WEEKEND JOURNAL.

Travel special issue: Seeking the sun

ALAIN DE BOTTON ON MODERN PILGRIMAGES

PLUS: TINA GAUDOIN'S LUGGAGE GUIDE

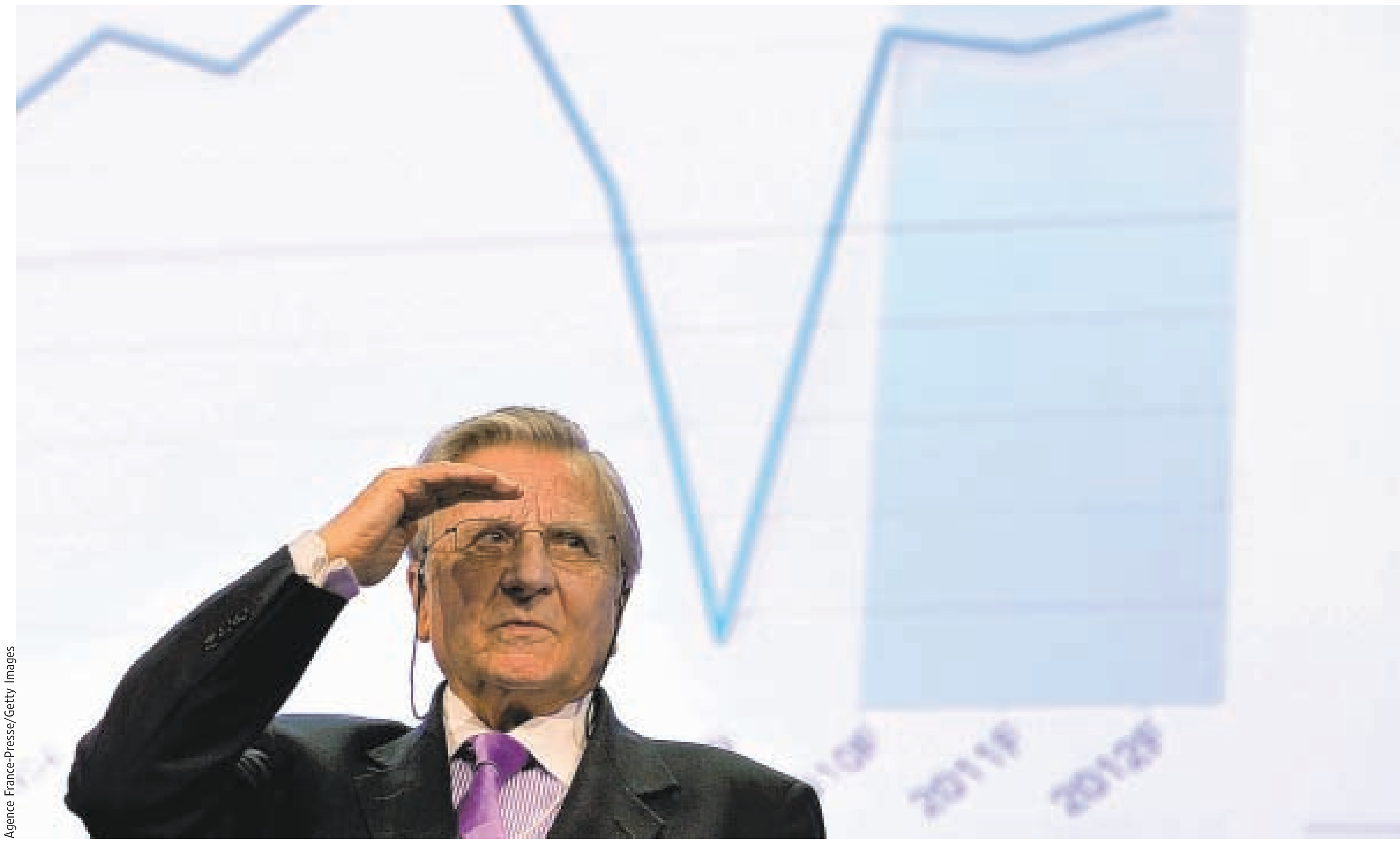
THE WALL STREET JOURNAL.

VOL. XXVIII NO. 253 EUROPE Friday - Sunday, January 28 - 30, 2011

DOWJONES A NEWS CORPORATION COMPANY europe.WSJ.com

Bailout fund's capacity to grow

By Matthew Dalton
And Stephen Fidler



Agence France-Presse/Getty Images

Jean-Claude Trichet, head of the European Central Bank, at the World Economic Forum meeting on Thursday in Davos, Switzerland.

DAVOS, Switzerland—Euro-zone governments will increase the lending capacity of their bailout fund and make it more flexible, but governments won't raise its current €440 billion in guarantees, European Economics Commissioner Olli Rehn said in an interview Thursday.

The likely decision may raise questions about whether there will be enough in the pot to finally put to rest doubts about the fund's ability to provide emergency finance for Portugal, Spain and other countries that might need it.

Some governments had wanted €1 trillion in guarantees to reassure financial markets. If the plan is agreed to, there should be a total of close to €700 billion available, if lending from the International Monetary Fund and other European Union governments is included.

The bailout funds are needed to shore up confidence in the European common currency. In a speech in Davos, French President Nicolas Sarkozy was emphatic in his defense of the euro, saying that those who were forecasting its demise "misunderstand" the nature of Europe.

"The euro is Europe, as Europe is 60 years of peace on our continent," Mr. Sarkozy said, adding in his own name and that of German Chancellor Angela Merkel that "we will never turn our backs on it, we will never abandon it."

The bailout fund—the European Financial Stability Facility—has suffered from an unexpected problem since it was created in late-night negotiations in May: To achieve a top AAA credit rating for the loans it makes, the fund must be overguaranteed by euro-zone member states.

As a result, its actual lending capacity is estimated at around €250 billion.

"Our goal is to reinforce the effective lending capacity of the EFSF and widen the scope of its activities, not to increase the headline figure," Mr. Rehn said in an interview with The Wall Street Journal on the sidelines of the World Economic Forum in Davos.

These discussions aren't likely to be settled at a Feb. 4 summit of EU leaders, Mr. Rehn said.

Final decisions on both the €440 billion ($603 billion) fund and a permanent fund intended to replace it in June 2013 will be taken at a summit late in March, he said.

He said the existing fund

Please turn to page 3

As EMI default looms, Citibank talks with Hands, other buyers

By Dana Cimilluca
And Ethan Smith

Citigroup Inc., which is expected to seize control of **EMI Group** Ltd. from beleaguered financier Guy Hands in coming months, has already made contact with parties that could quickly snap up the music company—and Mr. Hands is among those angling to grab the historic music company.

At the end of March, EMI's performance is expected to fall short of the targets in its roughly £3 billion ($4.79 billion) of borrowings from Citigroup. If, as expected, Mr. Hands fails to come up with the nearly £200 million required to make up for the shortfall, the business will go to Citigroup. The handover is expected to take place three months after a default, but people familiar with the matter say Citigroup is exploring ways to take control of the business sooner.

In anticipation of the company changing hands, and mindful of Citigroup's desire to get back the cash it has tied up in EMI as soon as possible, a number of potential bidders have begun circling. The price tag for all of EMI is expected to be in the range of £1.8 billion.

The most eye-popping name on the list of potential buyers is Mr. Hands, whose Terra Firma Capital Partners LP now owns EMI. Mr. Hands is exploring ways that Terra Firma can maintain an ownership stake in EMI, which under such a scenario might

Please turn to page 18

The Quirk

Editorial & Opinion

ElBaradei in Egypt as protests continue

CAIRO—Nobel Peace Prize laureate Mohammed ElBaradei, viewed by many among Egypt's loose grouping of young opposition groups as a potential leader, arrived in Egypt Thursday night after a third day of battles in several cities between police and protesters.

Demonstrators are planning larger protests for Friday, a day when few Egyptians work. The government said Thursday it is willing to talk with the protesters.

Mr. ElBaradei said he was seeking regime change and was ready to lead the opposition. Last year, Mr. ElBaradei was widely feted as Egypt's best alternative candidate to President Hosni Mubarak.

The White House said antigovernment protests are an opportunity for Mr. Mubarak to demonstrate his willingness to listen to his citizens and make political reforms.

THE WALL STREET JOURNAL.

£1.50

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

04
9 770921 986955

China's leaving Europe in slow lane

[Agenda]

By David Cottle

Deep in their cloisters in Brussels and Frankfurt, what must the Eurofaith's high priests say of the national governments with which they've been forced to deal?

When the doors are shut and the room has been swept for bugs it's not hard to imagine some frankly unpriestly invective unleashed against the heretics and schismatics of Greece, Ireland, Portugal and the rest.

Their travails have stalled the whole project, come alarmingly close to derailing it completely and may yet leave us all wondering what might have been. A little frustration would be only human.

The trouble is, time seems to move so much faster outside the euro zone than within. Global tectonic plates are shifting, China and the other emerging markets surge on at a pace unthinkable to the bloc's previous political generation.

Europe may get its act together and become what it promises to be. But, when China is planning a new conurbation 26 times the size of London, it's hard to avoid the conclusion that it needs to do it soon. While anyone still cares. Certainly before the center of economic gravity is simply too far away.

How trying it must be to have only suggestion, rather than force, with which to chasten the euro zone's bunglers and their tiresome democratic mandates.

It always falls laughably short. Look at the European Central Bank's efforts.

To give the bank its due, officials could hardly come within a mile of a microphone for years without pleading the case for the Stability and Growth Pact.

