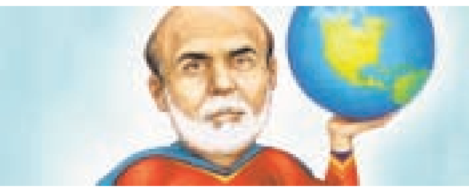
DJIA 11670.75 ▲ 0.81% | Nasdaq 2691.52 ▲ 1.46% | Stoxx Eur 600 278.02 ▲ 0.80% | FTSE 100 5899.94 ▲ Closed | DAX 6989.74 ▲ 1.09% | CAC 40 3900.86 ▲ 2.53% | Euro 1.3361 ▼ 0.41% | Pound 1.5467 ▼ 1.19%



Bernanke's balancing act: What we can expect in 2011

YEAR-END REVIEW OF MARKETS AND FINANCE 20-24

American Airlines indulges in a dogfight with Expedia

HEARD ON THE STREET 18

THE WALL STREET JOURNAL.

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Fiat weighs increase in Chrysler stake

European Pressphoto Agency

Fiat CEO Sergio Marchionne, right, at the Milan bourse for the start of trading in Fiat Industrial, Monday, says the firm could lift its stake in Chrysler. **Article on page 25**

Jump in manufacturing lifts global recovery hopes

By Sara Murray
And Paul Hannon

Factory activity ratcheted up world-wide in December, providing a boost of momentum to manufacturers heading into the new year.

An index of euro-zone manufacturing activity rose to 57.1 from 55.3 in November, according to Markit Economics. Readings above 50 indicate expansion.

In the U.S., a similar index increased to 57 in December from 56.6 the prior month, according to the Institute for Supply Management's survey of purchasing managers. And in Asia, factory activity remained strong, although growth slowed in China and India.

"You're getting a pretty consistent message that output's accelerating," said David Hensley, a J.P. Morgan Chase Bank analyst. Concerns about a manufacturing slowdown don't appear to be coming to fruition, Mr. Hensley said.

New orders were also up, a good indication that manufacturing will remain strong into this year.

In Europe, new orders grew at the fastest rate since April, led by Germany, the Netherlands, Austria and France. Export orders increased at the fastest pace for seven months, with the expansion particularly rapid in Germany and France.

Manufacturing firms are responding by hiring workers, with jobs growth at its highest since October 2000, although job losses continued in Spain and Greece.

German manufacturing activity was once again the strongest in the euro zone, with the PMI rising to 60.7 from 58.1 in November, its highest level since July.

But there were signs that some of the region's weaker economies were beginning to share in the manufacturing expansion. Ireland's PMI rose for the third straight month, to 52.2 from 51.2 in November, while Spain's PMI rose to 51.5 from 50.0.

Among other euro-zone economies, Italy's manufacturing PMI rose to 54.7 from 52.9, while the PMI for France's manufacturing sector fell to 57.2 from 57.9.

Activity continued to decline in Greece, where the PMI fell to 43.1 from 43.9 in November, its lowest level since August.

"Germany remained the star performer, seeing near-record growth," said Chris Williamson, an economist at Markit. "However, welcome signs of recoveries were also evident in the periphery, where export sales helped boost output growth."

In the U.S., meanwhile, economists viewed the strong manufacturing performance as a bright sign for future economic performance, despite factories' relatively modest weighting in total U.S. output.

"We saw significant recovery for much of the U.S. manufacturing sector in 2010," said Norbert Ore, who directs the ISM's survey. "Manufacturers that export have benefited from both global demand and the weaker dollar."

Mr. Ore expects a good start to the new year. "De-

Please turn to page 7

Fast start for stocks on 2011 optimism

European stocks climbed on the first trading day of 2011 amid optimism over global growth.

The German DAX 30, the strongest of the region's main markets last year, rose 1.1% to 6989.74, while the Paris CAC 40 surged 2.5% to 3900.86. London markets were closed.

On Wall Street, U.S. stocks rallied to two-year highs and added to gains after a gauge of manufacturing rose in December and construction spending rose more than expected in November. Bank of America jumped on a bad-loan settlement with Fannie Mae and Freddie Mac.

French banking stocks, one of 2010's laggards, jumped. Société Générale climbed 3.8% and BNP Paribas gained 3.6%.

But Piraeus Bank, Greece's fourth-largest lender, said its long-awaited €800 million rights issue will be priced at a sharper-than-expected discount.

■ Stocks rally in first trading session of new year 27

The Quirk

Dutch utilities help police weed out pot farmers who steal electricity. **Page 33**

Editorial & Opinion

How U.S. protectionism is destroying American jobs. **Page 11**

PAGE TWO

Two enemies who need each other

[Agenda]

By Irwin Stelzer

The Christmas truce is over and the battle between the financial markets and the euro-zone managers resumes. If understanding your enemy is essential to victory, the euro zone starts at a disadvantage. The disparate group that makes up the euro-zone general staff just doesn't understand how markets work. So when German Chancellor Angela Merkel and French President Nicolas Sarkozy announced that starting with the 2013 campaign they would inflict losses on investors, they were surprised that the counterattack took the form of a selloff of bonds and a rise in interest rates.

Now the battle recommences—between enemies who fail to realize that they need each other. The euro-zone army needs the market to provide capital, and the markets need the euro-zone generals to provide certainty and stability so that they can invest in relative safety.

End of military analogies. Investors are about to be called on by euro-zone borrowers to cough up record amounts of capital. European governments have to roll over about €555 billion ($742 billion) in debt in this new year, with euro-zone countries expected to borrow some €80 billion this month alone. The euro-zone bailout facility will be in the market for an additional €13 billion to fund its Irish adventure. All in all, forecasts Royal Bank of Scotland Group, European governments' gross debt issuance this year will come to €814 billion, 10% of it in January alone. All in addition to some €400 billion European banks are expected to need in the first half of this year.

Break that down and the vulnerability of the euro zone becomes even clearer. Portugal,

European Pressphoto Agency

Portugal's Minister of the Presidency Pedro Silva Pereira.

which found a cut in its credit rating in its Christmas stocking, needs €20 billion, and seems likely, despite the denials of Minister of the Presidency Pedro Silva Pereira, to tap the euro-zone bailout fund, even if China does take up €5 billion in bonds and Brazil picks up a billion or so more. The euro-zone bailout fund can easily handle a sum of that size. But Spain will need an estimated €80 billion, and that's real money.

There is an absence of what Tony Blair called 'joined up government'—a linkage of policies to one need.

The problem is exacerbated by leapfrogging. Every borrower wants to beat other borrowers to the market. That should make January and indeed the entire first quarter of this year very difficult for all borrowers, and drive up borrowing costs even for sounder borrowers such as Germany and France, which between them will be issuing €380 billion in bonds this year. Indeed, next week will tell us a lot. It should witness several auctions of government bonds at which investors will provide an indication of the interest rates they are likely to demand the rest of this year.

As they rang out the old year, euro-zone policy makers agreed on one thing: They had communicated poorly with the markets in 2010. There is some truth in that self-analysis, but only some. The fact is that they perfectly communicated their inability to agree on a policy for coping with the problem initiated by Greece's inability to fund its deficits. Some prescribe austerity, while others argue that such austerity will only produce a downward spiral of recession and eventual default. Some want the European Central Bank to buy more of the sovereign bonds that the market will absorb only at ruinously high interest rates, others want the bank to remain independent of the political problems of euro-zone members and concentrate on controlling inflation. Some want private investors to visit the barber before the euro zone tidies up the finances of unkempt members, others say the threat of such haircuts will only make the ultimate bailout more costly. Some speak of sovereign defaults, but only in a whisper.

Given the sad state of economic theory as a guide to practical policy, these differences are understandable. But two areas of agreement have emerged from the squabbling. The first is that there is no solution to the euro-zone crisis that does not include policies for stimulating growth in the periphery to match the rates in Germany and France. Portugal and Spain cannot avoid default or bailouts if they don't rack up significant economic growth. Just imagine the terms on which they would be able to borrow if their economies were growing at an annual rate of, say, 4%.

The good news is that there is renewed interest in peeling back the labor market restrictions, the barriers to new entrepreneurial ventures, the webs of regulations that stifle growth. The bad news is that such renewed interest is crashing against the Brussels inclination to tax and regulate. The cost of running the EU has gone up; the European Parliament is calling for a eurotax; new regulations that seem set to hobble the financial sector, misunderstood and loathed by market haters in Europe, are being implemented. In short, there is an absence of what Tony Blair called "joined up government"—a linkage of all policies to the one overwhelming need, in this case economic growth. But at least there are now voices calling for just such linkage.

The second area of agreement is that it is no longer possible to combine uniform monetary policy with 16—17, now that Estonia has signed on—separate fiscal policies. Some form of fiscal union is required if the euro is to be saved from the dustbin of history. Agreeing on the form of that closer union is the most urgent task facing the various players in the multidimensional game of europolitics. A series of difficult auctions next week, with interest rates climbing, might just speed agreement, giving investors some of the certainty they crave and euro-zone governments the cash they need.

—Irwin Stelzer is a director of economic-policy studies at the Hudson Institute.

What's News

■ **Europe's M&A marke**t continued to recover last quarter, and most investment bankers predict the improvement to roll into 2011 despite persistent concerns over Europe's financial health. **17**

■ **Bank of America agreed** to pay $2.8 billion to Fannie Mae and Freddie Mac to buy back soured mortgages. **17**

■ **Dutch lawmakers will grill** Shell this month over its operations in the Niger Delta, reflecting growing concern in the West about environmental damage stemming from oil spills in west Africa. **17**

■ **The EU is investigating** the legality of special "crisis" taxes imposed by Hungary on a handful of industries amid a feud between the country's government and its critics elsewhere in Europe. **5**

■ **Pakistan's government** appeared likely to survive the defection of a coalition partner, but faces hurdles passing economic overhauls. **8**

Inside

Management mistakes made by those rookie bosses. **31**

Manchester United's weakest squad—but still unbeaten. **32**

ONLINE TODAY

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The Source

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'Today, he is famous for appearing in a TV advert, squatting in a cupboard.'

