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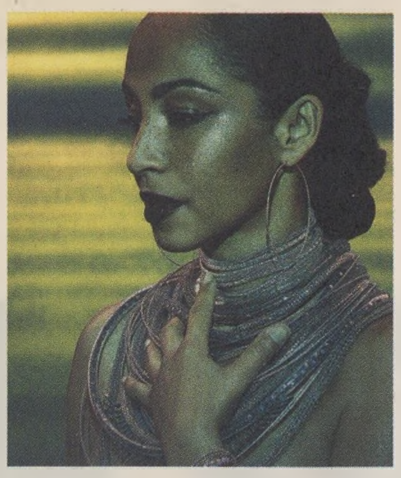

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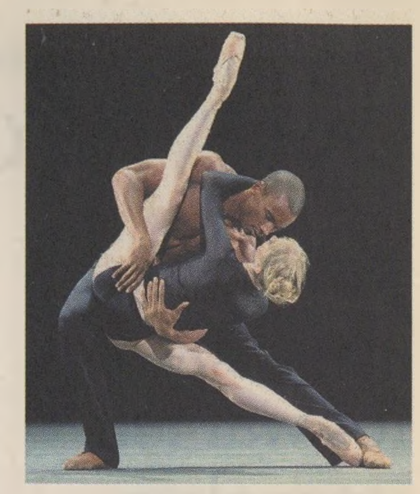

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Anti-Olympic graffiti in the Downtown Eastside neighborhood of Vancouver highlights the area's opposition to the Games, which are scheduled to open Friday just five blocks away.

The dark side of a city's Olympic glow

VANCOUVER, BRITISH COLUMBIA

Vancouver tries to deflect focus on drugs and blight near heart of the Games

BY GREG BISHOP

In this urban oasis widely considered one of the most livable places in the world, the Downtown Eastside is about 15 square blocks of something else.

At the corner of Main and Hastings, residents of the poorest postal code in Canada passed a recent Tuesday afternoon. One man lighted a crack pipe, inhaling deeply. Another urinated on a wall. Another burned a book of matches, muttering at the flame. Two men started fighting. One brandished a bicycle seat, the other a salad that spilled onto the sidewalk.

"All that over drugs," a passer-by said. "Welcome to the Downtown Eastside."

That scene unfolded five blocks from the site of the opening ceremony for the Winter Olympic Games, scheduled for Friday, and a five-minute drive from the athletes' village.

By bidding for the Games, Vancouver invited the world to visit. Now city officials are trying to redirect the international news media spotlight from this blighted neighborhood in the shadows of the picturesque North Shore Mountains.

News accounts throughout the world have zeroed in on the striking juxtaposition of the Downtown Eastside with the Winter Games.

"North America's festering sore of what do with its homeless and disenfranchised is crystallized in a few short blocks," The Sunday Times of Australia wrote. The Daily News of Egypt wrote, "Just be careful not to stray too far south of Gastown into the city's notoriously squalid and poverty-stricken notorious Downtown Eastside, where drugs and prostitution are rampant."

In response, British Columbia and Vancouver officials opened an information center in the neighborhood, with hopes of managing the way the story is told. Fact sheets are being distributed, and journalists are urged to consider positive developments in the neighborhood.

"Someone can write a negative story by taking a picture of someone in a doorway, but we have some things to celebrate," Rich Coleman, the minister of Housing and Social Development, said.

Host cities have long been accused of sanitizing rough areas before the Games: historic neighborhoods in
OLYMPICS, PAGE 2

LINDSEY VONN RACES TOWARD A DREAM
The U.S. skier is the best hope to bring home gold from Vancouver. *PAGE 11*

The euro spins into a severe political test

PARIS

Crisis in 16-nation zone exposes lack of leadership for the Union as a whole

BY STEVEN ERLANGER

What began with worries about the solvency of Greece, in the face of high deficits, fake statistics and low growth, has quickly become the most severe test of the 16-nation euro zone in its 11-year history.