Under current chief Jean-Claude Trichet and his predecessor, the late Wim Duisenberg, the mantra was the same. Stick with it. Please. Come on, guys.

But plead was all they could do. Compulsion was beyond their power.

If you recall, this benighted agreement was the euro zone's sole defense against charges of being a suboptimal currency area.

It is just that, of course—but, you see, this wouldn't ever matter because member states would Be Good.

European Pressphoto Agency

Presidents Hu and Obama at the White House last week.

> **Neither president gave the impression they'd be clearing anything afterward with Brussels.**

Living by the pact, they would refrain from maxing out national credit cards from which the limit had essentially been abolished, thanks to access to Germany's good name. So relax. The problems of being a suboptimal currency area would never arise. Nothing to see here. Move along.

Yeah, right, as my kids so often say.

Member states didn't listen to the ECB's pleas, of course. They generally preferred to keep the pork moving around their various client voters and to hell with whatever silly agreements they'd signed.

In the end, the poor old pact ended up more honored in the breach than the observance. Last year's persistent and ongoing debt catastrophe was the end result.

Now, according to a couple of reports this week, the International Monetary Fund remains very worried about Europe, despite signs of continuing recovery elsewhere.

Well, you may be thinking, so what? We're all still worried about Europe, aren't we? The bond markets certainly are. Indeed cynical old hands and the generally mischievous might even conclude that, if the IMF is worried, it's probably time to buy.

But in fact the fund's latest squeaks of concern come at a bad time for the Eurofaith's true believers.

Last week saw Presidents Obama and Hu greeting each other as equals in Washington, a telling measure of how quickly China is growing in America's rear-view mirror. It's still distant, for sure. But there's clearly nothing much in the way. Certainly not Europe.

Consider that for a second. The European Union has a larger nominal GDP than the U.S. and, for the moment, greater military reach than China. More aircraft carriers, higher-tech equipment, all that stuff.

To the faithful, these numbers mean Europe demands a seat at a global top table now exclusively the property of these two titans. But they know it hasn't got one.

Messrs. Obama, Hu and their entourages came out of the Washington trip as shapers of New World Order. Bad news for a union whose very reason to exist is to keep one pole of a multipolar world firmly planted in the old continent.

Neither president gave the impression they'd be clearing anything afterward with Brussels, from the Oval Office, perhaps, or the jet home to Beijing.

And yet, what is Europe doing? What it is usually doing. Looking inward, trying to resolve those internal contradictions Milton Friedman was always so worried about.

You can't be part of a New World Order if you are always condemned to remain at home, engaged in the diplomatic equivalent of washing your hair, as it seems Europe will be for a very long time to come.

We are already far from the lofty ambitions of the Eurofaith's founding fathers. They dreamed of making the virtue of global economic leadership out of what they deemed was the necessity of monetary union.

Remember their reveries of oil priced in euros? And then on, on, with commodities falling one by one to the inevitable until the dollar was unseated and replaced at the summit.

Now mere survival is the endgame as Europe gropes for a means of compulsion it should have had in the first place.

And oil? Straight from dollars to yuan in due course. Do not pass Brussels, do not collect two hundred euros. If they even still exist.

What's News

■ **BP was hit** with a legal challenge to its recent share-swap deal with Rosneft as the Russian partners in the U.K. company's TNK-BP joint venture sought an injunction to block the transaction. 17

■ **A U.S. panel** investigating the 2008 financial crisis blamed failures in financial regulation, flaws in corporate governance, and excessive borrowing as key elements leading to the meltdown. 9

■ **U.K. consumer confidence** collapsed at the start of 2011, a GfK survey found, raising fresh doubts about the sustainability of the recovery. 4

■ **German inflation** quickened in January, adding to evidence that energy and commodity prices are pushing euro-zone inflation further above the ECB's target. 5

■ **Prada plans to list** in Hong Kong, the Italian fashion house's latest attempt to break a long cycle of ditched stock-market listings. 17

Inside

Whatever you do, don't buy an airline ticket on... **27**

Young football stars are getting the big bucks. 28

ONLINE TODAY

Most read in Europe

1. Why Chinese Mothers Are Superior
2. Euro, Pound Face Inflation
3. Greece's Cosseted Classes Fight Red Tape Reform
4. Barclays Plans U.K. Job Cuts
5. Why Rich Parents Don't Matter

Most emailed in Europe

1. Why Chinese Mothers Are Superior
2. Greece's Cosseted Classes Fight Red Tape Reform
3. Opinion Europe: Johnny Munkhammar: The Swedish Model
4. Don't Buy an Airline Ticket On..
5. Couture Gets Tails Wagging

Davos Live

blogs.wsj.com/davos

'I certainly never expected to talk about my parenting skills, or lack thereof, at the World Economic Forum.'

Continuing coverage

Follow the latest news from the World Economic Forum at **wsj.com/davos**

Question of the day

Vote and discuss: How often do you watch TV shows and movies online?

Vote online today at **wsj.com/polls**

Previous results

Q: Do you expect any major achievements to come out of the annual meeting in Davos?

Yes	3%
Maybe	8%
No	89%

THE WALL STREET JOURNAL EUROPE
(ISSN 0921-99)
Commodity Quay, East Smithfield,
London, E1W 1AZ

SUBSCRIPTIONS, inquiries and address changes to: Telephone: +44 (0) 20 3426 1234. Calling time from 8 a.m. to 5 p.m. GMT. E-mail: subs.wsje@dowjones.com. Website: www.services.wsje.com

ADVERTISING SALES worldwide through Dow Jones International. Frankfurt: 49 69 29725 390; London: 44 203 426 1111; Paris: 331 40 17 17 01.

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

Registered as a newspaper at the Post Office.

Editeur responsable: Patience Wheatcroft M-17936-2003.

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

NEWS

Christie's sales rise as art rebounds

BY KELLY CROW

Christie's International PLC said it sold £3.3 billion ($5.25 billion) of fine and decorative art last year, up 53% from 2009 and surpassing its £3.1 billion in sales during the art market's prior peak in 2007.

The latest figures from the auction house indicate that collectors spent more on art last year than they did before recession hit the art market, thanks in large part to new buyers from the U.S. and Asia. Art experts say these newcomers have been buying luxury goods for years but have only recently started to invest in blue-chip paintings. Other collectors are amassing art now because they saw values soar a few years ago and bet they will profit from any run-up this time around.

Christie's Chief Executive Steven Murphy credited the auction house's performance to a "perfect storm" of factors, from the 23% uptick in first-time bidders last year to the availability of coveted, postwar pieces coming out of American estates built a half-century ago.

The estate of Los Angeles-based collectors Sidney and Frances Brody gave Christie's its biggest success of the year when one of the couple's trophies, Pablo Picasso's 1932 portrait of his mistress, "Nude, Green Leaves and Bust," sold for $106.5 million in May, the highest price ever paid for a work at auction.

Overall prices were up for all of the auction house's major art categories, including £766.6 million in Impressionist and modern art, up 53% from 2009; £602.6 million in postwar and contemporary art, up 148%; £569.6 million in Asian art, up 145%; and £334.2 million in jewelry, jadeite and watches, up 55%.

Christie's major sales hubs around the world fared well. The company sold £1.3 billion in the U.S., more than doubling its total from the year before. Sales across Europe totaled £1.1 billion, up 9%. Asia also continues to gain clout, with Christie's selling £465.8 million in Hong Kong last year, up 114%.

Hong Kong real-estate billionaire Joseph Lau paid Christie's £10.7 million for a pair of imperial cloisonne enameled crane censers, a type of incense vessel, during a Hong Kong sale in December.

Not all markets are rocketing like Asia's, however. Christie's sales were flat for Russian and Latin American art, along with its sales of collectible books and manuscripts.

Reuters

A man looks at an enameled flask from Christie's Hong Kong sale.

Europe official says rescue fund to boost lending

Continued from first page

would be altered to "reflect several though maybe not all of the general features" of the post-2013 fund.

He said governments wished to package proposals for both funds so as avoid asking national parliaments more than once.

The key sticking point to expanding the fund's headline size has been objections from Germany, Finland and the other stronger euro-zone nations to putting more taxpayer funding on the table.

"I'm not ready to open a discussion on euro-bonds or increasing the size of the EFSF," Finnish Prime Minister Mari Kiviniemi said in an interview in Davos.

Mr. Rehn said one issue being discussed was whether to use a development-bank model to finance the fund. Government shareholders of the World Bank and other development banks pledge capital to finance the banks, allowing them to borrow in the financial markets. But they only pay in a small proportion of the total, so it doesn't have a big impact on budgets.

Discussions to increase the fund's effectiveness include proposals to allow the fund to lend early to preempt a crisis and to finance government bond purchases.

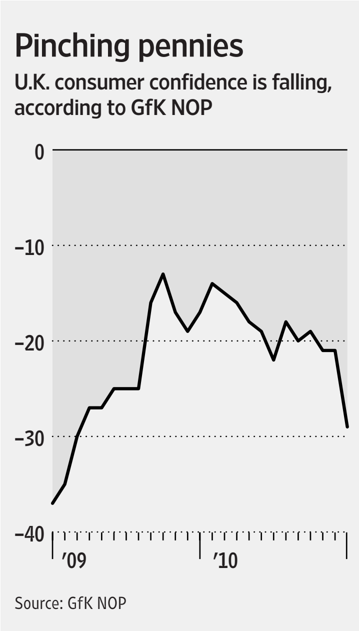
Euro-zone government debt is a key factor in talks on a new round of bank stress tests that are expected to begin in a matter of weeks. The new tests, to be published in June, must be more rigorous than last year's tests, which have been questioned for giving Irish banks passing grades, Mr. Rehn said. The commission wants EU national governments to have funds ready to recapitalize their banks as Spain has done, Mr. Rehn said, hinting some banks that passed last year's tests would fail this time.