Quentin Fottrell on Ireland's former leader, Bertie Ahern, and his decision to leave politics at the next election.

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Will 2011 see fiscal strengthening or further stress on the euro zone?

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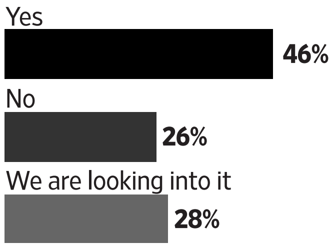

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THE YEAR AHEAD

What the world can expect in 2011

EUROPE

Soldier on, or take bear by the horns?

Europe in 2011 will be dominated by the issue that made 2010 so turbulent: the euro-zone debt crisis. Although a trillion dollars in government rescue funds have been set aside for the common currency's weaker economies and bailouts have been put in place for Greece and Ireland, few think the turmoil is over.

Initially, the focus of financial markets will likely turn to Portugal, which suffers from high debt and low growth, and then perhaps to Spain. Late last year, concerns emerged about Italy and Belgium.

The big question is whether governments, individually and collectively, will try to muddle through, as they tried for most of 2010, or make a more ambitious effort to change market sentiment.

The social price of government austerity and slow growth will continue to be felt, both inside the euro zone and beyond, including in the U.K., where government spending cuts will start to bite. Opposition to cuts could spill into street protests in several countries.

Few major elections are scheduled to take place in 2011, though they could be triggered in countries with weak or minority governments, such as Italy and Spain. Elsewhere, Russia watchers will be keeping an eye on Moscow as it continues to woo its neighbors to the west.

—Stephen Fidler

GLOBAL ECONOMY

A fine balance in a two-speed world

Global exports and imports plummeted during the financial crisis as consumers held on to cash, financing became scarce and businesses cut production. Now, the disconnect between developed and emerging (booming) economies is heightening trade tensions.

The U.S., Europe and Japan continue to struggle with too-low inflation, lackluster domestic demand and high unemployment. Developing nations face strong growth and too much inflation.

High on the 2011 agenda: a global push to rebalance the world economy so fast-growing nations consume more at home and rely less on exporting to consumers abroad. The hope is that expanding middle classes in China, India and other developing economies will buy more.

Currency policy remains a flash point. The U.S. and others want China to let its currency rise, braking its exports and its overheating economy, while giving exporters in the U.S. and Europe a better shot at boosting their own sales. Other developing economies, not only in Asia but around the world, worry about letting their currencies climb unless China moves, too.

U.S. lawmakers are threatening to impose penalties or tariffs on China if it doesn't allow the yuan to continue to climb. With U.S. unemployment projected to remain high for years, trade tensions are almost certain to persist, even if Congress approves a pending U.S.-South Korea free-trade pact.

—Sudeep Reddy

U.S. POLITICS

You go first. No, no, after you

The 2012 presidential race is set to attract a slew of Republicans eager to take on a battered but still largely popular incumbent.

Yet none of the dozen or so potential Republican challengers to President Barack Obama—among them Mitt Romney, Tim Pawlenty, Mike Huckabee, Sarah Palin, Newt Gingrich and Mike Pence—have made a formal step toward running yet. Some say they won't decide until at least April, while others may not jump in until autumn, a much later start than in recent years.

Republican contenders want to see what happens as GOP congressional leaders face off with President Obama and the weakened Democrats, starting this month. Partisan battles in Congress over spending, tax policy and the fate of the Obama health-care overhaul may do as much as anything to shape the race.

Possible GOP challengers are keenly aware of one irony: Republican successes in Congress this year could work in Mr. Obama's favor, especially if the president has a hand in trimming the deficit and revitalizing the economy.

Independent voters appear eager to see him working with Republicans on vital issues. No indicator will be more important, of course, than the unemployment rate, still over 9%.

Mr. Obama enters the early running for 2012 in pretty good shape. A recent Wall Street Journal/NBC News poll put him up by seven percentage points over Mr. Romney, the former Massachusetts governor, and by 22 points over Ms. Palin, the former Alaska governor.

The Iowa caucuses, the first contest of the 2012 elections, aren't scheduled to take place until February of next year, but already there are rumblings about moving the date up to January.

—Neil King Jr.

WAR

Melting snows and fractious partners

The last U.S. soldiers are expected to withdraw from Iraq this year, and the pullout of American troops from Afghanistan is set to begin. While the American military role in Iraq has already shrunk, with Iraqi security forces fighting the remains of the insurgency largely on their own, there is no sign yet of such a turnaround in Afghanistan.

Last year was the deadliest year for U.S.-led coalition troops in Afghanistan. American and allied forces have claimed success in clearing Taliban strongholds in southern Afghanistan, but coalition commanders caution that the impact of these offensives won't be known until the new fighting season starts in March.

The pace of the U.S. troop withdrawal, set to begin in July, and of the planned handover of Afghan districts and provinces to Afghan security control, will depend on how high insurgent violence spikes again once the snows melt in the spring.

In both countries, the U.S. will have to deal with fractious, often dysfunctional administrations. It has taken months for Iraqi Prime Minister Nouri al-Maliki to form a government, and many are already predicting a collapse of his unwieldy coalition, especially if the long-running dispute with the autonomous Kurdish government in the north over contested oil fields flares again.

Iraq, at least, has hopes of an economic boom, thanks to an expected surge in oil revenues. In Afghanistan, it is foreign aid that keeps the economy afloat, and widespread government corruption is expected to remain a major irritant in President Hamid Karzai's relations with Washington.

A new Afghan parliament, starting in late January, is likely to become another thorn in Mr. Karzai's side, possibly emerging as a serious center of opposition to his rule.

—Yaroslav Trofimov, Sam Dagher

Six people to watch

Axel Weber

Agence France-Presse/Getty Images

Germany's central-bank chief is the leading candidate to be the next head of the European Central Bank. Mr. Weber would solidify Germany's commitment to the euro, but his opposition to ECB government bond purchases as bailouts have dimmed his chances, some say.

Xi Jinping

Agence France-Presse/Getty Images

China's vice president is expected to take the reins from Hu Jintao in 2012. Little is known about Mr. Xi's views or intentions, though the 57-year-old will be more visible this year as he solidifies his domestic power base and his international chops.

Kim Jong Eun

Associated Press

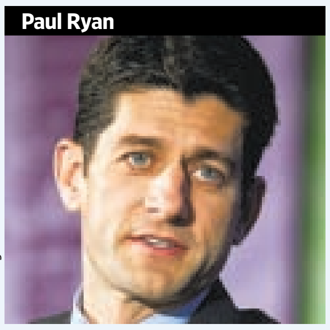
Tapped by his father as North Korea's third dictator, Kim Jong Eun won't take over until after Kim Jong Il dies or is incapacitated. But from now on, every act of the regime will be scrutinized for whether he was involved and whether it's good or bad for him.

Dilma Rousseff

Reuters

Brazil's new president inherits a soaring economy from predecessor Luiz Inácio Lula da Silva. With inflation, public spending and consumer credit on the rise, she must make sure the boom in Latin America's biggest economy doesn't turn into a bust.

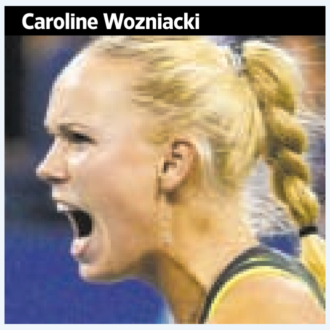
Paul Ryan



Bloomberg News

The up-and-coming Wisconsin Republican takes over this month as House Budget Committee chairman. He promises to cut U.S. federal spending deeply while working with the White House on a major tax-system overhaul. Some Republicans are touting him for 2012.

Caroline Wozniacki



Associated Press

The 20-year-old Dane—the world's top women's tennis player—will try to crack the sport's quartet of major titles this year, having yet to win the French Open, the Australian Open, the U.S. Open or Wimbledon. Her bid comes as many of the stars of women's tennis prepare to retire.

NUCLEAR THREAT

Two familiar players playing a close game

U.S. lawmakers' December passage of the Strategic Arms Reduction Treaty with Russia was an important advance in President Obama's push for global nuclear disarmament. But it's just the first in a series of U.S. initiatives to limit the threat of atomic weapons.

In the coming year, the Obama administration says, it will advance two key nonproliferation treaties that have stagnated: the Comprehensive Test Ban Treaty, which bans any future atomic weapons tests, and the Fissile Material Cutoff Treaty, which also prohibits the production of highly enriched uranium.

President Bill Clinton signed the CTBT in 1996 but failed to get Senate ratification. George W. Bush's administration introduced a plan in 2006 to globally ban the production of weapons-grade nuclear materials, but the U.S. has faced stiff resistance from countries such as Pakistan. The advances of Iran's and North Korea's nuclear programs could doom the White House's agenda.

The U.S. is scheduled to hold new disarmament talks with Iran late this month, but Tehran has indicated no willingness to stop producing nuclear fuel.

Pyongyang, meanwhile, has expanded its own nuclear infrastructure in recent years and has developed a new uranium-enrichment facility.

The potential ascension of two new nuclear-weapons states could fuel new arms races in the Middle East and Asia, and deal a potentially fatal blow to the U.N.'s Nuclear Nonproliferation Treaty. Both Iran and North Korea were initial signatories.

—Jay Solomon

TECH

An Apple a day and Android dreams

Internet innovations redistributed more wealth in 2010, led by a mobile model likely to keep reshaping high tech's power structure in the new year.

The most potent symbol is once-fading Apple Inc., now the world's most valuable technology company because Chief Executive Steve Jobs found ways to reinvent the cellphone and the tablet-style computer. Such portable products have emerged as the central battleground in technology, pushing the personal computer to the periphery.

Dozens of companies are racing to emulate the iconic iPhone and iPad, while hundreds more rush to develop games and other apps to run on mobile hardware. Many are exploiting the free Android software developed by Google Inc., which is recycling some of the ad revenues it siphons from print publications and other media.

