Republican politicians (which the Fed didn't anticipate) and from markets (which have confounded the Fed by pushing yields on 10-year Treasuries up lately.)

Those who deem QE2 ill-conceived note Fed estimates that QE2 could mean 750,000 more jobs by the end of 2012, and say: Change the law, and the Fed wouldn't be able to do this again. Those who see QE2 as well-intentioned but clumsy have a different argument: The Fed muddled the message, and left markets wondering about the Fed's commitment to keep inflation down in the future. "Inflating away the government's debt is a huge issue in people's minds," says former Fed economist Marvin Goodfriend, now at Carnegie Mellon University.

The solution, though, is not to strip unemployment from the Fed's mandate altogether, he and like-minded economists say. "A central bank should care not only about stabilizing inflation, but also stabilizing the business cycle," says former Fed governor Frederic Mishkin of Columbia Business School. The answer, he says, is to "clarify" the law by making price stability the primary, but not the sole objective.

In his academic days, Mr. Bernanke probably would have agreed. As Fed chairman, though, he is against reopening the Federal Reserve Act now. And to Congress, he says: If you don't want us to worry so much about unemployment, you should worry about it more. QE2 may help a little. But, he said last week, we could really use "near-term measures to enhance growth with strong, confidence-inducing steps to reduce longer-term structural deficits."

WORLD NEWS

Vatican elaborates on condom stance

BY STACY MEICHTRY
AND NATHANIA ZEVI

Pope Benedict XVI views the use of condoms among both homosexuals and heterosexuals as preferable to risking HIV infection, the Vatican said Tuesday, raising questions about whether the Vatican was relaxing its longstanding condemnation of condom use in general or only in a limited set of circumstances, such as when conception isn't possible.

Some analysts have questioned if the pope's remarks, made in a book-length interview released over the weekend, applied to the vast majority of HIV-infected people, because the pontiff in the interview cited the example of an HIV-infected male prostitute to make his point. Others played down the remarks, noting that major shifts in church teaching are traditionally handed down in formal Vatican documents, not in interviews with journalists.

In the interview with German journalist Peter Seewald, which took place in July, the pope made clear that he didn't consider condom use a "moral solution" to fighting the spread of infection, citing strategies that put abstinence first.

The pope then added: "There may be a basis in the case of some individuals, as perhaps when a male prostitute uses a condom, where this can be a first step in the direction of a moralization, a first assumption of responsibility, on the way toward recovering an awareness that not ev-



Pope Benedict XVI holds his new book, with journalist Peter Seewald, left, and Archbishop Salvatore Fisichella on Tuesday.

everything is allowed and that one cannot do whatever one wants."

Vatican spokesman Rev. Federico Lombardi told a news conference on Tuesday that he conveyed the media's "perplexity" directly to the pope, asking whether it made a difference if the prostitute in question was male or female. He said the pope said his reasoning applied to both sexes.

"The point is to take a step towards responsibility, to take into

consideration the risk of the life of the person with whom you have relations whether it's a man, woman or transsexual," Father Lombardi said.

The pope's comments on condom use are an attempt to tackle an issue that has been subject to years of debate between top church officials inside and outside the Vatican, said people familiar with the matter.

Pope Benedict's decision to articulate his views on condoms to a

journalist, rather than formulating a doctrinal document, is part of an unusual attempt to stir debate, the people said. The pope made "only small corrections" to the entire text, Mr. Seewald writes in a preface to the book, titled "The Light of the World: The Pope, the Church and the Signs of the Times."

The Vatican faces a delicate balancing act in extending the pope's position on condom use to heterosexual relationships. On the one

hand, the Vatican steadfastly defends its longtime ban on the use of condoms as a form of contraception. On Tuesday, Archbishop Salvatore Fisichella, a top Vatican official, told the news conference that contraception remained "intrinsically an evil," reiterating the church's teaching that sex should only occur within the bounds of marriage.

The pope made clear that he didn't consider condom use a 'moral solution' to fighting the spread of infection, citing strategies that put abstinence first.

By citing the example of a homosexual male prostitute, the pope didn't have to weigh the risk of HIV infection against the sin of contraception, said moral theologians. The issue gets more delicate when confronting the likelihood that heterosexual partners who use condoms to guard against HIV are preventing conception, said theologians.

"There's a weighing of one evil against another," said Rev. Robert Gahl, a professor of theology at the Pontifical University of Holy Cross in Rome. Father Gahl likened the pope's views to "telling someone who is drunk not to drive, but to take a bus. You're not endorsing drunkenness."