"We are encouraging the member states to ensure they have the necessary national financial backstops in case the stress tests reveal a weakness of capitalization," he said.

One of the most contentious issues surrounding the tests is whether they should include an economic scenario in which one or more euro-zone sovereign governments default on their debt.

—Geoffrey T. Smith and David Enrich contributed to this article.

EUROPE NEWS



Agence France-Presse/Getty Images

Oxford Street in London this month. Sales growth continues to decline.

Consumer confidence in U.K. falls, retail sales growth slows

By Paul Hannon
And Alex Brittain

LONDON—U.K. consumer confidence collapsed at the start of 2011, raising fresh doubts about the sustainability of the economic recovery.

Polling firm GfK NOP Friday said its main measure of consumer confidence fell to -29 in January from -21 in December to reach its lowest level in 22 months.

Consumers became far more pessimistic about the outlook for the economy in the coming 12 months, about their personal financial prospects and more reluctant to make major purchases, the survey says.

That suggests consumers will tighten their belts further in response to the prospect of big job losses in the public sector, wages that fail to keep up with inflation and higher taxes.

The U.K. economy contracted in the final three months of last year, and the sharp fall in consumer confidence makes it unlikely that it will experience a strong rebound in the first quarter of this year.

"January's eight point drop represents an astonishing collapse in consumer confidence," said Nick Moon, managing director of GfK NOP Social Research. "In the 35 years since the index began, confidence has only slumped this much on six occasions, the last being in the midst of the 1992 recession."

GfK carried out its survey between Jan. 7 and Jan. 16, before the Office for National Statistics delivered the surprising news that the economy shrank by 0.5% in the fourth quarter of 2010.

That news is likely to further weaken confidence in February.

The Confederation of British Industry Thursday said retail sales growth slowed in January, and is expected to continue to decelerate. Its monthly measure of sales volume fell to +37 in January from +56 in December, the weakest reading in three months.

The balance is the percentage of respondents reporting higher sales than in the corresponding period the previous year minus the percentage reporting weaker sales.

Consumers became far more pessimistic about the economic outlook, about their own financial prospects and more reluctant to make major purchases, a survey says.

"Consumer demand is expected to be weak in the coming months, as the spending power of households is hit by a combination of sharply rising prices and weak wage growth," said Ian McCafferty, chief economic adviser to the CBI. "Retailers can expect a challenging period ahead."

The fall in consumer confidence will once again raise questions about the wisdom of the government's plans to cut its huge budget deficit, which involve tax increases and spending cuts of some £111 billion over the next four years.

The opposition Labour Party has argued the government is moving too fast, and that its plans will backfire if the U.K. enters a double-dip recession, since weak growth reduces tax revenue and makes cutting the deficit more difficult.

However, the government Tuesday received backing from Bank of England Governor Mervyn King, who said it must stay the course. The bank has left its key interest rate unchanged at a record low of 0.5% since March 2009, despite an inflation rate that has risen well above its 2.0% target. The fourth-quarter contraction alongside indications that consumer demand will weaken mean the bank is unlikely to raise its key interest rate soon.

Five held in hacking investigation

By Cassell Bryan-Low

LONDON—U.K. police arrested five people linked to an online collective known as "Anonymous," a group behind recent attacks on companies and individuals that tried to impede the work of WikiLeaks, the document-leaking organization.

London's Metropolitan Police Service said it had arrested the people, who are males age 15 to 26 years old, in dawn raids Thursday at their homes.

The arrests relate "to recent and ongoing 'distributed denial of service' attacks by an online group calling themselves 'Anonymous,' " the police said. In such attacks, computers flood a server to prevent it from displaying a Web page.

The police said the arrests were part of a continuing investigation into the group, which began last year following reports of attacks it allegedly carried out "against several companies."

A police spokeswoman declined to identify the companies or comment on whether the arrests were related to the pro-WikiLeaks attacks specifically. The British police did say that their probe is being carried out together with law-enforcement agencies in Europe and the U.S.

Last month, a number of organizations and individuals sustained online attacks in what appeared to be an effort by hackers trying to exact revenge on behalf of WikiLeaks. Victims included **MasterCard** Inc. and **Visa Europe**, both of which had recently suspended payments to the website.

The companies had taken those steps against WikiLeaks against a backdrop of the site's showdown with the U.S. government over WikiLeaks' release of thousands of classified documents.

The attacks increased in intensity following the arrest in London of WikiLeaks founder Julian Assange in connection with sexual-misconduct allegations in Sweden. Mr. Assange, who is fighting extradition to Sweden, has denied the allegations and hasn't been formally charged.

Attacks also were launched at organizations and individuals connected with Mr. Assange's personal legal troubles.

That included the Swedish prosecutor's office and a lawyer representing the two women making allegations against Mr. Assange.

Following the attacks, Dutch police arrested two people in December that they linked to Anonymous. One of them was a 16-year-old male who Dutch police say was involved with the attacks on MasterCard and Visa.

The second was a 19-year-old male who allegedly had attacked the Dutch prosecutor's website in sympathy with the WikiLeaks hackers, authorities say.

Both have been charged with computer-related crimes and await trial, said Wim de Bruin, a spokesman for the Dutch prosecutor's office. He said Dutch police have been working with law enforcement in the U.S. and elsewhere in Europe.

"Anonymous" is well known to U.S. law enforcement, which in the past two years has successfully prosecuted at least two individuals that participated in the group's attacks on the Church of Scientology.

Computer specialists describe "Anonymous" as a loose-knit collective, which doesn't have a centralized hierarchy or chief, but communicates via Internet chat rooms and recruits new members through social networking sites like Twitter.

Its supporters have taken up wide-ranging campaigns in recent years including against the Church of Scientology and antipiracy groups, but security specialists believe it is likely that there are different individuals conducting the pro-WikiLeaks attacks than previous "Anonymous" campaigns.

Germany's plan: hitting debt brake

[Brussels Beat]

By Charles Forelle

The euro zone's crisis response is on the cusp of a second phase.

Phase One involves vigorous emergency budget-slashing and the bailing out of those stragglers whose efforts don't convince debt markets they're worth lending to. This phase may not be over.

Phase Two hasn't yet begun. It is to remake the euro zone in Germany's image. At least, that's what the Germans want, and the drama of this winter and spring will be how much of it they get. (Berlin has made dealing with Phase Two a condition for putting an end to Phase One.)

Germany has a wish list of tough new economic reforms it wants everyone else to undertake. None will be easy. Some—like the end of inflation-indexed wages—threaten to recast Europe's social fabric and rewrite the relationship between the state, workers and employers. Heady stuff that's hard to wrap up in a few meetings of technocrats and ministers in Brussels.

Take the idea of balanced-budget provisions. Germany has one, a so-called debt brake that comes into operation this year. Its rules are relatively simple: The federal government may run a "structural deficit"—the deficit excluding the effects of boom or recession—of no more than 0.35% of gross domestic product; any deviations from that level are logged, and once the accumulated balance reaches a set level, new borrowing to fund the structural deficit is restricted.

This may work in Germany. But what about elsewhere?

The data show that the bulk of euro-zone countries would struggle mightily to match Germany's fiscal restraint. Berlin is phasing in the structural-deficit requirement between this year and 2016. It's at least close to its target. Using the European Commission's procedure for calculating structural deficit, Germany is projected to report one of 1.4% of GDP next year.

The Netherlands, Finland and Luxembourg are the only other euro-zone countries expected to have a structural deficit below 2%. Greece? 4.7%. Spain? 4.8%. Portugal? 4.3%. Ireland? 8.9%.

Indeed, of the 17 euro-zone countries, only nine have ever met the 0.35% figure even once. (They are Germany, Estonia, Ireland, Spain, Cyprus, Luxembourg, the Netherlands, Austria and Finland.)

Notably absent from the list is France—the only triple-A-rated euro-zone country to run structural deficits persistently.

France's Nicolas Sarkozy has voiced support for constitutional debt limits, and last year he proposed requiring the French government to set five-year deficit targets. Still, it's a long way to a German debt brake.

Bloomberg News

An employee stocks shelves at a supermarket in Berlin. German consumer-price inflation rose in January.

Germany's inflation hits a two-year high

By Nina Koeppen
And Christopher Emsden

FRANKFURT—German inflation accelerated in January to its highest rate in over two years, adding to evidence that rising energy and commodity prices are pushing euro-zone inflation further above the European Central Bank's target.

Meanwhile, a top ECB official warned Thursday that rising costs of imported goods into the euro bloc, coupled with higher food and commodity prices, can't be dismissed by central bankers, stoking fears that the ECB may raise interest rates this year.

The euro rose on the comments by ECB board member Lorenzo Bini Smaghi. Expectations of higher interest rates tend to push up a currency's exchange rate.

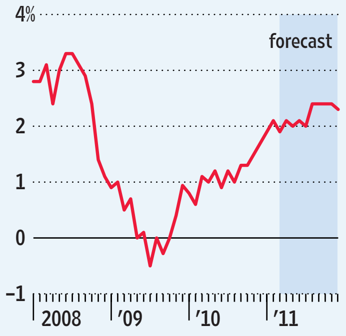
Annual consumer-price inflation in Germany rose to 1.9% in January from 1.7% in December. That is the highest annual gain since October 2008, when prices rose 2.4%, Germany's statistics office said.