Smartphones powered by the operating system are already a major industry, while the fate of Android-powered tablets is one of the big questions of 2011.

Consumers on cellphones also helped fuel the surge of social networks like Facebook and Twitter. Another big question for this year will be whether such companies—including Groupon, the local-deals pioneer that turned down a $6 billion bid from Google—will go public or continue to build their lofty valuations as private companies.

There is little doubt that suppliers to corporate computer rooms, such as Cisco Systems Inc., will keep thriving in 2011 and buying smaller companies. But questions about mobility are likely to dog Intel Corp. and Microsoft Corp., whose chips and software, respectively, dominate PCs but have yet to prove their relevance in pocket-sized devices.

"I don't know how the traditional PC industry will survive," said Jen-Hsun Huang, chief executive of Nvidia Corp., whose chip company competes with Intel.

—Don Clark

■ Year-end review of markets and finance 20-24

EUROPE NEWS

France seeks growth by looking to Germany for tax guidance

[The Outlook]

By Sebastian Moffett

Paris

The French government thinks it knows the solution to its slow growth and loss of industry: Be more German.

French auto makers expected in 2010 to make little more than half the number of vehicles they did in France five years earlier; German car production is around the same as it was five years earlier. France expects to post 1.6% economic growth for 2010, and less than 2% in 2011 and 2012, according to the European Commission; Germany is forecast to post 3.7% for 2010 followed by 2%-plus the following two years. France's budget deficit is forecast to be about 7% of gross domestic product in 2012; Germany's is expected to fall below 3%, according to the Organization for Economic Cooperation and Development.

"I admire the German model," French President Nicolas Sarkozy said recently. "We need to learn from some aspects."

The government is now carrying out a detailed comparison of its tax system with that of Germany, which has lower corporate and payroll taxes than France. "The point of departure for this study is convergence with Germany," France's budget minister, François Baroin, said in December. "It's to make our economy more competitive."

Germany traditionally has grown more from investment and exports, which are now booming thanks to demand from China, and it generally has run smaller budget deficits than France.

France, by contrast, has grown mainly through consumption over the past decade. This has been helped by public spending. Paris hasn't recorded a budget surplus for more than three decades. But that model has been threatened by the past two years of economic crisis, which have pushed up France's budget deficits.

The government in France doesn't yet face the kind of financing problems that confront Ireland and Greece, which both have required international bailout packages, or Portugal and Spain, which now pay 3.6 percentage points more than Germany to borrow. Despite recent speculation, ratings agencies have so far maintained France's triple-A bond ratings, and it pays just 0.4 percentage point more than Germany to borrow.

One reason ratings agencies approve of France is its determination to reduce its budget deficit. Among other tax increases for 2011, the top rate of income tax—on earnings over €70,830 ($94,118)—will rise to 41% from 40%.

Tax increases could hurt Mr. Sarkozy ahead of France's 2012 presidential election, though. In 2007, he was elected after pledging to reduce taxes: He addressed France's growing legion of tax exiles and implored them, "Come back!"

Mr. Sarkozy doesn't want the tax increases to weigh on French businesses, which already face some of the highest payroll taxes in the world. One move to relieve some of their burden came in 2009, when the government abolished a regional tax on capital spending peculiar to France. This, said the government, would reduce the tax burden on corporations by some €12 billion in 2010.

The government is also considering whether to abolish France's wealth tax and its "fiscal shield"—a device that means no taxpayer need pay more than 50% of his or her revenue in taxes.

Mr. Sarkozy thinks the wealth tax causes businesses and rich taxpayers to leave France for countries with less-costly regimes; the shield was designed to stem the outward flow.

But government figures show that the wealthy are still leaving France. And the shield is unpopular in a country where many people don't like the government sending big refund checks to the rich.

"When Germany got rid of its wealth tax it also got rid of its tax shield," Mr. Sarkozy said in November. "We have to create a tax system in which our taxes would be comparable and compatible" with taxes in Germany.

Still, the net government receipts from the wealth tax and tax shield were about €2.4 billion in 2009, and Mr. Sarkozy conceded that he might try to make up the shortfall with a new tax on capital. Another idea being floated by lawmakers is a rise in the value-added tax.

Eventually, economists say, France might have to grapple with the size of its government. France's total tax burden—from income tax to payroll taxes—is 42%, compared with 37% in Germany and 24% in the U.S., according to the OECD.

"Tax reduction is impossible because we have such high expenditure," says Mathilde Lemoine, an HSBC economist. "There's a limit to how German France can be because the French state is so large."

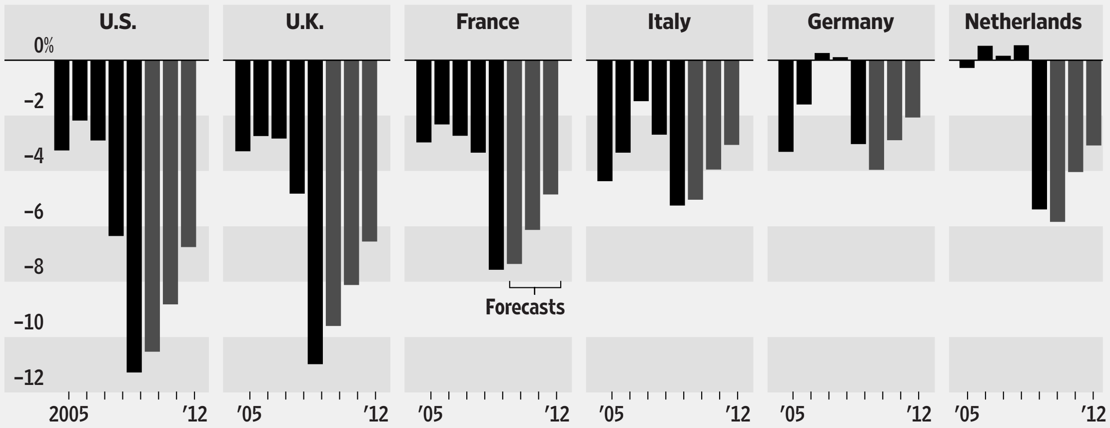
The trouble is that cutting spending and benefits is politically risky. When Mr. Sarkozy raised the basic retirement age to 62—still lower than in other big economies—from 60 this past autumn, workers went on strike, blockading ports and oil refineries.

European Pressphoto Agency

President Nicolas Sarkozy thinks France's wealth tax causes businesses and rich taxpayers to leave the country.

Comparing notes

France, with its high spending and slow growth, hasn't reduced its budget deficit as much as some fellow European countries. Surplus/deficit as a percentage of GDP:



Source: OECD

Eventually, economists say, France might have to grapple with the size of its government. France's total tax burden—from income tax to payroll taxes—is 42%.

China plans to continue buying debt from Spain

By Jonathan House And David Roman

MADRID—China supports Spain's economic reforms and will continue buying Spanish government debt, Chinese Vice Premier Li Keqiang wrote in a newspaper editorial, the latest sign of China's growing role in protecting the stability of the European Union, its largest export market.

"We have confidence in the European financial market, and, in particular, the Spanish financial market, which has meant the purchase of its public debt, something which we will continue to do in the future," Mr. Li wrote in El País, Spain's largest-circulation general newspaper, on the eve of a visit to Spain that will start Tuesday.

Mr. Li will meet with Spanish leaders including King Juan Carlos, Prime Minister José Luis Rodríguez Zapatero, Finance Minister Elena Salgado and Foreign Minister Trinidad Jiménez. The number of high-profile meetings, unusual for a foreign visitor who isn't a head of government or state, is evidence of the interest caused by the visit in cash-strapped Spain, which will again issue large amounts of debt this year.

Spain has faced increasing difficulties in financing a yawning budget deficit after Greece's financial meltdown in early 2010 sparked concerns over the problems of other fiscally frail euro-zone countries. Spain responded with emergency budget cuts as well as politically difficult reforms designed to boost economic growth, but markets have been wary of the country's economic prospects.

China has provided crucial support to volatile financial markets with its purchases of euro-zone sovereign debt. China is one of the biggest foreign owners of Spanish sovereign debt, with around 10% of the total.

"China supports the measures taken by Spain to achieve an economic and financial adjustment, in the firm belief that it will obtain a complete economic recovery," Mr. Li said in the editorial. "The Chinese side is willing to explore with its Spanish counterpart any positive and effective cooperation possibilities."

Last month, Moody's Investors Service warned it might lower Spain's debt rating because of the country's relatively high refinancing needs and the possibility that it might have to inject fresh capital into its banks. A key concern is that many Spanish borrowers will be refinancing debts this year, at a time when investors are nervous about taking on any European risk. According to Moody's, Spain's central government must raise about €170 billion ($227 billion) in 2011.

Fears that the country may need a bailout package similar to those received last year by Ireland and Greece have hit the euro. Spain is the fourth-largest euro-zone economy and any bailout would be big.

Beijing is wary of the effect of a wider euro-zone crisis on export demand; a tumbling euro would make Chinese exports less competitive across Europe.

EU probes Hungary's special taxes

By Gordon Fairclough

BUDAPEST—The European Union is investigating the legality of special "crisis" taxes imposed by Hungary on a handful of industries amid an escalating feud between the country's populist new government and its increasingly outspoken critics elsewhere in Europe.

Tensions have mounted as Hungary takes over the rotating presidency of the EU and could complicate the regional bloc's efforts to make progress on a series of important measures aimed at bolstering the Continent's economic recovery.

The probe of the taxes, which have fallen most heavily on large, foreign companies, comes on top of criticism of a new Hungarian media law by officials of other EU states and members of the European Parliament, who say it goes against the EU's commitment to press freedom.

Hungary's government has dismissed the complaints, saying the new temporary taxes, which are to last through the end of 2012, and the media law are in line with the spirit and the letter of EU treaties and regulations.

"This is a politically motivated and coordinated attack" by companies unhappy about the taxes and their home-country governments, said Zoltan Kovacs, a state secretary in Hungary's Ministry of Public Administration and Justice. "It's payback, with interest."