Drug reduces risk of HIV transmission

BY BETSY MCKAY
AND AMY DOCKSER MARCUS

The scientific quest to prevent AIDS is gaining momentum, with a large new study released Tuesday showing that an existing antiretroviral drug can ward off infection with the virus.

The study of nearly 2,500 gay and bisexual men on four continents follows two other recent breakthroughs in AIDS-prevention research after years of frustration and as the cost of treating HIV/AIDS globally continues to rise, with about 2.7 million new HIV infections every year. Results of one clinical trial in 2009 showed that an AIDS vaccine offered partial protection, while another study released in July demonstrated that a vaginal gel containing an antiretroviral drug cut the risk of HIV infection for women by 39% when they applied it before and after sex.

In the latest study, published online in the *New England Journal of Medicine*, gay and bisexual men who took the drug and used other measures such as condoms and counseling to prevent infection were 44% less likely to become infected than a control group taking a placebo in addition to condoms and counseling. Men who took the pill every day, as the regimen prescribed, had a 73% lower risk of infection.

The findings "represent a major advance in HIV research," said Kevin Fenton, director of the U.S. Centers for Disease Control and Prevention's center for HIV/AIDS programs and

research, in an interview. Gay and bisexual men make up about 48% of the more than one million people the CDC estimates are infected with HIV in the U.S., and the agency says the rate of new HIV diagnoses among that group is more than 44 times that of other men and more than 40 times that of women.

But the results also pointed to multiple challenges in widely implementing use of the pill, a combination of the drugs tenofovir and emtricitabine, to prevent infection, Dr. Fenton and others cautioned. The drug combination is known by the brand name Truvada and made by Gilead Sciences Inc. Antiretrovirals work by inhibiting an enzyme that the virus uses to replicate its genetic material.

Some of the men didn't adhere to the daily drug regimen, and blood tests showed that some who said they did in fact didn't, raising questions about how easy it will be to get men at high risk of infection—outside the rarified setting of a clinical trial—to take the drug as they should. "The trial is a biological success and a behavioral challenge," said Mitchell Warren, executive director of AVAC, a group that tracks and promotes AIDS-prevention research.

Public-health officials are concerned that people could take the drug and become complacent about using condoms or other measures. In the study, the risk of HIV infection was reduced only 21% in men whose adherence to the drug regimen was less than 90%.

You finally have a new reason to invest globally. International freight traffic last month jumped 27% year-on-year, down from 34% last August, but 6% above the pre-recession peak in 2008. Demand continues to follow economic recovery and trade patterns, with the Asia-Pacific region, the Middle East, Latin America and Africa growing quickest, while North America found some more strength in the middle ground. In a reflection of trends in passenger traffic, Europe is growing at half the rate of the fastest-grow the regions isn't all the information you need. The weaker value of the euro will help the European exporters eventually to increase cargo volumes. International air-passenger traffic in June soared 12% from the same month a year ago as the aviation industry continued to recover much faster than expected. Confidence remains high and there is no indication that the recovery will stall any time soon. With government stimulus packages tailing off and restocking largely completed, But can you trust it? The CEO of the company, which represents some 230 airlines world-wide, comprising 93% of scheduled international air traffic, said that sharp regional differences were evident in the recovery.

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NORTH KOREAN ATTACK

Recent skirmishes between North Korea and South Korea:

- **June 1999:** South Korean navy sinks a North Korean ship in firefight on the maritime border in the Yellow Sea west of the Koreas. Precise casualties unknown but at least 18 North Koreans are presumed killed.
- **November 2001:** North Korean soldiers fire at a South Korean guardpost in the demilitarized zone and South Koreans return fire. No injuries reported.
- **June 2002:** North Korea sinks a South Korean frigate in a clash involving several ships from both sides. Six South Korean sailors and an estimated 13 North Koreans are killed.
- **July 2003:** North Korean soldiers fire machine guns at a South Korean observation post

in the demilitarized zone, and South Korean soldiers fire back. No injuries reported.

- **April 2005:** North Korea announces a South Korean soldier fired a shot at a North Korean border post in the demilitarized zone. No injuries reported.

- **May 2006:** South Korean soldiers in the demilitarized zone fire warning shots at two North Korean soldiers who cross into South Korean territory. No one injured.

- **October 2006:** South Korean soldiers fire 40 warning shots at five North Korean soldiers who entered South Korean territory. No one was injured.