"As already seen during the course of 2010, the inflation rate in January was led by strong price increases for heating oil and fuel, but also for fruit and vegetables," the statistics office said.

Price increases were more subdued than many economists had expected due to heavy postholiday discounts on clothing and lower prices for package holidays.

Inflation worries

Germany's inflation, change from previous year



Source: UniCredit

Still, analysts say the trend throughout the euro bloc is toward higher inflation as the effects of rising food, energy and raw materials prices filter through. Consumers are already feeling the pinch. In a monthly survey from the European Commission, consumer inflation expectations rose to their highest level in more than two years. If workers are able to negotiate higher wages in response to inflation, it could push prices even higher, in what the ECB calls "second-round" effects.

Inflation across the 17-member euro zone is already at a two-year high of 2.2%, above the ECB's target of just under 2%. Based on the German figures, inflation should rise again in January, economists say.

"If there is any euro-zone country where the risk of second-round effects from energy and food prices is imminent, then it is Germany," said ING Bank economist Carsten Brzeski. "After 10 years of wage moderation, strong economic growth and dropping unemployment will lead to stronger wage growth this year, increasing the headache" for ECB officials, he says.

ECB officials have elevated their anti-inflation rhetoric over the past two weeks, signaling they are willing to raise rates if inflationary pressures take hold despite economic weakness in the euro bloc's fragile periphery, including Ireland, Greece, Portugal and Spain.

Mr. Bini Smaghi escalated the tough talk. In a speech, he warned that commodity prices can be "expected" to grow in line with global economic growth rather than the more anemic pace of the euro area, while the benign disinflationary price effect of manufacturing goods imported from developing countries "seems to have ended."

Ukraine charges opposition leader

By James Marson

KIEV, Ukraine—Prosecutors opened a second criminal case against Ukrainian opposition leader Yulia Tymoshenko Thursday, raising the pressure on the former prime minister, who claims the investigation is politically driven.

The state prosecutor's office accused Ms. Tymoshenko of abuse of office in causing losses of $8.5 million to the Treasury during the procurement of vehicles for use as ambulances in 2009. Prosecutors said Ms. Tymoshenko had exceeded her power by importing 1,000 Opel Combo vehicles, which weren't designed for medical use.

Authorities have said the vehicles were used for political campaigning during Ms. Tymoshenko's run for the presidency last year. She lost in a runoff to Viktor Yanukovych.

She had already been charged with abuse of office in a separate case. She denies the allegations in both cases.

"They have fabricated another case against me," Ms. Tymoshenko told reporters Thursday as she left the prosecutor general's office in Kiev. "It's a criminal move," she added, repeating claims that the investigations amounted to "political repression."

Ms. Tymoshenko, who held office from 2007 to 2010, has come under increasing pressure from Mr. Yanukovych since he took office as president in February and then ousted her from the government.

Mr. Yanukovych has since engineered a constitutional change enabling him to fire the prime minister and other cabinet officials. He has further consolidated his power by appointing allies to head the security service and prosecutor's office.

Critics have accused him and his allies of intimidating opposition groups and overseeing attacks on press freedom, contentions his administration denies.

Ms. Tymoshenko has been called in for questioning more than 15 times since the start of December. In the other case, she is accused of misspending $520 million in government funds allocated for environmental projects.

U.S. and European Union officials have raised concerns that investigations of opposition politicians in Ukraine are selective and politically motivated.

Valeriy Khoroshkovskiy, Ukraine's security service chief, has denied any political motivation to the investigations. "We haven't got a separate legal code for members of the opposition," he said in a recent interview. He played down Western criticism of investigations of opposition figures, saying he saw it as a call for dialogue.

Mr. Khoroshkovskiy said the government was committed to fighting corruption, noting the arrest last year of a deputy minister from the current government, who is still being detained.

Speaking in parliament recently, Interior Minister Anatoliy Mohyliov said criminal cases had been launched against 115 members of the pro-Yanukovych Party of Regions and 73 against members of Ms. Tymoshenko's party.

Mr. Khoroshkovskiy, a close ally of Mr. Yanukovych, said Ms. Tymoshenko was complaining of attacks on democratic freedoms to distract attention from her alleged wrongdoing.

Political observers are uncertain whether the authorities will jail Ms. Tymoshenko.

Reuters

Opposition leader Yulia Tymoshenko, right, greeted supporters this month.

Spain nears broad support for overhaul of pensions

By Daniel de la Puente
And Jonathan House

MADRID—Spain's government is close to winning broad support from opposition parties and unions for a pension-system overhaul aimed at putting public finances on a more stable footing and shoring up investor confidence in the country's ailing economy.

A spokesman for Prime Minister José Luis Rodriguez Zapatero said Mr. Zapatero has spoken with opposition leader Mariano Rajoy about the plan and that Mr. Rajoy has agreed to support at least some parts of it, though the spokesman didn't specify which ones. Mr. Zapatero's Socialist party doesn't have a parliamentary majority. Comisiones Obreras, the country's largest union, also said an agreement on the overhaul was close.

The government Friday at its weekly cabinet meeting will approve draft legislation that will raise the country's retirement age to 67 from 65, a change that was fiercely opposed by unions, which threatened to call the country's second general strike in less than six months.

To win the unions' support, the government has agreed to allow workers to retire earlier than 67 in certain cases.

Spain has come under intense pressure in recent months from the European Union and financial markets to take measures to narrow a double-digit budget deficit and stimulate economic growth following the collapse of a decadelong housing boom. The measures have been made more difficult by Mr. Zapatero's lack of a parliamentary majority. The prime minister pushed through a new package of austerity measures in May by a single vote.

Though the country's pensions system is currently healthy, a rapidly aging population presents it with one of the European Union's biggest long-term challenges. Spain's parliamentary commission on pensions estimates the number of people collecting a pension in Spain could nearly double to 17 million in the year 2050.

Once the government approves the legislation Friday, it will send it to parliament for debate. Earlier this week, Spain's parliament signed off on reform recommendations made by the pensions committee, which are broadly similar to those of the government.

■ Financial crisis forces a close look at pension reforms 7

Grumbling at BofA pay shift

By Dan Fitzpatrick
And David Enrich

Bank of America Corp. intends to give some investment bankers a greater share of their bonuses in cash, the latest Wall Street compensation move irking banking chieftains as they meet in Davos, Switzerland.

Bankers and traders making more than $5 million at the nation's largest bank by assets could receive as much as 30% of their year-end payout in cash, with at least 70% in deferred stock. Some could see a stock award of as much as 80% and 20% in cash.

. Those are more generous cash payments than the 5% the highest-paid investment bankers received in 2009. But last year's level was unusually low because the bank was restricted by federal pay rules as a condition of the $45 billion it received in U.S. aid.

Still, multiple bank executives gathered at the World Economic Forum in Davos grumbled that Bank of America would increase the cash portion of bonuses—news that traveled fast once the bank's employees were told.

Bloomberg News

Brian Moynihan, Bank of America's CEO, speaks at the Davos forum Thursday.

But Bank of America's terms are strikingly similar to those of **Credit Suisse Group**, for example. The Swiss bank defers all of the pay of its executive-board members. That's no different than the terms for direct reports of Bank of America's chief executive, Brian Moynihan, according to people familiar with the situation. The highest-paid managing directors at Credit Suisse, like Bank of America, will have 70% to 80% of their compensation deferred.

The rancor, despite the similarities in terms, is symptomatic of the highly charged issue of compensation, which took center stage at Davos. European bank executives gathered in the Alps this week are up in arms over the lack of similar rules governing payouts by their U.S. rivals.

"It's not a level playing field," said William Vereker, co-head of global investment banking at Nomura.

Such complaints are particularly acute from European bankers, who have to comply with new European Union requirements that bonuses be made up primarily of stock or other noncash instruments and must be deferred for at least three years. The most cash that can immediately be awarded is 20% of the overall payout.

U.S. regulators haven't yet settled on rules governing pay. Because the rules don't yet exist, U.S. policies are perceived as much more lenient than those across the Atlantic.

That doesn't mean there isn't plenty of sniping among U.S. banks. Within hours of recent compensation announcements, rivals griped that firms went too far in enriching their employees.

One banker, fearing that a rival firm was boosting base salaries, called it "absurd" to guarantee bigger pay regardless of the bank's future performance. After **Morgan Stanley**'s investment-banking division and **Goldman Sachs Group** Inc. announced that their 2010 compensation would be 43% and 39% of revenues, respectively, bankers at one rival firm, which paid less, blanched.

Goldman and Morgan Stanley declined to comment.

Their fear is that differences in pay between firms could make it harder to retain employees in search of better compensation. U.K.-based **HSBC Holdings** PLC has threatened to move its headquarters elsewhere because of regulations that include compensation curbs. The bank said it lost roughly a dozen employees to competitors with more lax pay rules.

Pressure in the U.S. to rein in pay has endured since the financial meltdown. The Financial Crisis Inquiry Commission, which issued a report on Thursday on the causes of the market meltdown, repeatedly spotlighted the role of Wall Street compensation systems in fueling excessive risk-taking. Financial-sector compensation, which generally equaled other paychecks in the half century after the Great Depression, rose to a level 80% higher between 1980 and 2007, the report said.

The FCIC noted that "the securities industry has reported record profits and is once again distributing large bonuses."

In Europe, banker bashing remains popular among politicians.