Friction between the European Union and Budapest started last summer.

Senior European officials, including the head of the EU's executive branch, José Manuel Barroso, and other members of the European Commission are to meet with Hungarian Prime Minister Viktor Orban this week in Budapest to mark the start of Hungary's six-month presidency.

The agenda for the talks hasn't been set, but "it is very likely that someone will raise these questions," Olivier Bailly, an EU spokesman, said Monday.


Associated Press

The government of Hungarian Prime Minister Viktor Orban, seen in October, is under scrutiny from the European Union.

In some ways the dispute between Budapest and Brussels goes to the heart of a debate over the proper distribution of power between national governments and the central authorities of the European Union.

"The EU basically has no right to interfere" in these sorts of policy decisions, says Hungary's Mr. Kovacs. The media law, for example, he says, "is a domestic matter."

Friction between the EU and Budapest started last summer, when the EU and the International Monetary Fund, which rescued a heavily indebted Hungary from the brink of insolvency in 2008, criticized Hungary for relying on short-term fixes instead of long-term spending cuts to shrink its budget deficit.

Among those short-term measures was a levy on banks aimed at raising roughly $1 billion annually in revenue for three years. As Hungary's budget position deteriorated further, the government imposed similar temporary taxes on energy, retail and telecommunications companies.

Many companies hit by the levies have protested. Last month, 13 large companies from France, Germany, Austria, the Netherlands and the Czech Republic, sent a letter of complaint to the EU, saying Hungary is targeting "select sectors and foreign companies in particular, to balance the state budget."

Other policies have drawn fire from the European Central Bank, which says that Hungary's moves to cap the pay of its central bank governor as well as proposed legislation aimed at changing the selection process for the bank's rate-setting committee threaten the central bank's independence.

Then there is the media law, passed by parliament late last year, which allows regulators to impose fines for "unbalanced" or "offensive" reports and sets limits for the amount of time that can be devoted to certain types of news. The law also requires bloggers to register with the government.

"The dissatisfaction is not just with one piece of legislation, but against the whole attitude of the Hungarian government," said Tibor Szanyi, a member of the Hungarian parliament from the opposition Socialist party. "Europe means compromise. Europe means common values."

Eniko Gyori, minister of state for European affairs at Hungary's foreign ministry, said that after a range of austerity measures imposed under Hungary's previous government, the country couldn't put additional burdens on ordinary people, so it turned to the special taxes on large companies.

"I don't expect them to be happy about it. But it's reality," she said. Ms. Gyori said the Hungarian government's goal is to get the country's economy growing again. To that end, it has cut personal income taxes and lowered the taxes that must be paid by smaller companies.

"The question is: how much economic liberty you have in the EU?" said Ms. Gyori. "We think every state does have economic freedom—within a certain framework, we have different methods and models."

She also called on critics to read the media law, which doesn't yet have an official English translation, and wait to see how it functions in practice before condemning it. "We are ready to listen to everyone," she said. Still, opposition to the law has been growing, at home and abroad. "This new law is unacceptable. Hungary must explain and the Commission must act," said Guy Verhofstadt, president of the European Parliament's Alliance of Liberals and Democrats for Europe. No EU state should be allowed to put "restrictions to freedoms that lie at the heart of our union of values," he said.

Hungary's left-leaning media have railed against the new law, which they say deals a serious blow to freedom of the press. Karoly T. Voros, editor in chief of the country's largest daily, Nepszabadsag, says the legislation is "a violation of fundamental human liberties."

Media more friendly to the government and the ruling Fidesz party, however, have come out in favor of the law. In an editorial Monday, Magyar Nemzet, a national daily newspaper with headquarters in Budapest, said the law was required to end 20 years of "lies, misleading reporting, malevolence and one-sidedness" by left-leaning media outlets.

—Margit Feher and Veronika Gulyas contributed to this article.

Points of contention

Some recent disagreements between Hungary and the EU

- European Union and International Monetary Fund negotiators walked away from loan talks with Hungary in July. The EU said the government wasn't doing enough to cut spending and was relying too much on a temporary tax on banks that it said could end up hurting the economy.
- European Central Bank said in December that it is 'closely following' developments in Hungary that it says pose a threat to the independence of the country's central bank. Such independence is guaranteed by an EU treaty.
- Officials from EU member states and members of the European Parliament criticize Hungary's new media law as contrary to EU values. Officials in Germany and Britain have hinted that Hungary should amend the law. Hungary says its critics are misinformed and should wait to see how the law is put into practice.

Getty Images

Incoming House Speaker John Boehner, center, addressed spending and health care at a December news conference.

Republicans to take aim at spending in new year

By Patrick O'Connor And Janet Hook

The Republican majority that takes over the House this week plans an ambitious drive to slash government spending by tens of billions of dollars in the next few months, a strategy that ensures that the capital soon will be consumed by intense debate over how and where to reduce the size of government.

The incoming House majority will start by offering two measures this week that carry more symbolism than substance. One will be a motion to repeal the health bill that President Barack Obama signed last year, and the second will be a measure to trim the cost of running the House itself. The health-care repeal isn't expected to go anywhere in the Senate, where Democrats retain the majority, and the package of cuts to the House budget will only save about $25 million from a federal budget that exceeds $3 trillion.

After that, however, Republicans in the House say they plan to move on to offer a far more sweeping package of "recissions," or elimination of spending previously approved, that will aim to bring domestic spending back to where it was before Mr. Obama became president. The skirmish over that proposal for spending cuts, coupled with related fights over government regulation and health care, will set the battle lines for the next two years as Washington returns to divided government.

Unlike its predecessors in the Republican Revolution of 1994, or among the Democrats who took charge of the House after the 2006 election, the new Republican majority doesn't return to power with a long to-do list of legislative priorities. Instead, party members say they were elected with one big mandate: Cut spending. The details of that push will unfold in the weeks leading up to the March 4 deadline for Congress to fund the federal government and play out against a backdrop of mounting federal deficits.

House Republicans have also set their sights on scaling back environmental regulations and tightening border security. But spending cuts are their primary focus, with a pledge to cut about 21% from the $477 billion lawmakers have approved for domestic discretionary spending this year.

"Getting a grip on this year's spending is only the first step in addressing our long term budget challenges—but it's a step we must take, and we must take it now," said incoming Budget Committee Chairman Paul Ryan (R., Wis.) in a statement.

Cutting spending in the middle of a fiscal year "is a total end run around the budget process," said Maryland Rep. Chris Van Hollen, the top Democrat on the budget committee.

Republicans will be treading a fine and politically risky line in trying to carry out a perceived election mandate. While Republican voters voiced their opposition to high deficits and spending, polls show that the programs that account for much of that growth—Medicare and Social Security, which benefit elderly Americans—are popular.

In another early move, Republicans are requiring the reading of the U.S. Constitution on Thursday—a nod to the tea-party activists who were so important to GOP victories in the fall and the movement's complaints that Congress has reached beyond its constitutional powers under the Obama administration.

First up among the proposed spending cuts is one that will be offered later this week to shave 5% from the operating budgets for individual members' offices, committees and leadership staff. Republicans estimate the package will save $25 million.

The bigger recission bill—which will essentially take back money that is already appropriated—will take shape over the next month or two. One target is part of the president's $814 billion stimulus that hasn't been promised to existing programs, which Republicans estimate would save $12 billion. The bulk of it includes funds for high-speed-rail projects. Also included is money provided for food stamps under a formula that presumed food prices would rise more than they actually did.

Even if the House passes the bill, there is no guarantee the Senate would send it to Mr. Obama, and the president isn't expected to sign any legislation that would gut his programs. White House economic adviser Austan Goolsbee suggested Sunday that Mr. Obama will try to beat the Republicans to the punch with cuts he is likely to spell out in his State of the Union address late this month. Mr. Goolsbee, in an appearance on ABC's "This Week," said: "We are going to have to make, in the medium run, a series of tough choices, and the president's not afraid to do that, and I think you will see in his budget that he's willing to."

Republicans aren't proposing an across-the-board cut on the government, so some departments could see deeper cuts than others. The top targets could be programs whose budgets saw a jump under Democrats, like foreign aid and Pell Grants for middle-income college students.

The Republican majority finds itself on a collision course with a number of federal agencies over regulatory policy, including the Justice Department and the Environmental Protection Agency. The House GOP could use the threat of spending cuts to pressure these and other agencies, like denying money to the Department of Health and Human Services for implementing the health-care bill or to the Securities and Exchange Commission to carry out new rules for the financial markets.

Rep. Fred Upton (R., Mich.), the incoming chairman of the Energy and Commerce Committee, said Sunday that his panel would hold "early" hearings on an EPA rule-making process already under way to set emissions limits on refineries and coal- and gas-fired power plants. He also threatened a congressional repeal of those regulations once they are announced.

The incoming majority has proposed changes to the rules governing the House that will make it easier for them to cut spending and repeal the health-care bill. Foremost is a change that would let Mr. Ryan, the incoming budget-committee chairman, set spending levels for the rest of the year without approval from other members of his panel or the broader House. Mr. Ryan said if the change passes, he will wait until the Congressional Budget Office releases its baseline budget projections later this month before setting the limits "that would take nonsecurity spending back to its prebailout, prestimulus spending levels."

New term brings new youth to the House Republicans

[Capital Journal]

By Gerald F. Seib

The House of Representatives won't undergo merely a partisan change when the new Congress convenes on Wednesday. It will, in many ways, undergo a generational change as well.

A new and younger set of Republicans lawmakers will move in when their party takes control of the House. Perhaps more important, the change also will empower a new and younger set of Republican leaders who will run the House—and who figure to be in positions of power within their party for years, if not decades, to come.

Overall, the influx of 87 new Republican House members who will be sworn in Wednesday will lower the average age of House Republicans to 54.9 from 56.5 in the last Congress, a new Wall Street Journal analysis of ages in the new Congress shows.