The health of the euro, which has been shaken as financial concerns have

NEWS ANALYSIS

spread this week from Greece to Portugal, Spain and Italy, is not simply a crisis of debts, rating agencies and volatile markets. It has at its heart elements of a political crisis, because it goes to the central dilemma of the European Union — the continuing centrality of individual sovereignty over economic and fiscal policy, which makes it difficult for the Union as a whole to exercise political leadership.

While no one expects that the European Union will allow Greece or other members to default or the euro zone to collapse, European leaders and the European Central Bank in Frankfurt will almost surely have to bend the rules to provide guarantees or loans, if necessary. But even tiding over countries in trouble will not solve the main flaw in the euro zone — the sharp divergence of national economies and the lack of significant fiscal coordination, let alone a single treasury.

"The challenges facing the euro zone are very serious," said Simon Tilford, chief economist for the Center for European Reform in London. "For countries that have become pretty uncompetitive in the euro zone and have weak public finances, the current environment is very dangerous."

At the same time, the European Union is undergoing a major political transition to new leaders, a new commission and Parliament, and a new governing
EURO ZONE, PAGE 8

Cost of debt puts strain on Europe's weak links

LONDON

Markets raise pressure for rescue of Greece and other indebted countries

BY LANDON THOMAS JR.

Fortress Europe is now under attack by the market.

For months, the conventional wisdom in Europe was that the speculative aims of bond traders and hedge fund investors would remain largely focused on Greece, Europe's chronic problem child.

But this week, the cost of insuring the debt of not just Greece, but Portugal and Spain as well, rose to record levels — causing stock markets to tumble, the euro to fall, and borrowing costs in the most vulnerable countries to soar.

As a result, governments in the euro zone, with 16 nations and a decade old, must now confront a new and disturbing reality: The deal they struck to create a common currency area, hoping that a single central bank could manage to paper over the divergent economic and financial conditions of its members, is finally being challenged.

"This is the first big test for the European monetary system," said Christopher Wood, an investment strategist for Credit Lyonnais securities in Asia. "And it is clear this year that global macro risk will come from Euroland and not the U.S."

On Friday, the cost of insuring Greek, Spanish and Portuguese debt eased from their record highs, perhaps on comments made by Dominique Strauss-Kahn, the managing director of the International
DEBT, PAGE 8

WORLD STOCKS SLIP ON E.U. DEBT FEARS
Investors around the world fled stocks and the euro, amid expectations that Greece would need a bailout. *PAGE 7*

EUROPE FACES CREDIT-DEFAULT-SWAP RISK
Regulators worry that the instruments complicate the debt situation. *PAGE 8*

I.M.F. DISCIPLINE SUGGESTED FOR GREECE
The I.M.F. should be the one to rescue Greece, Otmar Issing said. *PAGE 9*

CHARLES MCQUILLAN/AGENCE FRANCE-PRESSE

Hard-fought accord Gerry Adams of Sinn Fein talking to party members Friday after the announcement in Northern Ireland of a deal to save power sharing. *PAGE 3*

Poverty as accomplice in death of child maid

LAHORE, PAKISTAN

BY SABRINA TAVERNISE

The death already seemed like a bitter injustice. A maid died after unexplained injuries she received in the house of her rich employer. But it got worse: She was 12.

Her employer — a lawyer and former head of the Lahore Bar Association — says she fell down stairs, and died Jan. 22 of complications from a skin disease. Her family says she was tortured. A Lahore court on Thursday gave the police four more days to draw their own conclusions.

Whatever the case, the death of Shazia Masih, a wisp of a girl from a bone-poor family, has outraged Pakistanis and served as a vivid reminder of the powerlessness of the poor.

Many wealthy Pakistanis employ children as servants, often to help with their own youngsters, a relatively common practice that Pakistani law does not prohibit. Shadowy figures at the edges of birthday parties and nights out in fancy restaurants, these young servants form a growing portion of Pakistan's domestic labor force.

But the root of this problem is poverty, Pakistanis say, and a law would do little to stem the tide of desperate young people from the countryside looking for work.