Despite the griping over Bank of America's compensation structure, the company seems sensitive to the coming regulatory rules. Even though some bankers are receiving more cash, the total bonus pool for investment bankers and traders was down in 2010 as compared with 2009, said people familiar with the situation. In 2009, the pay for investment bankers and traders was more than $4 billion.

"We feel that our pay practices are fair and appropriate for our employees and our shareholders," a Bank of America spokesman said.

Even though the bank lost $2.2 billion in 2010, its investment-banking and trading units earned $6.3 billion.

Mexican leader hits at tweaking of currency

By Stephen Fidler

Mexican President Felipe Calderón warned Thursday of the dangers of currency manipulation by emerging economies, saying his government had no plans to join the growing trend.

He also pledged he wouldn't back down from a crackdown on drug traffickers that has sharply raised the country's murder rate.

In an interview with The Wall Street Journal at a meeting of the World Economic Forum in Davos, Mr. Calderón said Mexico respected market judgments and wouldn't intervene to try to depress the value of its currency.

Countries including China, Brazil and Turkey have taken measures to keep their currency values lower or to stop capital inflows.

"We are not intervening, we are not establishing taxes to do this, we are not manipulating the currency," he said.

He said he had concerns about the growing number of countries intervening in this way.

"Of course we have a concern....In my opinion, the state interventions in currency markets sooner or later become too dangerous for a country," he said.

The Mexican peso has appreciated against other currencies, but the authorities haven't faced the waves of capital experienced by countries such as Brazil and Turkey.

One reason is that Mexico's interest rates of about 4% are roughly the same level as inflation, and are lower than many other emerging economies.

Mr. Calderón pledged he wouldn't let up on a crackdown on drug traffickers that has led to a sharp jump in homicides, to more than 15,000 last year.

He said he believed the country had passed an "inflection point" in 2010, with drug-related killings beginning to fall from the middle of the year.

This followed a pattern seen when traffickers were confronted in Colombia—but in much less time, he said.

Twenty out of 37 drug kingpins had been imprisoned or killed since the government put out a "Most Wanted" poster two years ago. He said this had caused instability and violence within drugs gangs.

"The gangs are becoming weaker, they are losing capacity of maneuver, and losing capacity of leadership. That's part of my duty. Of course, I'd like to do the duty without the secondary impact" of a high murder rate.

He added: "For me there is no choice. The duty is to fight crime particularly organized crime, otherwise they will take control of the important parts of the government or important parts of the country. So we'll act on time to fix the problem. The alternative doesn't exist."

Asked about immigration, the touchiest topic in U.S.-Mexican relations, the president said he hoped there would be a renewed effort to find a solution for the millions of Mexican immigrants "who are providing services to the American economy."

What was happening in panel discussions

[Davos Dispatches]

Dispatches from
blogs.wsj.com/Davos

J.P. Morgan chief bemoans bankers' rep

A plaintive cry from one of the world's top bankers on behalf of his industry pierced through an otherwise tame panel discussion here: "I don't lump all media together," said Jamie Dimon, chief executive of J.P. Morgan Chase & Co. "There's good and there's bad. There's irresponsible and ignorant and there's really smart media. Well, not all bankers are the same. And I just think this constant refrain 'bankers, bankers, bankers,'—it's just a really unproductive and unfair way of treating people."

Mr. Dimon was responding to a question from moderator Fareed Zakaria on why banks haven't increased their lending significantly post-crisis.

Mr. Dimon mounted an emotional, minutes-long defense of his industry, which has been the target of public outrage after needing hundreds of billions of dollars of taxpayer support during the financial crisis.

Mr. Dimon argued that J.P. Morgan was one of the good banks; he implied that it didn't need to accept money from the Troubled Asset Relief Program, the much-reviled government fund that provided hundreds of billions of dollars in capital to U.S. banks. And he portrayed the bank's decision to buy Bear Stearns in 2008 as something like an act of kindness to the U.S. government.

Critics would argue that even if J.P. Morgan itself didn't need capital from TARP, the collapse of many of its trading partners would ultimately threaten its existence.

—Matthew Dalton

China Inc. makes splash with Mandarin session

The panel, "The Future of Chinese Enterprises," like most other China-focused programs at the World Economic Forum, enjoyed a packed conference room. But instead of hearing valuable advice on how China's many struggling private enterprises will survive, the audience got an earful of lecturing by a senior government official and a top state-owned firm executive in defense of a state-run economy.

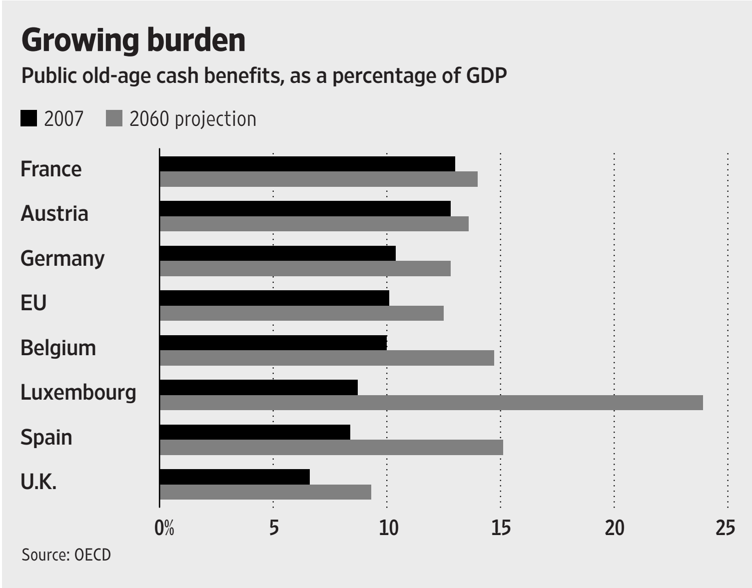
Peng Sen, vice chairman of the National Development and Reform Commission, Beijing's top economic planning agency, listed statistics that showed the importance of China's private sector: 90% of the country's enterprises, in terms of absolute numbers, are private; 51% of the country's total investment last year came from the private sector. He didn't mention that the country's most important sectors, such as infrastructure, resources, banking and telecommunications, are dominated by state-run firms.

Yu Rumin, chairman of Tianjin Port Co., China's third-largest port operator, was challenged by the moderator, a professor and central bank adviser, with an unexpected and unusual joke. Li Daokui, the moderator, asked Mr. Yu: "Somebody told me that even if you spend a whole month playing golf and letting a puppy run your company, the latter will still be able to make a lot of money, because life is simply too easy for state-run enterprises."

Mr. Yu didn't seem offended but he argued that state-run firms aren't what they used to be. "Many SOEs are listed companies now and we operate in the way that the capital market requires us to," Mr. Yu said.

—Shen Hong

European Pressphoto Agency



A demonstration against pension changes Thursday in Bilbao. Spain is among a number of EU countries that have pension systems expected to pose major economic burdens over the next decades.

Crisis forces look at pension reforms

By Matthew Dalton

The global economic crisis has forced policy makers to confront a long-simmering problem fraught with political danger: the growing burden that public pension systems are placing on government budgets in an era of large deficits and mounting debt.

With the global elite gathered in Davos this week, there is much fretting about the threat to the developed world's public finances posed by their aging societies and slow postcrisis economic growth. Doubts about governments' ability to pay pension benefits are central to these worries.

Public retirement plans have helped sharply reduce poverty rates among the elderly across the developed world over the past 60 years and few politicians have risked the electoral backlash that would likely arise from an effort to cut pension benefits.

But now, national and local governments in the U.S. and Europe—nudged and in some cases forced by the crisis—are moving to pare back these plans in ways that might have been politically unthinkable a few years ago.

"The crisis took a system that was rather stressed at the seams and broke some of the seams," said Nicholas Barr, an expert on pensions at the London School of Economics.

In Europe, even countries with healthy budget positions are being forced to reform their pension systems. The European Commission said in 2009 that it expects Luxembourg, which boasts one of the European Union's lowest budget deficits, will see pension payments chew up nearly 25% of gross domestic product in 2060, tied with Greece for the largest pension burden in the EU.

The sovereign-debt crisis has prompted Greece, under pressure from the EU and the International Monetary Fund, to raise the minimum retirement age and cut benefits, prompting violent protests in the streets of Athens.

A number of other EU countries have pension systems that the European Commission expects will pose major economic burdens over the next 50 years: Spain and Belgium are both expected to spend around 15% of GDP on public pensions; Slovenia is expected to pay nearly 19% of GDP; and Ireland is seen spending roughly 11% on pensions.

Rising numbers of retirees, sharp economic contractions during the economic crisis and overly generous pension promises have, to varying degrees, put severe strains on these systems.

Labor unions have been the staunchest opponents of efforts to cut benefits. Union officials say cuts aren't inevitable if governments can engineer higher economic growth and employment rates, which would maximize the number of workers paying into the pension system.

Spain's government is expected on Friday to approve draft legislation that will raise the country's retirement age to 67, up from 65 currently.

"The battle is not only to raise birth rates," said Henri Lourdelle of the European Trade Union Confederation. "The true battle is to raise productivity, to raise employment, to raise investment."

Raising the retirement age is one of the main steps being pushed by EU governments.

With people living much longer than they did 50 years ago, a higher retirement age would simply maintain the ratio of working years to retirement years.

But critics note that wealthier people have seen most of the gains in life expectancy. A higher retirement age would disproportionately reduce benefits to poorer, less-educated workers.

Nevertheless, a higher retirement age needs to be part of pension reforms, says Mr. Barr of the London School of Economics.

"You can't let that sad fact immobilize pension policy forever," he said. "Unless it's part of the story, the rest is a waste of time."