By contrast, Democrats in the House are moving in the opposite direction on the age scale. The 2010 election swept from office some of the party's younger members from moderate swing districts, and the result is a Democratic caucus that is both more liberal and grayer. The average age of a Democratic House member will rise to 60.2 from 58. (Go to **WSJ.com/US** to see an interactive graphic of changing ages in Congress.)

The Republican wave is literally bringing a new generation of GOP legislators to Washington. Michigan's Third District will be represented by 30-year-old Justin Amash, Illinois's 11th District by 32-year-old Adam Kinzinger, Alabama's Second District by 34-year-old Martha Roby. And so on.

More striking is the generational change in House leadership. That change isn't so dramatic at the very top. New Republican House Speaker John Boehner is 61 years old, compared with 70-year-old outgoing Democratic Speaker Nancy Pelosi.

But just below the speaker the change is stark. The new House Republican leader will be Rep. Eric Cantor, 47. Outgoing Democratic Leader Steny Hoyer is 71.

The number three spot in the Republican leadership, the post of majority whip, will be held by Rep. Kevin McCarthy, 45. By contrast, outgoing Democratic Whip James Clyburn is 70.

Mr. Cantor insists this generational change is no accident. It's the direct result, he says, of the so-called Young Guns program that set out to recruit a new set of Republican congressional candidates for the 2010 campaign. That program was established by Messrs. Cantor and McCarthy, along with 40-year-old Rep. Paul Ryan, who now will become chairman of the budget committee. (Mr. Ryan succeeds departing Democratic Chairman John Spratt, 68.)

The broader question is what substantive impact this wave of new, young Republicans will have on Congress's work. Mr. Cantor says the generational change will produce more unconventional approaches—and that the newcomers' common denominator is a commitment to attack government spending.

"I think that these are individuals who know we can't keep doing things and striking deals the way it's been done in the past," he says in an interview. "We have to start acting like governors, and the way families are acting, and that means stopping the spending."

Even Republican leaders acknowledge, though, that they may sometimes have their hands full controlling their youth movement. Others predict the passionate views of these conservative newcomers, many with tea-party loyalties, may stand in the way of compromise, even when their leaders decide it's necessary. (Think: raising the federal debt ceiling.)

Just below the speaker, the generational change is stark. The new House GOP leader will be Eric Cantor, 47. Outgoing Democratic Leader Steny Hoyer is 71.

"What's discouraging about it among Republicans is that it reinforces an intensely ideological view of the world, with relatively little sense of institutional loyalty or commitment, and no real embrace of Congress as a deliberative body where members can engage in good-faith negotiations," says Tom Mann, a congressional scholar at the Brookings Institution.

But not doing things the way they've been done before is the point for many new members; Mr. Cantor says to expect "thinking outside the box."

As it happens, there's something of the same kind of change going on in the Senate, but there the generational change is more intriguing among Democrats. The average age of Senate Democrats has dropped just slightly—to 63.1 from 63.4—but more important is the emergence of a new set of younger Democratic senators, including the Udall brothers, Tom of New Mexico and Mark of Colorado; Michael Bennet of Colorado; and Jeff Merkley of Oregon. They also are eager for change, and have been leading a charge to reform the Senate's antiquated filibuster rules.

Of course, youth won't be served everywhere. The House Appropriations Committee, which passes around federal spending, will be run by the venerable Republican Rep. Hal Rogers, who turned 73 on New Year's Eve.

Still, as of Wednesday, it will be possible for the 49-year-old president, Barack Obama, to meet with the House's majority leader, majority whip and budget committee chairman—and for all in the room to be under the age of 50.

U.S. NEWS

Schwarzenegger exits, legacy vague

BY STU WOO

SACRAMENTO, Calif.—California Gov. Arnold Schwarzenegger, the former action-movie hero, said he would "blow up the boxes" of state government when he became governor of the most populous U.S. state more than six years ago.

California poses special challenges for those who occupy the governor's chair: Its cap on property taxes limits the chief executive's options, and its free-wheeling voter-initiative process can undermine a leader's best-laid plans. Even so, Mr. Schwarzenegger's struggle to improve the state's finances amid an uncertain economy illustrates the difficulties looming before the nation's 26 new governors, many of whom face fiscal problems much like those facing California in 2003.

Mr. Schwarzenegger came to office after an extraordinary recall election to replace Democratic Gov. Gray Davis that featured 135 candidates, from established state politicians to minor celebrities.

As Mr. Schwarzenegger left office Monday, the bureaucratic "boxes" he targeted remained. Although Mr. Schwarzenegger, a Republican, successfully collaborated with the Democratic-dominated legislature to pass a landmark greenhouse-gas emissions law, he failed to solve the state's fiscal crises. That leaves Democratic Gov. Jerry Brown, who was inaugurated Monday, with a projected $28 billion budget shortfall through June 2012.

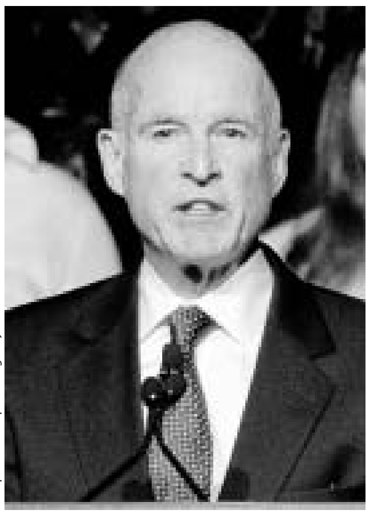
Mr. Schwarzenegger's legacy may now hinge on whether incremental and unproven revisions to the state's electoral and fiscal systems pan out.

"He started out with his 'Terminator' sunglasses, and he's going out with green eyeshades," said John Pitney, a Claremont McKenna College political scientist and former GOP official. "Perhaps reforms of the primary process and redistricting will have some long-lasting effects, but only time will tell."


Associated Press

Those political-system revisions could lead voters to elect more-centrist lawmakers: They charge an independent panel rather than the state legislature with drawing district lines for legislative races, and they eliminate traditional partisan primary elections. But some political scientists say the changes will have little or no effect.

Mr. Schwarzenegger also won two long sought-after changes to the budget system. One created a two-tiered pension system for government workers, which his office estimated would save the state $100 billion over 30 years. The other created a 2012 ballot measure that would impose a spending limit on the state budget. Experts say future governors can easily do away with the pension revision.


European Pressphoto Agency

Arnold Schwarzenegger, left, pushed legislation to cut carbon emissions as California governor. Successor Jerry Brown, 72, above, is returning to a post he left 28 years ago.

Mr. Schwarzenegger's administration was marred during the past two years as he presided over a cumulative $90 billion budget shortfall and legislative gridlock that forced the state to issue IOUs for only the second time since the Great Depression. As pressure rose to rein in government, he raised taxes and slashed spending, especially on education.

Mr. Schwarzenegger said he was unsure what his next step would be. He has said that he would consider returning to acting if the script was right, but that running for the U.S. Senate was unlikely.

He blundered in 2005, when voters rejected four ballot measures that Mr. Schwarzenegger said were needed to fix California. Labor unions assailed the slate of initiatives, which would have imposed a budgetary spending cap and created a new legislative redistricting panel, among other things.

"Picking a fight with the teachers and nurses [unions], or choosing to do redistricting in the manner in which he chose to do it; all of those things were misspent capital," said Don Perata, a former Democratic California Senate president during Mr. Schwarzenegger's term.

In 2006 and 2007, the self-described centrist governor pivoted and began working with Democratic lawmakers. Their biggest achievement: passing AB 32, legislation that requires emissions of greenhouse gases in the state to be reduced to 1990 levels by 2020.

Mr. Schwarzenegger easily won re-election in 2006 and, during 2007, his approval rating rebounded to about 60%. But a year later, California's economy cratered. The state faced the first of its budget shortfalls, which worsened in part because Mr. Schwarzenegger borrowed to close gaps during his first tenure.

Financial difficulties dominated the final two years of his administration. He and legislators engaged in budget stalemates, forcing the state to issue the IOUs and delay construction projects. Republicans reviled him for raising taxes. Democrats and social-welfare groups decried his spending cuts to education, and health and social programs.

Mr. Schwarzenegger did end his tenure on a winning note. In addition to his budget changes, he helped defeat an oil-industry-backed ballot measure that would have suspended AB 32.

In an interview in August, Mr. Schwarzenegger, 63, conceded that he did not streamline government as much as he had hoped to do.

"It's true that we did not blow up all the boxes I intended to blow up. It was more difficult than I thought," Mr. Schwarzenegger said. "That does not mean it was wrong to have that goal, because I think that if you have no goal, then you wouldn't go after that in the first place. I always shoot for the top, and whatever you can get under the circumstances, you get," Mr. Schwarzenegger said.

Office market shows sign of life

BY ANTON TROIANOVSKI

The amount of office space occupied by U.S. businesses increased for the first time in nearly three years in the fourth quarter of 2010 as more companies that had been postponing real-estate decisions got back into the leasing market.

Average office rents also rose, by 0.2% to $22.09 per square foot, registering their first uptick since the second quarter of 2008, according to property research firm Reis Inc. While the 79 metropolitan areas tracked by Reis vary greatly, the national trend means that in many regions the balance of power is shifting to landlords from tenants.

The office market has been hard hit by job losses. From January 2008 to September 2010, businesses vacated 137.8 million square feet of office space—more than the inventory in Chicago's central business district. In the last three months of 2010, however, occupied office space in the U.S. grew by 2.5 million square feet.

On the whole, the office-market recovery remains weak. The national vacancy rate of 17.6%, unchanged from the third quarter of 2010, is the highest since 1993, according to Reis. Average rents are still well below highs of more than $25 per square foot in mid-2008.

Real-estate developers expect more pain to come this year as more debt comes due, refinancing options remain limited, and supply continues to exceed demand in overbuilt markets like Phoenix and Las Vegas.