"You can't imagine the poverty," said Muhamed Sharif, an employment agent who supplies maids, gardeners and security guards to wealthy residents of Lahore. "Sometimes they come in hungry. They will do anything for work."

It was raw need that brought Shazia into the house of Chaudhry Naeem, in a wealthy neighborhood in this leafy city in eastern Pakistan. She received $8 a month to wash his floors, his cars and his toilets, her mother said, money that went toward paying off a family debt. Her parents, a house cleaner and a trash collector, earn $62 a month, too little to afford meat or fruit.

The system seemed to conspire against Shazia. The middleman who got her the job was pocketing a chunk of what Mr. Naeem was paying. Because Shazia was a minor, she was not issued a badge by the neighborhood security agency, making her invisible in effect.

If Mr. Naeem's lawyer is to be believed, Shazia was even rejected by her mother, Nasreen Bibi, who promised repeatedly to take her back, but never did because she could not afford to keep her. Ms. Bibi denies the accusation.

The circumstances of Shazia's death
PAKISTAN, PAGE 6

JASON TANNER FOR THE NEW YORK TIMES

Shazia Masih's mother, right, and aunt in the family's one-room dwelling in Lahore.

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Business

PHOTOS BY MICHAEL FALCO FOR THE NEW YORK TIMES

Stephen Seremetis, who is buying a loft under development in Jersey City, is convinced prices will not fall much further. "Real estate has bottomed out, and it's time to step in," he says.

Praying for a flood of bonus cash

NEW YORK

Early signs of a revival in luxury real estate are tied to bankers' fortunes

BY HILARY STOUT

For bonus season in the world's financial capitals, and after suffering through a miserable 2009, those who cater to the needs and desires of wealthy bankers are anticipating the return of newly flush customers to their showrooms and shop floors.

While most ordinary people are up in arms over the quick turnaround in banking fortunes and regulators are fuming over ballooning bonuses, there is at least one group that cannot wait for the bankers' money to start flowing again: residential real-estate brokers.

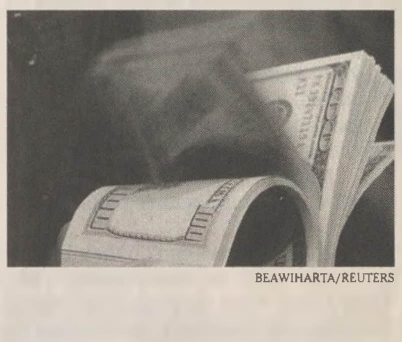
In London, Hong Kong and especially New York, for the past few months there have been signs that the market for high-end homes and apartments is reawakening, and an infusion of "banker cash" could be just the catalyst to drive a full-fledged recovery.

But just how powerful a force the bonus money will be is still in question. For all the bankers showing up to browse, deal after deal seems to be in limbo, its fate hinging on critical details: How much bonus money will the buyer get, and how much of it will be liquid?

"The bankers are back," said Pamela Liebman, the president of the Corcoran Group. But, she said, the effect is "more about the confidence than the cash."

By that she means that reports of large bonus pools at Wall Street firms have contributed to an overall sense among prospective buyers that things are getting better, not worse. And brokers say that the rise of the stock market last year, along with very low mortgage rates and prices that have sunk a good 20 percent to 25 percent below 2007 highs, had already started to calm the nerves of buyers at all income levels.

In one indication of increasing interest in higher-end properties, searches for listings of New York City homes priced above $2 million and above $5 million on the real estate search engine Trulia.com have grown significantly. In December 2009, the latest full month for which figures were available, searches for homes over $2 million grew 24 percent compared with December 2008. Searches for homes priced above $5 million increased 13 percent over the same period.



BEAWIHARTA/REUTERS

"Banker cash" could be just the catalyst for a recovery.

Luxury home prices in central London rose last month at the fastest annual pace since April 2008, according to Knight Frank, a real estate agency based in London.