Spain's government Friday is set to approve draft legislation that will raise the country's retirement age to 67 from 65 currently. To win unions' support, the government has offered the possibility of workers retiring earlier than 67 in certain cases.

In the U.S., state and local governments face a looming crisis in their ability to pay benefits, experts say. As with other pension funds around the world, the crisis knocked their investment portfolios, exacerbating the funding challenges that already existed because of the growing number of U.S. retirees whose benefits must be paid.

Some estimate that the gap between current U.S. state and local pension assets and future obligations to pay benefits is more than $3 trillion. But this figure depends heavily on the return that pension funds will earn in the coming decades.

The $3 trillion estimate assumes that funds will earn only the "risk-free" rate: the return that comes from investing in U.S. Treasury bonds and other super-safe government securities.

Most funds invest more aggressively and can expect to earn higher returns, which will do much to close the funding gap.

But this is a dubious strategy, says Doug Elliott, a Brookings Institution expert on pensions. It carries a significant risk that state and local pensions—which are mainly "defined benefit" plans that guarantee payments to retirees for as long as they live—won't be able to make promised payments if their more aggressive investment strategies don't yield the promised returns.

Attendees brave the snow with fanciful footwear

By Tracy Corrigan

A lot of planning goes into every visit to the World Economic Forum, the annual gathering of movers and shakers at the stunning Swiss ski resort of Davos. Which clients to meet, which events to sponsor, which parties to attend.

However, the world's business leaders appear to have spent very little time worrying about what to wear.

Some of us are wasting hours a day changing from snow boots or green rubber boots to more elegant shoes and back again, in order to rush through Davos's snowy streets from a meeting in one hotel to lunch at another.

But the world's top executives didn't get where they are today by fussing with footwear. Instead, they have come up with a simple strategic solution—stick with a favorite business suit, dark gray or black, and shelve the shoes.

WSJ reporters

Bank executive Jamie Dimon, left, chose practicality, while others tried for fashionability or no statement at all.

Instead, a weird range of snow boots, sneakers, climbing shoes and hiking boots is on display in the halls and meeting rooms of Davos, as bankers debate the dangers of excessive regulation and economists worry about slow growth and rising inflation.

The dark suit/snow shoe combination isn't a good look, but what it lacks in style it makes up for in practicality. But why stop there? Having dispensed with the formal footwear, why not go the whole hog and don winter leisure wear appropriate to a Swiss ski resort?

The reason is partly that the Davos crowd is conservative, as well as practical. It doesn't seem to have occurred to delegates that this was an option.

Furthermore, it isn't really necessary, since the temperature is warmer than New York even though the ground is permanently snowy. A warm overcoat, and perhaps a hat, suffice, once foot comfort is assured.

Nevertheless, there are interesting nuances to be detected in the choice of footwear. The more conservative, or perhaps the more aesthetically inclined, have donned short but sturdy boots which, when worn with a suit, could pass for shoes unless subjected to close examination. Others are shameless, or daring, pairing formal suits with robust hiking boots or shiny running shoes.

Since executives are almost always clad in identical uniforms, the choice of sturdy boots for a risk-averse banker, or running shoes for a nimble chief executives may be revealing.

WSJ.com

ONLINE TODAY: To see a video of Davos attendees' footwear choices, go to **WSJ.com/Davos.**

U.S. NEWS

What sent states into a fiscal tailspin?

[Capital]

By David Wessel

Amid all the debate about bankruptcy and bailouts and all the headlines about local-government layoffs, benefit cuts, reduced services and tax increases, ponder one simple question:

How the heck did state and local governments get in such trouble?

It's no small matter. State and local governments are a big and growing part of the U.S. economy. They account for 15% of all economic output, up from less than 12% two decades ago.

They employ one in every seven workers, more than manufacturing.

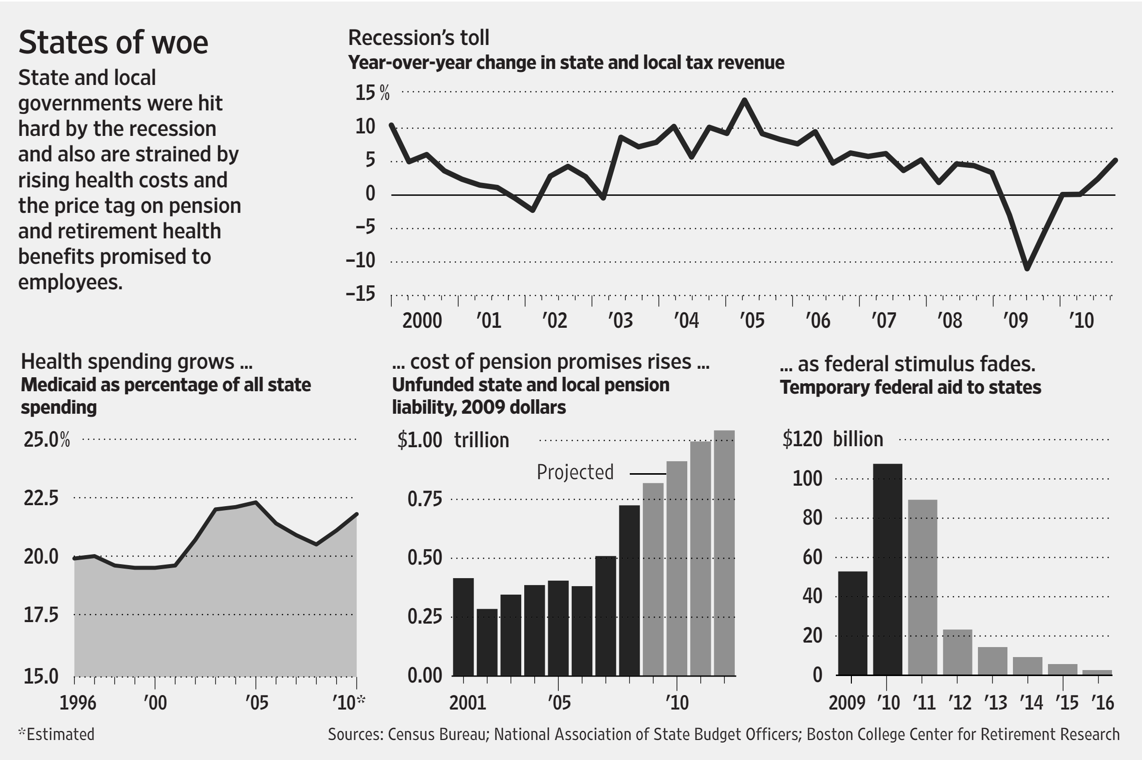
Here are four of the big causes of today's fiscal woes:

It was the recession.

The deep and long recession devastated tax revenue. At the worst point, in early 2009, state and local tax revenue combined were down 11% from year-earlier levels. Local governments took a hit from the housing bust. State governments got hammered when the income, spending and capital gains they tax declined.

Despite an improving U.S. economy, tax receipts at the state level remain 12% below prerecession peaks.

The federal fiscal stimulus offset some of that drop in tax revenue, warding off bigger spending cuts and tax increases that would have exacerbated the recession. But no one was prepared for a downturn like the one we had. Rainy-day funds were depleted. State unemployment-compensation funds borrowed from Washington interest-free, only to find the grace period expiring before the jobless were working again. At the same time, the recession boosted demand for state services such as community colleges and the state-federal Medicaid health-insurance program for the poor.



It was the boom.

In the good times, governments enjoyed and spent a tax windfall; state and local tax revenue rose 36% in the five years before the bust.

In the mid-2000s, overall receipts—taxes and federal grants—rose rapidly. In the ensuing years, spending rose rapidly, too. Flush with money, government did more, often encouraged by voters who wanted more spending on education, for instance.

Going into the recession, spending exceeded the revenue that states and localities can expect to collect in normal times. The gaping budget holes vexing city councils and state legislatures are largely the result of the recession; projected future deficits aren't. And those won't go away without scaling back government (beyond the half a million state- and local-government jobs cut already) or raising taxes (beyond the $40 billion in tax and fee increases that the National Association of State Budget Officers estimates state governments alone have legislated in the past two years).

It's health care.

When the economy heals, state and local revenue will grow again. But that won't relieve unsustainable pressures that predate the recession, especially health costs.

In 1978, health spending—from Medicaid to employee benefits—accounted for 12% of state and local spending. Twenty years later, it was 20% of much larger budgets.

"The primary driver of fiscal challenges for state and local government continues to be growth in health costs," the congressional Government Accountability Office says. Medicaid accounts for more than $1 in every $5 of state spending, more than states spend on elementary and secondary education.

State governments are covering more people and the cost of caring for them is rising faster than nearly anything else. Soon the extra federal aid provided during the recession will run out. Missouri, for instance, estimates it would need a 3% jump in revenue to cover the projected $200 million increase in Medicaid costs next year, according to the National Conference of State Legislatures.

The Obama health-care law expands the number of Americans insured by Medicaid, which already covers 55 million people.

It's the pensions.

By any metric, and there's a debate over which is the right one, state and local governments haven't set aside enough money to cover pension or retiree health-benefit promises they've made to their workers. Governments and public-employee unions agreed to pension and health benefits—and stuck future taxpayers with the tab.

States and localities got religion in the mid-1970s and began funding their pensions more soundly, but then a long bull market led management and unions to count on super-charged stock-market returns to cover the future costs.

Stock-market busts of the early and late 2000s show the downsides of that strategy.

Now governments need to put a lot of money into the pension funds or dilute the promises or, at least for new hires, move away from old-style pensions to the 401(k)-style plans common in the private sector, or all three.