But as businesses gain confidence about their growth prospects amid a strengthening economy, markets across the country are seeing signs of improvement. The biggest increases in average rents in the fourth quarter came in Pittsburgh, New York City and San Francisco, thanks in part to demand for space from financial-services and technology firms. French financial giant Societe Generale last month announced a 20-year, 444,000 square-foot lease on Manhattan's Park Avenue, the biggest office lease in Manhattan in 2010.

In Cleveland, closely held technology provider MCPc Inc. last week announced a 98,000 square-foot, 10-year lease in a downtown office building. To accommodate growth in recent years, MCPc had been adding satellite facilities, accumulating 65,000 square feet in the suburbs. Now the company wants to consolidate in a more visible location.

"It's been inefficient, but it's got us through the recession," says Chief Executive Mike Trebilcock. "It's time to come out of the comfort of the suburbs and put ourselves front and center."

Deep-pocketed real-estate investors are noting of signs of stability in the office market and starting to make bets in cities hit hard by the recession. In Atlanta, Parkway Properties Inc. said last month it was under contract to buy the office and retail portion of a 50-story tower in the upscale Buckhead neighborhood for $167.3 million, or about $346 per square foot. It's one of the priciest office-building deals Atlanta has seen in years, and comes despite a glut of new space in Buckhead.

Meanwhile in Miami, a property fund managed by an affiliate of Jones Lang LaSalle Inc., the commercial real-estate brokerage, is paying $106 million for the I.M.-Pei-designed Miami Tower. "Miami is a cyclical market that, we think, will recover sometime," said Jim Hutchinson, who runs the fund.

Miami's 15.9% vacancy rate is slightly below the national average. Other Sun-Belt metropolitan areas are suffering from more oversupply, with vacancy rates still hovering around 25% in Las Vegas, Phoenix, and California's Inland Empire.

Jump in manufacturing bodes well for the new year

Continued from first page

cember's strong readings in new orders and production, combined with positive comments from the panel, should create momentum as we go into the first quarter of 2011," he said.

Last year ended on a high note at Red Wing Shoe Co., in Redwing, Minn. A year ago, the company was planning to shut down a factory in Danville, Ky. But growing orders prompted it to keep the plant's doors open and to modestly add to its companywide headcount of about 2,100 workers.

"We ended up with quite a strong year on all measures—on revenues and shipments and earnings," said company president David Murphy.

In Asia, manufacturing in South Korea and Taiwan accelerated in December even as expansion in China and India slowed, with developed markets in the U.S. and Europe supporting the region's exporters.

The data released Monday by HSBC Holdings PLC highlighted continued strength in Asia but also reinforced concerns about rising inflationary pressures that likely will prompt some central banks in the region to keep tightening monetary policy.

The figures suggested the South Korean and Taiwanese economies continued to rebound from a lull late last year, when fears of setbacks in the U.S. and European economies sent ripples of caution through Asia, where growth remains dependent on exports.

—Michael S. Derby, Aries Poon and Arran Scott contributed to this article.

WORLD NEWS

Defection hobbles Pakistani leader

By Tom Wright

The government of Pakistan President Asif Ali Zardari appeared set to hang on to power despite a disintegration of the ruling coalition Sunday, following signs that a key opposition party is unlikely to force a no-confidence vote.

But the government's shaky standing will limit its ability to take unpopular steps, including a tax overhaul, that foreign donors say are needed to avert an economic meltdown.

The Pakistan-Muslim League (N), the main opposition party, is likely to decide at a Tuesday meeting of its executive committee not to attempt to topple the government, said Raoof Hasan, a media consultant to the party who is close to Shahbaz Sharif, president of the PML(N) and brother of party founder Nawaz Sharif, the former prime minister.

Prime Minister Yousuf Raza Gilani met with Shahbaz Sharif, who is also chief minister of Punjab province, in Lahore on Monday in a bid to avert a crisis. PML(N) executive board member, Chaudhry Nisar Ali Khan, said after the meeting that the party had agreed not to destabilize the government, but didn't elaborate, the Associated Press reported.

On Sunday, a key coalition partner of the Pakistan People's Party-led government, the Muttahida Qaumi Movement, joined the opposition, depriving the administration of a majority in the National Assembly—the lower house of Parliament—making it difficult to pass new economic policies.

Where the government has pushed overhauls, such as slashing petroleum subsidies, it has faced a backlash in the National Assembly. The MQM on Sunday cited rising petroleum prices as one reason for joining the opposition.

Under Pakistan's parliamentary system, a government doesn't fall automatically on losing a majority

Agence France-Presse/Getty Images

Hayder Abbas Rizvi, whose MQM party abandoned the ruling coalition Sunday, arrived at Parliament on Monday.

but must be voted out by a no-confidence motion, passed by a majority of lawmakers. Pakistan's opposition is also fractured, making it unlikely that the PML(N) could win such a vote, Mr. Hasan said.

Farhatullah Babar, a spokesman for Mr. Zardari, said the government believed the opposition wasn't united enough to win a no-confidence vote. The government now faces the challenge of tackling an escalating economic crisis without a majority in the National Assembly.

Foreign donors including the International Monetary Fund, World Bank and Asian Development Bank have been frustrated over Pakistan's failure to tackle a growing budget deficit by implementing changes aimed at boosting revenue and cutting spending.

The U.S., one of the largest donors to multilateral institutions, has publicly called on Pakistan to do more. In October, Secretary of State Hillary Clinton told a meeting of Pakistan's foreign donors in Brussels that the country must increase tax revenue, which in 2010 equaled 10.2% of gross domestic product, one of the world's lowest ratios.

But the prospect of boosting tax revenue appears bleak amid the current political crisis, Pakistani and Western officials say.

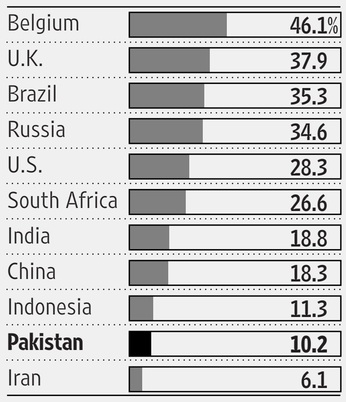
Mr. Zardari's government has faced opposition from the PML(N) to its efforts to bring in a general sales tax, a move backed by the U.S. and other donors. The PML(N) says such a tax will hurt ordinary Pakistanis. The party wants sectors that benefit the elite but are currently exempt, such as agriculture and construction, to also face taxation.

Pakistan's budget deficit has grown to between 6% and 8% of GDP, above a 4% target for the current fiscal year to June 30. To fund the shortfall, the government borrowed $3.6 billion from the central bank from July 1 to early December, a move that amounted to printing money, stoking inflation.

Foreign donors have begun over the past six months to withhold aid

Taking a cut

Tax revenue as percentage of GDP in 2010, for selected countries



Source: Heritage Foundation

on which the government depends until tax overhauls and other changes, such as reducing electricity subsidies, are implemented.

The World Bank and Asian Development Bank haven't transferred any of a combined $3 billion in budget support pledged for this fiscal year, said a senior Pakistan Finance Ministry official. The IMF has withheld $3.5 billion from an $11.3 billion emergency loan package.

To be sure, donors are unlikely to allow Pakistan's economy to spiral out of control, given the central role the country plays in supporting the U.S.-led war against the Taliban in Afghanistan.

For now, Pakistan's foreign reserves are worth five months of imports, meaning the government hasn't yet reached a balance of payments crisis like one in November 2008 that forced the country to call in the IMF.

The situation could change, however, if the government fails to take action to reduce its deficit, forcing donors to re-evaluate their strategy of withholding funds, said a senior Western official in Islamabad.

Seoul vows to boost defenses

By Evan Ramstad

SEOUL—South Korean President Lee Myung-bak used his New Year's message to warn North Korea to halt its "military adventurism," underscoring the greater priority that heightened regional tension has demanded, though much of his address dealt with economic issues.

A year ago, Mr. Lee hardly mentioned North Korea in his New Year's message. But after the North's two military attacks against the South in 2010, Mr. Lee spent the first five minutes of the 25-minute speech on what he called its "grave challenges."

"The North must come to the realization that nothing can be gained through military adventurism," Mr. Lee said. "They cannot speak of peace and solidarity among Korean people while shelling civilians and threatening compatriots with nuclear attacks."

On Nov. 23, North Korea attacked the South's Yeonpyeong Island with artillery fire that killed two South Korean soldiers and two civilians, destroyed about 30 homes and damaged most other buildings in a village where about 1,400 people lived.

Since then, Mr. Lee's government and the South's military have repeatedly expressed in strong lan-

Associated Press

President Lee Myung-bak spoke of 'grave challenges' on Monday.

guage that South Korea will strike back at any more attacks from North Korea.

On Monday, Mr. Lee compared the South's reaction to the Nov. 23 attack to what happened in the U.S. after the Sept. 11, 2001, terrorist attack, noting that Washington used that event to re-evaluate its security and intelligence strategies.

"The shelling of Yeonpyeong Island also served as an opportunity for us to reflect on our security readiness and overhaul our defense posture," Mr. Lee said. "As the safety and security of the Korean people is absolute, there cannot be any delay in establishing security measures."

North Korea's annual New Year's message followed its usual pattern of offering an olive branch to Seoul, then warning South Korea that it is ready to fight and outlining a list of things the South should do, including ending its military alliance with the U.S., to smooth relations.

Mr. Lee said he remains open to dialogue with North Korea but only if it doesn't lead to bluster from Pyongyang. "If the North exhibits sincerity, we have both the will and the plan to drastically enhance economic cooperation," he said.

In the 2010 speech, Mr. Lee made a similar offer in his brief mention of the North. He urged Pyongyang to return to the six-nation nuclear disarmament talks, set up a new organization for inter-Korean dialogue, and look for the remains of casualties from the Korean War of the 1950s. "I hope that North Korea will engage in genuine dialogue," he said at the time.

Most of Mr. Lee's speech this year focused on economic matters, such as expansion of the nation's welfare program and efforts to create more jobs for young adults just out of college or military service. He reiterated previously stated goals of 5% gross domestic product growth in 2011 and inflation under 3%.