But "while buyers are back in force, vendors are few and far between," Liam Bailey, head of residential research at Knight Frank, told Bloomberg News. Some owners, Mr. Bailey said, are waiting to put houses on the market until they see how the outcome of the British general election, which must be held by June, affects regulation of the financial industry and taxation of banker bonuses.

In Hong Kong, prices have been on the mend for months, thanks to the fact that the global crisis left most of Asia relatively unscathed. Average prices sagged after the crisis unfolded in late 2008 but rebounded quickly, regaining their pre-crisis levels late last year.

"Hong Kong property will experience significant price gains throughout 2010 and into 2011," Eric Wong, head of Asia real estate research at UBS, wrote in a note to clients Thursday.

Foreign bankers with their bonuses are quite active in the mid-market — apartments worth about 7 million to 15 million Hong Kong dollars, or about $900,000 to $1.9 million — though so far they are mostly "staying conservative," said Anthony Hindmarsh of Qi-Homes, a real estate agency in the city that focuses on expatriates. "There is still a lot of uncertainty out there."

No one expects a return to the days when a banker, bonus in hand, went out, looked at five fancy properties in a day and picked one. Brokers say that banker

BONUS, PAGE 9

World stocks slip on E.U. debt fears

PARIS

Troubled bloc members are showing ambivalence about austerity measures

BY MATTHEW SALTMARSH

Investors' concerns about the public finances of countries on the periphery of the euro area intensified Friday, pushing stocks and the euro down, as speculation mounted that Greece might need an external bailout to meet its obligations.

Worries about a domino effect were compounded by a vote Friday in the Portuguese Parliament, suggesting that the minority government there would have a tough time imposing new austerity measures. Greece is already facing strikes over proposed spending cuts, which are expected to spread next week.

The FTSE-100 in London closed down 1.5 percent at 5,060.90. In Paris, the CAC-40 plunged 3.4 percent to close at 3,615.55, while the DAX in Germany slid 1.8 percent to finish at 5,434. At midday in New York, the Dow Jones was down 0.7 percent at 9,931.75.

Economists said the fiscal and budgetary demands of euro-zone membership were limiting the options for Greece, as possibly for other euro-area countries, to address its fiscal problems. Euro members, for instance, cannot devalue their currencies to regain competitiveness, or cut interest rates. That dynamic has pushed investors to sell the bonds of those countries in recent weeks.

"All the problems that the boom had hidden are coming to the fore," said George Magnus, senior economic adviser at UBS in London. "The rising tide of economic growth lift all boats. With hard times, the problems come into view."

Unable to embark on the kind of fiscal and monetary stimulus seen in the United States and Britain, that leaves a bailout as the most likely near term solution, for Greece at least.

"It's the only way to settle markets on a durable basis," Mr. Magnus said

Stephen Jen, director of economics at BlueGold Capital Management in London, denied that speculators were "ganging up" on countries in trouble, as the Greek prime minister has charged.

"In the case of Greece, the market is right about the fragility of the economy, and for all of them there is a lack of competitiveness from years of neglect," Mr. Jen said. "There may be social problems, and the current governments might not be around to see this through."

The euro sagged against the dollar Friday — a trend likely to be quietly welcomed by European politicians like President Nicolas Sarkozy of France who have been calling for a weaker currency to help exports.

The concerns about the euro area also drove up the value of the Swiss franc, traditionally seen as a safe haven, against the euro to a 15-month high. That prompted a reported intervention by the Swiss National Bank.

In late trading in London, the euro was hovering around $1.36. That is a sharp drop from the $1.50 level it was trading at in November. The euro also fell early Friday to 1.4559 Swiss francs. In November, it was trading at around 1.51 Swiss francs.

Yields on the benchmark 10-year bonds of Spain, Portugal, Ireland and Greece moved lower in late trading Friday, offering investors some relief, after having risen early in the session. Bond yields and prices move inversely.

The situation was bound to be discussed by finance ministers and central bank governors from the Group of 7 countries at a meeting over the weekend in the Canadian town of Iqaluit. E.U. leaders will also gather Thursday for a summit in Brussels. The issue of the peripheral European economies is not formally on the agenda of that meeting, but officials said it was bound to be discussed.