- **November 2009:** A South Korean naval patrol boat inflicts heavy damage on a North Korean military vessel near the countries' maritime border in the Yellow Sea. Unknown number of North Koreans injured.

- **January 2010:** North Korea

fires land-based artillery rounds into water near the inter-Korean border in the Yellow Sea.

- **March 2010:** South Korean warship Cheonan sinks, killing 46 sailors, near a South Korea-controlled island several miles south of the maritime border in the Yellow Sea. Investigation turns up remnants of a North Korean torpedo at the sinking site.

- **October 2010:** North Korean soldiers fire two shots near a South Korean guard post in the

demilitarized zone. South Korean soldiers fire three shots back. No one was injured.

- **Nov. 23, 2010:** North Korea fires artillery rockets at South Korea's Yeonpyeong island near a disputed border, setting houses on fire and prompting the south to return fire and dispatch fighter jets to the area. Two South Korean marines were killed.

Source: WSJ reporting; photos: aza (3)



The South Korean navy raises a patrol boat that sank during a battle with North Korean warships in the Yellow Sea.



South Korean soldiers stand guard near the demilitarized zone north of Seoul a day after soldiers briefly traded the machine-gun fire in the border zone.



In July, the South's Defense Ministry displays a part of what Seoul says is a North Korean torpedo responsible for the sinking of South Korean warship Cheonan in March.

China treads warily, airs North's side

BY JEREMY PAGE

BEIJING—China reacted with customary caution to North Korea's shelling of a South Korean island, giving prominence on state television to Pyongyang's version of events, in a response that places Beijing increasingly at odds with the U.S. and other countries frustrated with its unwillingness to rein in an old socialist ally.

China is the one country with leverage over North Korea, keeping the regime from collapse with shipments of food and energy. Yet, as one of the worst crises on the Korean peninsula since the 1950-53 Korean War unfolds, China has avoided taking sides.

Beijing even risked appearing to implicitly brush off the incident, with its state-run Xinhua news agency announcing just hours after the deadly North Korean attack that a Chinese government delegation visiting North Korea had signed a new deal on economic and trade cooperation with its neighbor.

China has already antagonized many of its Asian neighbors—particularly Japan—by making more assertive territorial claims in the South and East China Seas in recent months.

The U.S. and many other Western countries are growing increasingly alarmed at China's more muscular diplomacy on a range of issues, including trade, climate change and human rights. China's unwillingness to go against North Korea, even as it escalates its military belligerence, is likely to further strain its relations in a region nervous about its strategic intentions.

Stephen Bosworth, special U.S. envoy for North Korea, arrived in Beijing for emergency talks Tuesday following the weekend's revelations that North Korea has dramatically expanded its nuclear program. The Chinese government also reserved judgment on the nuclear issue, calling only for a resumption of talks between North and South Korea, China, Russia, Japan and the U.S.

"China hopes that the relevant parties will do more to contribute to peace and stability in the region," a spokesman for the Chinese Foreign Ministry, Hong Lei, told reporters.

There was a suggestion of partiality, however, when the evening news broadcast on China's main state-controlled television channel gave greater prominence to North Korea's official version of events on the shelling, which blamed South Korea for firing at it first.

Mr. Bosworth's mission in Beijing, following talks in Seoul and Tokyo over the last two days, is to persuade China to use its clout to curb North Korea's increasingly provocative behavior. But China's primary concern isn't to prevent North Korea from developing a nuclear weapon, but to ensure that the regime there doesn't suddenly collapse, sending a flood of refugees into northeastern China.

There is also a common view among Chinese experts that a strong, unified Korea represents a threat to China as it would bring to its border a key U.S. ally, and the People's Liberation Army would end up face-to-face with thousands of U.S. troops stationed in the South.

—Josh Chin contributed to this article.

Seoul returns fire; others urge calm

Continued from first page said the U.S. will work with global leaders to figure out how to best deal with North Korea's attack.

Col. David Lapan, the Pentagon spokesman, said that no additional U.S. military assets had been moved to the region, nor were any discussions of immediately holding military exercises planned.

Catherine Ashton, the EU's foreign policy chief, called on the "North Korean authorities to refrain from any action that risks further escalation and to fully respect the Korean Armistice Agreement."