A few big states are in decent shape, such as Massachusetts and Florida. But the problem is acute in a few very big states—California, Illinois and New Jersey—that offered very generous pensions or didn't make the annual contributions that even the most lenient accounting rules required, or both.

State and local governments have been putting about 3.8% of their budgets into pensions. If they continue to count on 8% investment returns, which doesn't seem prudent, they will need to put in 5% by 2014. Using a more reasonable rate of return of 5%, Boston College's Center for Retirement Research estimates, states will have to put 9.1% of their budgets into pensions, on average. For California, Illinois and New Jersey, it's 12%.

In state legislatures and city councils, just as in the Congress in Washington, tinkering won't suffice.

IMF urges U.S. to fix deficit-cutting moves

By Michael R. Crittenden

WASHINGTON—The U.S. will need to make a "significant adjustment" to its fiscal policies if the government intends to meet the goal of halving the deficit by 2013, the International Monetary Fund said Thursday.

The fund was critical of the decision by U.S. lawmakers late last year to extend a package of tax cuts—"its stimulative impact will be small, relative to its fiscal cost"—and noted that the U.S. is the only major advanced economy implementing procyclical policies this year. The decision by policy makers in the U.S., and to an extent Japan, to delay efforts to strengthen their fiscal position needs to be addressed, the report said.

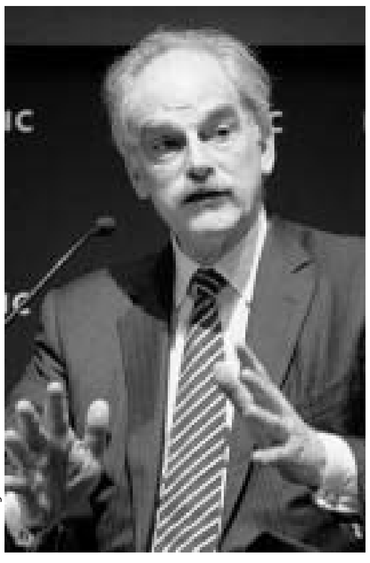
"For these two countries I think there is now a more urgent need to fix their fiscal adjustment credentials by identifying in more detail the fiscal measures that will be taken...to reduce deficits," said Carlo Cottarelli, director of the IMF's fiscal affairs department.

Leaders of the Group of 20 industrialized nations reached an agreement at a meeting last year to address their fiscal positions, including a commitment for the U.S. to cut its deficit in half by 2013. IMF Deputy Managing Director John Lipsky, appearing on CNBC from the World Economic Forum in Switzerland on Thursday, expressed doubts about Washington's ability to meet that goal.

He's skeptical "because this year the U.S. deficit is probably going to go up slightly, not go down as was planned previously," Mr. Lipsky said.

"The United States and Japan...need in particular to strengthen their adjustment credentials by detailing the measures they intend to adopt to honor their commitments to reduce deficits and debt," the IMF said.

The White House and lawmakers from both parties on Capitol Hill have frequently acknowledged the concerns surrounding the deficit. President Barack Obama, speaking Tuesday during the State of the Union address, called for a five-year freeze in domestic spending; such a change would reduce the deficit by more than $400 billion over 10 years.



Bloomberg News

IMF's John Lipsky Thursday in Davos.

"Now that the worst of the recession is over, we have to confront the fact that our government spends more than it takes in. That is not sustainable," Mr. Obama said.

Mr. Cottarelli said the IMF welcomed Mr. Obama's focus on dealing with discretionary spending, but said the U.S. needs to go further to find ways to increase tax revenue and cut costs in even politically popular programs.

"On Social Security, and here I will include all entitlement spending...for the U.S. there will be a need for actions in this area," he told reporters at a press conference in Washington.

He offered a similar prescription for Japan, suggesting it was not a surprise that Standard and Poor's lowered its rating on the nation's sovereign debt. Japan's problems are "well known," Mr. Cottarelli said, and suggested an increase in the country's value-added tax could help reduce its deficit.

"I think what is particularly important for Japan is tax reform is being discussed currently. I think it's good because tax reform and action on the revenue side is going to be very important," Mr. Cottarelli said, suggesting there is "definite room to raise" the country's consumption tax.

More broadly, the IMF said the world's economies are expected to reduce their deficits at a slower-than-expected pace in 2011, while the overall debt ratio is expected to climb to more than 100% of gross domestic product. Debt concerns in Europe, combined with the risk that some emerging market economies may be "overheating," are cause for worry, the fund said.

"Altogether, sovereign risks remain elevated and in some cases have increased since November, underlining the need for more robust and specific medium-term consolidation plans," the report said.

The IMF sounded a note of caution to the emerging market economies that have grown rapidly in the last several years, warning against any push to increase spending in the current environment.

"Many emerging economies need to rebuild fiscal buffers more rapidly to address overheating concerns; create scope to respond to any growth slowdown; or avoid relapsing into procyclical policies that would undermine credibility," the IMF said.

Warning signs preceded crisis

By Maya Jackson Randall

WASHINGTON—A blue-ribbon panel investigating the 2008 financial crisis blamed failures in financial regulation, flaws in corporate governance and excessive borrowing as key elements leading to the meltdown, Financial Crisis Inquiry Commission Chairman Phil Angelides said Thursday.

"Despite the expressed view of many on Wall Street and in Washington that the crisis could not have been foreseen or avoided, there were warning signs," said Mr. Angelides. "The greatest tragedy would be to accept the refrain that no one could have seen this coming and thus nothing could have been done. If we accept this notion, it will happen again."

FINANCIAL CRISIS REPORT

The commission's final report, which the panel sent to President Barack Obama Thursday, found the crisis was caused by widespread deficiencies in financial regulation such as the Federal Reserve's failure to stem toxic mortgages over the past decade.

Corporate-governance issues and "an explosive mix of excessive borrowing" contributed to the crisis, as well, the report finds. It also points to governance breakdowns at companies such as **American International Group** Inc. and Fannie Mae.

In addition, the 500-plus page report says key policy makers weren't prepared for the meltdown and there were "systemic breaches in accountability and ethics at all levels."

The report cites burgeoning mortgage fraud around the country in the years running up to the meltdown and notes that major financial institutions packaged loans into securities that they had reason to suspect didn't meet their standards.

The failures were widespread, it says, even blaming the public.

"As a nation, we must also accept responsibility for what we permitted to occur," it says. Still, it says, "we do place special responsibility with the public leaders charged with protecting our financial system. No one said, 'No.' "

Bloomberg News

FCIC chief Phil Angelides displays a copy of the crisis report, which cites 'an explosive mix of excessive borrowing.'

The 10-member commission reviewed millions of pages of documents and conducted interviews with more than 700 witnesses. The panel held 19 days of public hearings in communities across the country.

The commission was created in May 2009 to investigate the causes of the financial and economic crisis. Congressional Democratic leaders appointed six members of the panel. The Republican leadership picked four.

The report's scope is expansive, but partisan divisions that emerged during its drafting could detract from its long-term impact on policy. Republican members of the panel dissented, saying they couldn't support the majority's conclusions.

"Instead of pursuing a thorough study, the commission's majority used its extensive statutory investigative authority to seek only the facts that supported its initial assumptions—that the crisis was caused by 'deregulation' or lax regulation, greed and recklessness on Wall Street, predatory lending in the mortgage market, unregulated derivatives and a financial system addicted to excessive risk-taking," Peter Wallison, a Republican-appointed commission member who is also a fellow at the American Enterprise Institute, wrote in his dissent.

"The commission did not seriously investigate any other cause, and did not effectively connect the factors," he wrote.

In addition, Republican members Bill Thomas, Keith Hennessey and Douglas Holtz-Eakin said the commission's explanation of the crisis was too broad. They criticized it for cataloging every possible shortcoming. Mr. Thomas is the panel's Republican vice chairman and a former Republican congressman from California. Mr. Hennessey served as a top economic adviser to President George W. Bush during the 2008 financial crisis, and Mr. Holtz-Eakin is a leading Republican economist and former head of the Congressional Budget Office.

The three commissioners narrowed the causes of the crisis down to 10, faulting, among other things: credit and housing bubbles; nontraditional mortgages; failures in credit-rating and securitization; financial firms' massive housing risk; firms holding too little capital; the ease at which losses spread through the system; bad bets on housing; and market shock and panic.

It is unclear how the report's findings will shape financial regulations. Congress passed a broad rewrite of federal banking laws last year. Lawmakers are expected to consider overhauling the nation's housing-finance system.

Claims rise for benefits by jobless; orders slide

By Jeff Bater And Sara Murray

New claims for jobless benefits rose last week and orders in December fell for durable goods, according to reports Thursday indicating the struggle of an economy trying to gather steam.

More data showed a modest revival in housing demand as the battered building sector that was a factor in sending the economy into recession attempts to recover.

The Labor Department reported the number of idled U.S. workers filing new claims for benefits rose by 51,000 to 454,000 in the week ended Jan. 22. Analysts said the data were likely distorted by winter weather and think new claims will resume a downward course.

The four-week moving average for claims, designed to smooth out volatility, increased 15,750 to 428,750.

"This jump in the number of new filers is likely to prove temporary and should reverse next week," RBS Economics Research said in a note to clients. "Since early October, the four-week average in initial claims has been trending firmly to the downside, and we see no reason to suspect that that trajectory has changed."

Still, while the U.S. labor market is gradually improving as the 18-month-old economic recovery gains momentum, it will take a long time to make up for all the jobs lost during the 2007-09 recession.