Privately, euro-zone officials have said that the initial plans for a possible bailout of Greece have already been discussed.

In Lisbon, the Portuguese Parliament passed a bill on regional finances that was opposed by the minority Socialist government, which had said the law was unacceptable as it would increase the budget deficit, Reuters reported.

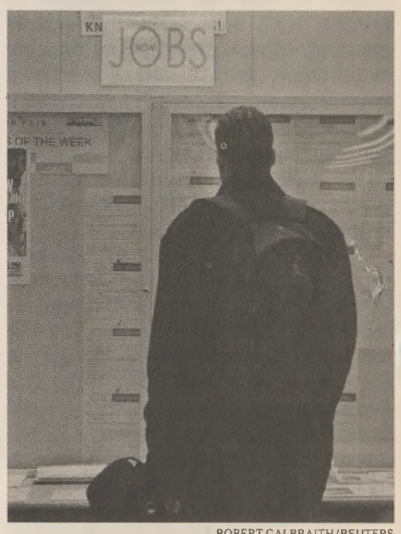
On Thursday, Greek tax officials went on strike against an austerity plan meant to pull the country out of its debt crisis. More actions are expected in coming weeks.

Asian stock markets also remained skittish on Friday. The Nikkei-225 lost 2.9 percent in Tokyo. In mainland China, the Shanghai Composite index fell 1.9 percent, while the Hang Seng in Hong Kong closed down 3.3 percent.

Mixed U.S. jobs data dim recovery picture

NEW YORK

BY PETER S. GOODMAN AND JAVIER C. HERNANDEZ



ROBERT GALBRAITH/REUTERS

The U.S. jobless rate fell to 9.7 percent, but it was met with some skepticism.

The unemployment rate in the United States fell to 9.7 percent in January from 10 percent, the U.S. Labor Department reported Friday, buoying hopes that the country's worst job market in at least a quarter-century was finally improving.

The economy shed an additional 20,000 net jobs during the month, underscoring the considerable strains remaining in millions of American households. Yet that figure marked a continued decline in the pace of deterioration. Economists focused on a host of encouraging signs that suggested recovery after the worst recession since the Great Depression.

Manufacturing added 11,000 jobs in January, the first monthly increase since November 2007, while factories recorded a modest increase in the length of the workweek. Temporary workers grew by 52,000, and the overall American workweek lengthened, reinforcing the view that commercial activity is awakening after more than two years of veritable hibernation.

"It does signal that the economy is continuing to improve," said John E. Silvia, chief economist at Wells Fargo in Charlotte, North Carolina. "You don't have a boom, but you have an economic recovery. It's a positive sign."

Yet despite the hopeful indications, the government's monthly snapshot of the labor market came wrapped in an unusual degree of statistical uncertainty, economists said, intensifying the debate about the staying power and vigor of the apparent economic recovery.

The Labor Department revised past data to show that the economy had 1.36 million fewer jobs in December than previously thought. The revisions showed that the economy lost 150,000 jobs in December — far more than the 85,000 initially reported.

The report also featured a new way in which the government estimates the population, which is used to calculate the unemployment rate. This prompted some economists to dismiss the drop in joblessness as a statistical quirk.

"The message is, you can't believe what they tell you," said Joshua Shapiro, chief U.S. economist at MFR in New York. "Everyone goes crazy over today's number, but history has been rewritten. Things are not comparable from month to month."

Mr. Shapiro focused on the caution that still grips many households amid a time of economic anxiety, suggesting that this would continue to dampen consumer spending, which accounts for more than two-thirds of the American economy. This situation should keep employers reluctant to hire, limiting the wages that workers have to spend at other businesses. "The question is, what is the rate of improvement going to be?" Mr. Shapiro asked. "Very slow. We don't see companies going crazy on the hiring."

Some forecasts envisage the jobless rate reaching nearly 11 percent by the end of the year, which would raise the prospect of new shocks to the system: a retreat in consumer spending, and fresh fears in the banking system as jobless people lose the wherewithal to pay their mortgages, amplifying an already disturbing wave of foreclosures.