Afghan court to probe alleged election fraud

By Maria Abi-Habib

KABUL—Afghanistan's Supreme Court said it will investigate more than 400 cases of alleged fraud in the country's September parliamentary elections, a move that could complicate the appointment of a new Parliament.

Monday's announcement comes two weeks before the deadline to inaugurate the new Parliament. If the investigation leaves the overall results uncertain, Afghanistan could find itself in a constitutional crisis.

A quarter of the 5.6 million ballots cast during the Sept. 18 polls were thrown out due to alleged ballot stuffing or voter intimidation.

The Supreme Court's decision could stir ethnic tensions. Pashtuns, the country's largest ethnic group, are demanding a new election after they fared poorly.

Winning candidates and some Western observers say that President Hamid Karzai, a Pashtun, is using the Supreme Court to put allies in power. The president appoints the members of the Supreme Court with Parliament's approval.

Mr. Karzai's spokesman, Waheed Omer, denied those allegations.

Haji Sediqullah Haqiq, chief of the Supreme Court's special tribunal on elections, said that the court is "independent and is not under any pressure."

Mr. Haqiq didn't specify how many of the alleged fraud cases may affect the preliminary winners for Parliament's 246 seats, but he said changes would be made. "According to the constitution, the Supreme Court is the final arbiter on elections" and can annul them, Mr. Haqiq said. "If they inaugurate the new Parliament before we can make a ruling, it will create chaos."

The international community has rallied behind the results certified last month by the country's election authorities. The United Nations has appealed for Afghanistan's courts to stay out of election matters.

"Lately we've seen foreign embassies support the results of the fraudulent elections without allowing the courts to decide. It's unseemly that our allies, who are trying to win the hearts and the minds of Afghans, are ignoring the millions that want the results contested in court," said Daud Sultanzoy, a Pashtun member of Parliament who lost his seat in the election.

WORLD NEWS

Agence France-Presse/Getty Images

Workers place bottles of cooking oil at a supermarket in China's Anhui province. Food prices are driving China's inflation.

China's kitchens suffer cooking oil inflation

BY JAMES T. AREDDY

SHANGHAI—These days, Liu Chuansheng nervously scouts five locations before he buys cooking oil, illustrating how a sudden rise in the price of the Chinese kitchen's most vital ingredient has become close to a national crisis.

On a recent Friday, the 33-year-old, who runs a breakfast stand with his wife, wheeled a shopping cart into the aisle of a **C.P. Lotus** Corp. superstore in northern Shanghai, eying only prices. In seconds, his wife emptied the shelves of its 11 remaining bottles of **Cofco** Ltd. "Five Lakes" soybean oil, the discount choice at 47.90 yuan, or about $7.20, for five liters (1.32 gallons).

At the checkout, Mr. Liu separated their $79 purchase into three batches to sidestep the store's four-bottle maximum and government bans on hoarding. To transport the provisions to their food stand, Mr. Liu placed two bottles into the basket of his blue electric scooter and balanced nine more on the running board. His wife plopped on back.

Mr. Liu's livelihood is now just as precariously balanced. He reckons his cooking-oil costs shot up 27% in 2010.

Rising food prices helped to push China's consumer-price index to a two-year high of 5.1% in November, and nowhere are the pressures felt more deeply than with cooking oil, more vital in Chinese cooking than even rice. Rising oil prices mean daily hardship for Chinese on meager incomes. And though food represents only about one-third of the CPI, it accounts for about 75% of the index's recent rise.

Such price challenges are a primary reason China's central bank abruptly raised interest rates twice in 10 weeks, most recently on Christmas Day. The next day, Premier Wen Jiabao went on national radio to take questions from anxious listeners worried about inflation.

According to a report on Saturday, China's official purchasing managers index declined to 53.9 in December from 55.2 in November. Bank of America-Merrill Lynch economist Lu Ting warned that the input price

Heating up

The cost of cooking oil in China has risen quickly.

The wholesale price of soybean oil in metric tons.

Note: 10,000 yuan=$1,517

Source: Shanghai Pansun Information & Technology Co.

reading is "still quite high," and that Chinese authorities "will have to tolerate a relatively high inflation in the coming years."

Chinese housing has long been pricey, and an increasingly broad array of prices appears to be following. The National Development and Reform Commission in late December, for instance, announced a 3.77% rise in retail gasoline prices, to the equivalent of $3.50 a gallon, for an 11% increase in about a year.

But the main oil shock the Chinese face is at the stove rather than the pump. In a nation where few kitchens include an oven, cooking oil is so valued that a jug of it is an appropriate gift.

Wholesale soybean oil rose 23% last year through early December to about $1,451 a metric ton, with most of the gain since July, according to research firm Shanghai Pansun Information & Technology Co. It is a potentially explosive trend. Three years ago, as oil prices were similarly surging, a stampede killed three people and injured 30 during a promotion offering about 20% off five-liter bottles of oil in the city of Chongqing. Prices hit $2,009 a ton in early 2008, Pansun reported.

At the Lotus store in Shanghai, shoppers appeared highly discriminating. Several perused bottles carrying the fish logo of China's most famous brand, "Arawana," produced by Singapore-based **Wilmar International** Ltd., but balked at the 52.90 yuan, or $7.90 price.

They included a young woman in a red jacket who took her cue from her husband's right foot, which he extended toward the 70-cent cheaper Cofco brand. She grabbed two of those—then put one back, explaining that her income as a cleaner is limited and that she is raising a 10-year-old daughter.

Pressures are building at China's ubiquitous neighborhood mom-and-pop oil vendors. At the Wang family oil station in Shanghai's Putuo district, some customers buy only enough for one meal. Chalk scribbles on an oil-storage tank that itemize unpaid purchases reflect the cost pressures: "A Shandong guy owes 30 yuan" and "Mr. Huang bought 490 yuan worth on Dec. 6."

Beijing moved to snuff out rumors that cooking oil is in short supply by auctioning millions of tons from national reserves. The national planning agency has declared that supply "is completely guaranteed." In November, the government ordered the largest producers to cap retail prices through March. And it quintupled the fine for conspiring to raise prices to five million yuan, or $750,000.

For now, the measures appear to have put a lid on edible-oil prices. Yet one midsize producer in Shanghai says they are also discouraging production. and he has now deactivated half of his plant.

Soybeans represent the U.S.'s single-biggest export to China: $9.19 billion in 2009, topping the combined value of semiconductors and plastic materials, according to U.S. data. Driven by China, U.S. soybean shipments will likely break records in the year ending Sept. 30, reaching 1.59 billion bushels, the U.S. Department of Agriculture says in a December report. But the appetite of China's "crushers" can fluctuate wildly, and they also import rapeseed, sunflower, corn and peanut oil feedstock from countries as varied as Argentina and Ukraine.

—Julie Zhu contributed to this article.

Hong Kong trade in yuan faces curbs

BY PETER STEIN AND FIONA LAW

HONG KONG—New regulations on trade in China's currency could slow expansion in one of the foreign-exchange industry's growth markets.

Under guidelines announced last month, banks in Hong Kong face restrictions on their ability to access yuan through China's foreign-exchange market.

They also must limit their net open positions in China's currency, that is, bets on the yuan's future movement, to 10% of their assets or liabilities denominated in the currency.

Bankers and traders say the new rules will increase funding costs for local banks, and limit their ability to offer currency futures or other derivatives that many have viewed as a source of future revenue growth.

In announcing the new guidelines following discussions with the People's Bank of China, the Hong Kong Monetary Authority referred to them as "refinements" to existing arrangements.

However, Frances Cheung, a senior strategist at Crédit Agricole, said, "The guidelines look more like restrictions as they limit the source of yuan flowing into Hong Kong, potentially squeezing yuan liquidity in the city's banking system."

Not long ago, use of the yuan, also called the renminbi, was largely confined within China's borders thanks to the country's strict capital controls. But in recent months, an experimental loosening of the restrictions has helped daily trading in the yuan outside mainland China to grow into a $400 million market centered in Hong Kong, a former British colony under Chinese sovereignty but with its own laws and financial system.

While this new trade in yuan is tiny compared with the $4 trillion in daily trading on global currency markets, the speed of its growth has become a source of excitement for many traders.

Many have predicted that within a few years China's currency could become a major force in global trade and a new source of business for banks that offer foreign-exchange services.

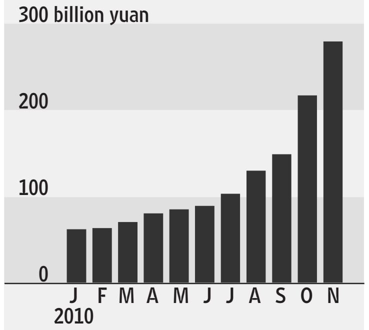
Bankers say the moves reflect China's interest in measured growth in yuan trading, not a desire to undo any past liberalizations aimed at promoting the currency's use outside the mainland. But they say the changes also underscore a desire among Chinese regulators to keep speculators from taking advantage of the new market to bet on the yuan's movement and potentially destabilize the economy.

Traders say the curb on a bank's net open position in yuan will have an especially big impact on banks' ability to offer currency forwards, swaps or other derivatives. For example, in order for a bank to offer a contract worth $50 million to buy yuan at a fixed rate in a year's time, under the new rules it would need to hold $500 million in yuan assets such as bonds, or $500 million worth of yuan deposits.

While the market for yuan derivatives is still in its early stages and should continue to grow this year, the cap on a bank's net open yuan position limits the business's future potential, said Gerrard Katz, head of

Growing money

Hong Kong's yuan deposits



Source: Hong Kong Monetary Authority

foreign-exchange trading at Standard Chartered. "It definitely will have some impact in terms of the overall market," he said.

A spokeswoman for the HKMA said the new guidelines are aimed at promoting "two-way movement in the yuan," including movement of the currency back into mainland China, not just into Hong Kong. She also said the limit on net open positions is designed to limit risk for the banks, given that the yuan isn't a freely convertible currency, and that having too much exposure to its movements could pose problems if a bank needed to buy or sell a large amount of yuan at one time.