"Despite some improvement, the labor markets remain relatively soft," Insight Economics analyst Steven Wood wrote in a research note.

Continuing claims for unemployment benefits, those drawn by jobless Americans for more than one week, rose 94,000 to 4 million for the week ending Jan. 15, according to the Labor Department.

A weak spot for factories emerged Thursday as orders for manufactured durable goods, which are designed to last at least three years, fell 2.5% last month from November to a seasonally adjusted $191 billion, the Commerce Department said. Orders fell 0.1% the prior month.

The drop was driven by a sharp decline in aircraft orders. Stripping out transportation, new orders rose 0.5% last month.

Shipments of manufactured goods, meanwhile, ticked up 1.4% to $200.4 billion.

There were signs that business investment continued to improve last month as well.

A measure of demand for capital goods that excludes aircraft and defense orders and gauges business spending rose 1.4% in December. That follows a 3.1% increase in November.

Demand for homes firmed in December, the National Association of Realtors said in a separate report Thursday, as its index of pending home sales increased for the fifth time in six months. The pending home sales index, which is based on signed housing contracts and is an indicator of future sales, rose 2% to 93.7 in December.

Tax redo seeks 'level playing field'

By David Wessel

In his State of the Union address, President Barack Obama called on Congress to embark on a major revamp of corporate taxes: "[S]implify the system. Get rid of the loopholes. And use the savings to lower the corporate tax rate for the first time in 25 years—without adding to our deficit."

Treasury Secretary Timothy Geithner talked to The Wall Street Journal about the initiative. He emphasized the administration's insistence on offsetting lowering the corporate rate, now 35%, by eliminating deductions, credits and incentives. Raising more revenue from businesses in light of global competition "isn't realistic," he said. But, given the deficit, "We can't raise taxes on individuals to lower business taxes."

Mr. Geithner wouldn't say if the administration wants to move from taxing multinational corporations' global profits and instead tax only domestic profits, as most other countries do and as U.S. business wants. But he said a "level playing field" is a major goal.

Q. How would corporate tax reform help economic growth?

A. Lowering rates, removing the distortions in the present system, helps growth because it allows business to compete on the basis of performance and return rather than on their ability to get or protect special provisions in the tax code. If you level the playing field, you allow the market rather than the tax system to drive investment.

Q. How much does the corporate tax rate need to fall to make a difference?

A. To have a more competitive system, you want to try to bring down the rate closer to the range of our major trading partners. We have a high statutory rate, which is made necessary by all the special provisions. How low you can go depends on how much of the reform you can achieve.

Q. What's the point of going through the political minefield if this doesn't ultimately lower the business tax burden?

A. All businesses want lower taxes. But businesses understand that their success as businesses depends in part on what the government does—on education, infrastructure, national security....Most businesses understand that we have limited resources, that we can't raise taxes on individuals to lower business taxes and that unsustainable long-term deficits hurt growth too.

Bloomberg News

Treasury chief Timothy Geithner makes the case for a corporate-tax overhaul.

Q. What's the point of going through all this if it doesn't raise revenue to reduce the deficit?

A. You've had a very broad substantial reduction in corporate tax rates outside the U.S. That occurs at a time when it's much easier—because of technology—for companies to shift investment and income to take advantage of lower tax rates overseas. We can't expect to raise significant additional revenue from business, as a share of GDP, from the corporate tax without hurting our competitive position, without hurting growth. It isn't realistic.

Q. What are the next steps?

A. It's good for confidence if we can find things that both Democrats and Republicans want to do. We're going to keep consulting—with key committee chairmen ... with other stakeholders, with architects of past reforms, both ones that worked and those that didn't. Everybody who looks at the current system says: We can do better than this. And there's a lot of interest in doing it.

WORLD NEWS

ElBaradei returns, Egypt rallies loom

By Matt Bradley

CAIRO—Nobel Peace Prize laureate and pro-democracy figure Mohamed ElBaradei returned to Egypt on Thursday, seeking to mend strained alliances with the opposition leaders who this week rallied ordinary Egyptians to hold mass antigovernment demonstrations in his absence.

Mr. ElBaradei's return came ahead of countrywide demonstrations planned to take place after noon prayers Friday, a weekend day when few in the Arab world's most-populous nation work. Organizers and observers said the planned events had the potential to eclipse those held Tuesday, Egypt's largest in decades, as people who took notice of the week's rallies join in.

Small protests continued throughout Egypt on Thursday in cities including Suez. Also Thursday, Egypt's ruling party said it is willing to hear protesters' concerns.

Mr. ElBaradei arrived late Thursday, greeted by friends and some supporters. "It is a critical time in the life of Egypt," he told reporters upon his arrival. "I wish we didn't have to go into the streets to impress upon the regime that they have to change."

Friday's planned rallies will be closely watched in the region, as they are expected to provide an early read on the strength of the bonds between Egypt's newly influential alliance of opposition groups and Mr. ElBaradei, the man they have fitfully embraced as their leader.

Agence France-Presse/Getty Images

Nobel laureate and former U.N. nuclear watchdog chief Mohammed ElBaradei arriving in Cairo on Thursday evening.

The chief architects of Tuesday's Egypt rallies are members of the National Association for Change, a grouping of opposition movements that Mr. ElBaradei assembled around him last summer. In a country where public dissent is rare and demonstrators infrequent, these organizers spurred tens of thousands of people—primarily middle-class, Internet-savvy Egyptians apparently emboldened by popular protests that helped overthrow Tunisia's president two weeks ago—to turn out to protest the regime of President Hosni Mubarak.

Several of these organizers now say they are disappointed with Mr. ElBaradei for spending large chunks of time outside Egypt, adding that he has returned too late for a wave of protests that got started without him. Some youthful protesters likened Mr. ElBaradei's arrival to that of an adult trying to take credit for his children's accomplishments.

These people and other observers say Mr. ElBaradei will now have to regain trust of these demonstrators. The protest's organizers concede, however, that Mr. ElBaradei—a rare secular liberal whose prominence allowed him to campaign outside the limited menu of Egyptian political ideologies—is one of the few figures capable of rallying these disparate groups around him.

The political ambitions of Mr. ElBaradei, the 68-year-old former head of the International Atomic Energy Agency, remain frustratingly unclear to many of those who support him. Egyptian presidential elections are set for this fall, and the regime's tight grip on power has made it virtually impossible for outside candidates to emerge. Many Egyptians believe Mr. Mubarak, 82 years old, is preparing his son Gamal to succeed him.

Mr. ElBaradei has said he won't run for president unless Mr. Mubarak makes key changes to the constitution, including lifting barriers for independent candidates. Egypt requires presidential candidates to serve for at least a year as head of a recognized political party.

Those close to Mr ElBaradei acknowledge his nebulous intentions—his desire to run for president has also appeared to waver—have disappointed many. But some of Mr. ElBaradei's supporters point to the continuing political vacillation in Tunisia as an example of how even the most organic, grass-roots democracy movements ultimately need strong leadership to allay fears of chaos that could accompany any leadership change.

Of Mr. ElBaradei's return, Hossam Badrawi, a member of the powerful policies secretariat of the ruling National Democratic Party, said: "He's a citizen coming back to his country. It's his right to do that."

Egypt's government also said Thursday it is willing to talk to protesters and widen political participation, especially among Egypt's youth.

Thousands protest regime in Yemen

By Hakim al-Masmari
And Margaret Coker

SAN'A, Yemen—Thousands of Yemenis, inspired by the wave of activism spreading across the Middle East, marched through the capital demanding the removal of their longtime president, in one of the largest protests seen in this autocratic nation in years.

The demonstrations, organized by a committee of opposition parties, wound through four central districts of the city, with protesters shouting for the removal of President Ali Abdullah Saleh, a key U.S. counterterrorism ally whose government has long been criticized by Yemenis for repression and corruption.

Demonstrators who gathered at San'a University and separately along the ancient gates of the old walled city center said they were demanding improvements in living conditions as well as political change. Many chanted: "President—leave peacefully before being forced out the Ben Ali way," invoking how mass protests forced the resignation of Tunisian President Zine al-Abidine Ben Ali two weeks ago.

Since the reunification of the northern and southern sides of the country in 1990 and a brutal civil war shortly afterward, Mr. Saleh has sidelined opposition groups and placed his relatives and close allies in key military and political posts.

In Yemen this month, Secretary of State Hillary Clinton called on Mr. Saleh to pursue political and economic change, while reaffirming U.S. military and developmental support.

Like Mr. Ben Ali and Egyptian President Hosni Mubarak, Mr. Saleh has often cited security issues as a reason to stall political change. His government is battling a separatist movement in the south, a rebel group in the north and al Qaeda cells, which are active in many of Yemen's provinces.

Yemen's political groups have a history of showing a united front against the leader. Since mid-2010, they have participated in "National Dialogue" talks with Mr. Saleh's party in attempts to forge a power-sharing agreement.

Mr. Saleh called off those talks in late 2010, his aides and opposition officials say, in part due to the opposition's refusal to compromise over their demands.

The protests held Thursday, a weekend day in Yemen, were organized by the same steering committee that participated in the political talks. Leaders from the Joint Meeting Parties, which are made up of Islamic groups and staunchly secular Socialists, among others, met Monday to plan their protest strategy.

"The Saleh regime has failed to manage the country for more than 30 years, and now the time has come for the political parties to lead popular protest against this regime," said Aidrous al-Naqib, a representative of Yemen's Socialist Party within the JMP.

JMP leaders say they will hold rolling protests each Thursday until they win political concessions from the president.