Such gloomy visions are at the center of concerns that the ending of the so-called Great Recession could merely mark the beginning of a long period of disappointingly slow growth, or perhaps a pause before another downturn — one that could be difficult to escape.

Even amid the signs of improvement, the report offered up another batch of evidence that times remain bitterly hard.

The so-called underemployment rate — which counts the involuntary part-timers along with people who have given up looking for work — was 16.5 percent in January. That amounted to an improvement from 17.3 percent a month earlier, yet it was nearly double the level of three years ago.

BAE to pay $450 million to settle bribery cases

NEW YORK

BY CHRISTOPHER DREW AND NICOLA CLARK

BAE Systems, Europe's largest military contractor, has agreed to plead guilty to two criminal charges and pay nearly $450 million in penalties in the United States and Britain to end long-running investigations into questionable payments made to win contracts overseas.

Under its settlement with the U.S. Justice Department, BAE will pay a $400 million fine and plead guilty to one count of conspiring to make false statements about having an internal program to comply with anti-bribery laws. The Justice Department complaint said the charge related to over $200 million of business that BAE had won until 2003 in the Czech Republic, Hungary, Saudi Arabia and other countries.

BAE, based in Britain, said it would also plead guilty in London to accounting violations for failing to properly record commissions paid to a marketing consultant involved in its sale of a radar system to Tanzania in 1999. BAE said it would pay about $50 million in Britain in fines and a charitable payment to Tanzania.

BAE, which had not previously acknowledged any wrongdoing, said in a statement that it "very much regrets and accepts full responsibility for these past shortcomings." The company said the last of the illegal activities took place in 2002. BAE also said it had since changed the way it does business.

Sam Jaffa, a spokesman for the Serious Fraud Office, described the settlement as a "pragmatic" one that would allow BAE to put the lengthy investigations behind it and allow the fraud agency to redeploy personnel and other resources to cases of "actual financial fraud."

But British advocacy groups that had fought several court battles to push the British authorities to investigate BAE for corruption in weapons deals with Saudi Arabia and other countries expressed outrage at the settlement.

"This settlement means that the truth about these serious allegations against BAE will never be known," said Nicholas Hildyard, a campaigner for the Corner House, a social justice advocacy group. "The U.K. fine may well be unprecedented, but it may easily create the perception that alleged bribers can simply pay their way out of trouble."

The British part of the investigation has long been controversial, and Tony Blair as prime minister halted British efforts to investigate the deals with Saudi Arabia in late 2006, citing concerns about national security.

The dealings with the Czech Republic and Hungary involved Gripen fighter jets. But BAE's activities in Saudi Arabia, where it had an $80 billion contract since the 1980s to supply fighter jets and other military hardware, have long attracted far greater interest.

It has also long been reported that the U.S. Justice Department was examining payments that BAE made to Saudi officials, including $2 billion that it deposited into bank accounts of Prince Bandar bin Sultan, the kingdom's former ambassador to the United States. The criminal information released on Friday by the Justice Department did not name Prince Bandar, who has denied wrongdoing. But the document said that the company had paid substantial benefits to one Saudi official through payments in the United States and elsewhere.

Nicola Clark reported from Paris.

Joe Nocera is on leave.

PETROS GIANNAKOURIS/THE ASSOCIATED PRESS

Firefighters in Greece demonstrating against planned spending cuts. Strikes and protests in Southern Europe have made it difficult for governments to implement austerity measures.

Euro spins into severe political test

EURO ZONE, FROM PAGE 1

treaty, the Lisbon treaty, which creates a new president and foreign-affairs chief. But even if all these positions were filled and functioning, there would still be serious questions about whether the union or its leading member states would step up and take charge before further damage was done.

In some sense, inside the union, there is still a game of chicken among sovereign states, with Greece counting on help and other countries holding back until Athens pays a steep price for its profligacy and manipulation of statistics. But the delay is costly, and there are deeper structural problems that few want to discuss.