The People's Bank of China didn't respond to a faxed request for comment.

China has taken a number of steps to promote the use of yuan to settle trade normally conducted in dollars. That and the ability of Hong Kong residents to acquire yuan more readily than people overseas has led to a surge in yuan deposits in the city's banking system.

Those deposits totaled 280 billion yuan ($42.48 billion) at the end of November, up 29% from the previous month and up 246% since the end of last year.

Investment banks that don't collect retail deposits in yuan have a smaller pool of yuan liquidity at their disposal. That makes the cap on their net open positions especially challenging, traders and analysts say.

"You need to have strong yuan deposits or you need to buy a lot of yuan-denominated assets such as bonds to boost up yuan balance sheet," said a trader at a European bank. "The cost of trading will be much higher."

A trader at another European bank said the new cap "will be quite a big change in business compared with the past few months."

This trader believes one knock-on effect will be that deposit-taking banks may choose not to chase yuan deposits as aggressively as before, because their ability to make money with those deposits by offering foreign-exchange swaps or futures contracts will be constrained. "You really have to think twice about what you do with the money," he said.

In a research note Monday, Barclays said rising yuan deposits are "a near-term drag on Hong Kong bank margins and profitability" because lenders can't find ways to profitably invest the yuan they collect. While many eagerly subscribe to yuan-denominated bonds issued in Hong Kong, the amount of such debt is still limited and yields are low.

WORLD NEWS

Australian flooding worsens

By Lyndal McFarland

MELBOURNE—The Australian military began rushing supplies to a town slowly being swamped by floodwaters Monday as authorities warned that floods devastating large parts of Queensland state are set to worsen in some areas.

A proper assessment of damage is expected only after the floodwaters, which follow torrential rains associated with the La Niña weather pattern, recede. But many expect damage to run to billions of dollars.

Floods affecting an area the size of France and Germany combined have forced thousands of residents to flee their homes, affecting as many as 200,000 people.

So far two people have died, with the latest casualty a 38-year-old man whose boat was swamped in central Queensland. A 41-year-old woman died after being swept from a vehicle attempting to cross a flooded causeway. Another man is missing and feared dead after the car he was traveling in was swept from a flooded causeway in the state's central west, police said.

Coal mining, haulage and export is the major industry in central Queensland, a major global source of coking coal used in steelmaking. Central Queensland and the Hunter Valley in New South Wales are the heartland of Australia's US$51 billion-a-year coal export industry.

The floods have forced many of the biggest miners—including **BHP Billiton** Ltd., **Rio Tinto** Ltd. and **Anglo American** PLC—to stop production and cancel deliveries to key customers.

"We have three-quarters of our coal fields unable to operate and unable to supply markets," Queensland Premier Anna Bligh told Australian Broadcasting Corp. television.

"There is likely to be a significant long-term effect of that, not only nationally, but also internationally," she said, noting the state provides half of the world's supply of coking coal. "So there is a remarkable problem out there in the mining industry....They will have a long, slow climb back to full production," she said.

Crops and livestock also have suffered.

European Pressphoto Agency

Residents walk through rising floodwaters in North Rockhampton, Australia, on Monday. The city of about 75,000 people was bracing for the worst, with the swollen Fitzroy River not expected to hit its peak until Wednesday.

"We are going to see an economic impact; there's no doubt about that," Prime Minister Julia Gillard told ABC Radio on Monday. "When floodwaters recede, we're going to see a lot of damage to roads, to bridges, to schools, to the community facilities that everybody relies on. We can't assess what that's going to cost until we can see the damage."

Water levels have begun to recede in some of the worst-hit areas around towns such as Emerald and Condamine. But residents of Rockhampton, a city of around 75,000 people 40 kilometers inland from Australia's Coral Sea coast, were bracing for the worst, with the swollen Fitzroy River not expected to hit its peak until Wednesday.

Ms. Bligh said military aircraft will fly supplies to Mackay Airport, with 100 tons of food and supplies to be trucked to Rockhampton before the last road link to the city is cut. Floodwaters are expected to peak in Rockhampton at 9.4 meters on Wednesday after hitting nine meters Monday.

Large parts of the city, including Rockhampton's airport, are already underwater and authorities have warned the town could be cut off for more than a week. In addition to rising floodwaters, residents are battling poisonous snakes seeking dry ground, along with contaminated water.

Queensland will delay its midyear budget review to take the flood impact into account, the state treasurer, Andrew Fraser, said over the weekend.

"The cost to the state will be huge, both in direct costs such as rebuilding roads and other damaged infrastructure and providing relief payments to families, but also in lost income while the mining, agriculture and tourism sectors recover," Mr. Fraser said in a statement Saturday.

Severe storms also caused a cinema roof to collapse Monday in the New South Wales city of Bathurst, injuring dozens.

Meanwhile, operators of oil fields off the coast of Western Australia moved to restart output Monday following a weekend cyclone warning.

Dampier and Port Hedland, Australia's two key iron-ore ports, came back online over the weekend after both had cleared ships from their harbors Friday in preparation for a potential cyclone.

The tropical low-pressure system that forced the precautionary shutdown moved away from the Western Australia state coast, and now isn't expected to affect the mainland.

Israel panel urges steep rise in oil, gas taxes

By Guy Chazan

Israel looks set to push through a sharp increase in oil and gas taxes after a committee of experts recommended nearly doubling the state's share of future revenue from oil and gas finds.

The Sheshinski Committee, headed by Eytan Sheshinski, an expert in public finance, made its recommendations in the face of fierce opposition from energy companies that have invested billions of dollars in exploring for oil and gas off the Israeli coast.

Those efforts were rewarded late last year when **Noble Energy** Inc. confirmed earlier estimates that its vast Leviathan field in the eastern Mediterranean contained 16 trillion cubic feet of natural gas—making it the world's largest deepwater gas discovery in a decade. The find is so large it could ultimately allow Israel to become a gas exporter.

Noble and its partners were strongly opposed to any tax changes, particularly those that might be applied retroactively to existing fields, and lobbied hard against them. Noble couldn't be reached to comment on the committee's recommendation.

The committee said any field that started producing by 2014 would be partially exempt from the increased tax rate.

The committee recommended increasing the state's share of revenue from oil and gas finds to between 52% and 62% from 30% now.

That was less than had been proposed under the committee's interim recommendations, published in November. It also said royalty rates, levied on production, should remain at their current rate of 12.5%.

There was also good news for Noble and its project to develop Tamar, a gas field about half the size of Leviathan that it discovered in 2009.

The committee said any field that started producing by 2014 would be partially exempt from the increased tax rate, which would be levied only after the producers had recovered 200% of their initial investment in exploring for and developing the oil and gas. Tamar is expected to meet that criterion.

The concession on Tamar could help to kick-start development of the field, which was put on hold after the Sheshinski committee put forward its original proposals in November. Then, banks went sour on the project and Delek Energy Ltd., Noble's partner, which is an arm of **Delek Group**, said it would have to re-evaluate the field.

Israeli Finance Minister Yuval Steinitz had long argued for tax increases, saying Israel's current petroleum tax regime, which dates from 1952, was far too generous to oil firms.

Steel project in India clears hurdle

By Prasenjit Bhattacharya

NEW DELHI—India's largest-ever foreign-investment proposal caught a tailwind Monday, when a federal panel approved a plan by South Korea's **Posco** to build a $12 billion steel project in eastern India.

Although final environmental clearance rests with India's environment minister, whose decision is likely within the month, the panel's approval makes it harder for the government to block the project in Orissa state.

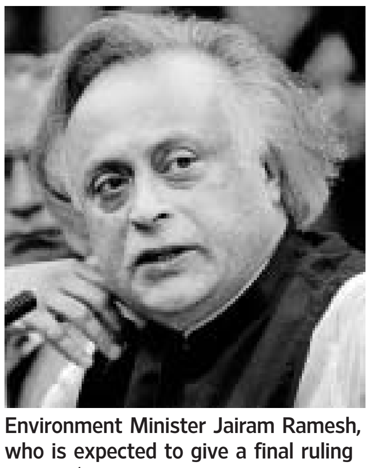
The news came as a relief to the company, whose project hasn't budged for five years. Monday's decision by the federal environmental panel also lends encouragement to other foreign and domestic companies that have run up against the government's recent hard line on environmental clearances.

Posco's project, like several other proposed steel plants in India, also has faced strong opposition from local landowners who said the massive development would deprive them of their homes and livelihoods. Posco's plant still awaits approval from a committee considering whether the project violates tribal rights.

The government-appointed environmental panel said Monday that the initial approval given to the plant in 2007 appeared justified in light of new data.

The case is being closely watched not just because of its scale, but also because India's environment ministry of late has thwarted several high-profile projects, such as coal mines, on the grounds that proper environmental clearances hadn't been received.

Environment Minister Jairam Ramesh has become a focal point for industry criticism that his department leans too heavily toward environmental protection at the expense of fostering responsible development. Mr. Ramesh has said the Posco project would be among the most difficult decisions he has faced in office. He couldn't be reached for comment Monday.



Associated Press

Environment Minister Jairam Ramesh, who is expected to give a final ruling on the $12 billion steel project this month, has faced industry criticism.

The environmental panel agreed with a ruling by Orissa's provincial government that the compensation paid to displaced farmers and fishermen for the Posco project was fair. The panel also said drinking water for the local population won't be affected by the project. The panel said the 4,000 acres sought by Posco appeared compact, given that other steelmakers use more land for similar-sized projects.

The approval is limited, however, to the initial production capacity of the plant, which is around four million tons a year. Every stage of expansion for the project, which Posco hopes will produce 12 million tons a year, will require separate clearances, the panel reiterated.

It also said 5% of the total project cost should be used for socially relevant projects in the area and that one-quarter of the project area—1,000 acres—should be reserved as green space.

Within six months of the start of construction, Posco is to submit to authorities its plan to build a township for the workers.