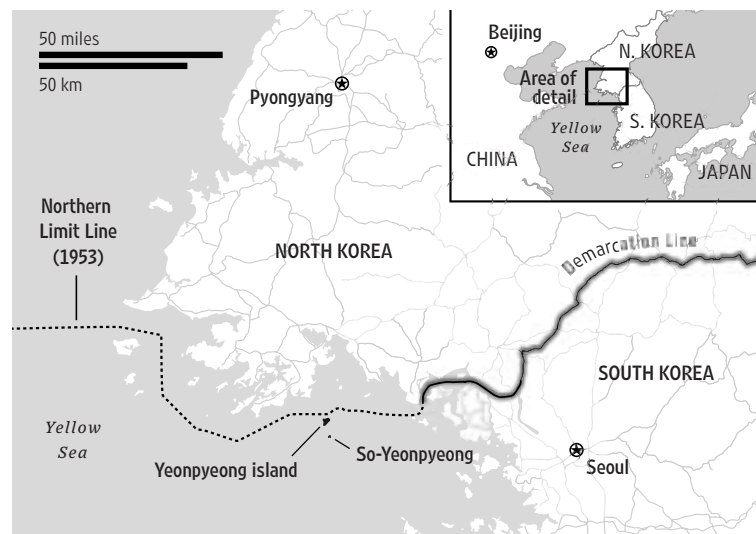
A spokesman for the Ministry of Foreign Affairs in China, North Korea's main benefactor, called for peace and stability. "We hope all involved parties will do more to promote peace on the Korean Peninsula," Hong Lei said during a regular news conference.

U.N. Secretary-General Ban Ki-moon also condemned the attack, calling it "one of the gravest incidents since the end of the Korean War." British U.N. Ambassador Mark Lyall Grant, whose country holds the Security Council presidency, said a council meeting is likely to be held Wednesday.

Relations soured dramatically between the two Koreas over the past two years, as North Korea's totalitarian regime became angered at South Korea's decision to cut off economic assistance unless it ends its pursuit of nuclear weapons. The issue of North Korean nuclear weapons intensified over the weekend after the revelation that Pyongyang had already installed thousands of centrifuges to produce nuclear fuel at its Yongbyon nuclear facility.

The exchange of fire comes less than two months after North Korean dictator Kim Jong Il began a process of transferring power to his son Kim Jong Eun, a process that analysts have said is likely to be volatile as the younger Mr. Kim grapples for authority over the North's military.

The incident roiled financial markets in Asia, briefly sending the U.S. dollar sharply higher before it gave back some gains, on a flight from what are considered riskier invest-



ments. The Bank of Korea convened an emergency meeting to discuss potential effects. Several financial analysts quickly issued reports that said they didn't expect South Korea's stock market to be affected.

The episode adds to a list of more than 30 fatal or life-threatening attacks by the North against the South—including plane bombings, assassinations and naval skirmishes—since the two countries fought the Korean War in the 1950s.

Most recently, a South Korean warship sank in March about 65 kilometers west of the island hit Tuesday. South Korea blamed North Korea for the sinking, citing an exploded torpedo it found and other evidence.

A spokesman for South Korea's Joint Chief of Staff said "scores of rounds" were fired by the North. The artillery was fired from positions south of the North Korean city of Haeju. Video captured by closed-circuit monitoring cameras showed people scrambling out of buildings as explosions rocked the island.

The artillery fire came without warning at 2:34 p.m. local time and lasted for 65 minutes, military officials said. About 250 residents escaped the island in fishing boats and arrived in the port city of Incheon two hours later. As the sun set, fires continued burning in numerous

homes and buildings and smoke covered the island, according to people there and on a nearby island called So-yeonpyeong.

The incident shocked South Koreans, who have become accustomed through the years to provocations by North Korea.

"If this leads to any other provocation, it really will be disturbing in many ways," Song Young-min, an insurance consultant and military reservist, as he watched the news on his cellphone in downtown Seoul.

From the island of So-yeonpyeong, residents watched as the rockets hit the larger Yeonpyeong island.

The two Yeonpyeong islands are the easternmost of five small islands that are just a few kilometers away from the maritime border known in South Korea as the Northern Limit Line, or NLL, drawn up by the United Nations after the end of the Korean War in 1953.

The North has objected to the line since the early 1970s, arguing in part that the line forces its ships to take lengthy detours to international shipping lanes. Its objections led to two deadly skirmishes in the area in 1999 and 2002.

—Joe Lauria, Jieun Shin, In-soo Nam, Aaron Back and Megumi Fujikawa contributed to this article.