NEWS ANALYSIS

Northern Europe at least has some prospects for growing its way out of deficits. "But for Southern Europe, it's hard to think of anything positive for an investor," Mr. Tilford said. "There's a rapidly aging population, little growth for years, and governments largely in denial about needed reforms for productivity."

Greece, Portugal, Spain and Italy – known now as the PIIGS, if Ireland is included — are the weak sisters of Europe, with high structural deficits matched with low prospects for the kind of economic growth and productivity improvements that can bring them back to health. The north-south split is partly geographic, partly cultural, partly religious and partly historical, but the southerners tend to be poorer and have less competitive economies.

"The markets are having fun testing the euro," said Nicolas Véron, senior fellow at Bruegel, an economic policy research institute in Brussels. But the markets are also increasing pressure on the biggest European countries, like Germany and France, to figure out ways to rescue Greece, which is already facing strikes in the face of current austerity measures, and to bolster the others.

The biggest questions are about leadership, however, with the European Union undergoing a triple political transition. "Who's in charge now?" asked Antonio Missoroli, director of studies for the European Policy Center in Brussels. "Nobody yet, and it may still take time."

First, he noted, there is a newly nominated European Commission, which serves as the executive, and a new Parliament, which has been holding up some key commission appointments. Second, the commissioner in charge of this crisis, Joaquín Almunia, is a lame duck, due to switch jobs and become competition commissioner.

His successor as commissioner for economic and monetary affairs, Olli Rehn, is already the commissioner for enlargement. Both men are considered very capable and can work together, but it is difficult to do two jobs at once.

And third, the European Union is transitioning to a new form of leadership under the recently ratified Lisbon Treaty. There is now a European president, Herman Van Rompuy, and a new European minister for foreign affairs, Catherine Ashton, who are still filling out their staffs and figuring out their competencies.

Mr. Van Rompuy has moved more quickly, and he has announced an informal economic summit meeting for next Thursday, to get the member countries to concentrate on the crisis.

But the Lisbon Treaty itself has little influence on economic management, so the Union is still operating under old rules developed haphazardly in earlier treaties, like the stability and growth pact adopted in advance of the euro that calls for annual budget deficits of 3 percent or less, which may be outdated but which Germany in particular will not change.

After long wrangling, the pact was reformed in 2005 to allow countries coming out of recession more time to get back in shape. But the cap was kept.

The European Central Bank under Jean-Claude Trichet has been flexible in its handling of the recession, staying within the rules but overseeing the rescue by other entities of Ireland, Hungary, Romania and Latvia. The International Monetary Fund has played a key role in the non-euro-zone countries. But the bank is legally prevented from bailing out a member state.

Still, default for a member of the euro zone is simply unacceptable, European officials and analysts say — a country is not a bank. At the moment, even calling in the International Monetary Fund to help Greece is considered too embarrassing and not yet necessary, given the new Greek government's growing understanding of the depth of its problems and the pain required to begin to solve them.

More likely, they say, is a set of bilateral loans or loan guarantees from richer countries like Germany. Leaders in France, Germany and other European countries have already begun discussing privately how such aid might be structured, officials said last week.

"It's highly unlikely Greece will be allowed to default," Mr. Missoroli said. "But no one wants to say that out loud to take the pressure off the Greek government. So it's a fragile balancing act: How much pressure can you exercise on Greece and how much can it bear?"

Mr. Tilford said that "the E.U. wants to humiliate the Greek political establishment and see them taking difficult decisions." But if those decisions result in

"It's highly unlikely Greece will be allowed to default. But no one wants to say that out loud to take the pressure off the Greek government."

major unrest or a deflationary spiral, he said, "then Europe will step in to help."

But it is also unprecedented, and difficult politically, for the European Union, or any member country, to impose conditions for economic adjustment on another member country, which is why some analysts continue to urge I.M.F. involvement.

Jacques Mistral, an economist at the French Institute for International Relations, said that the main actors now were Mr. Trichet and the leaders and finance ministers of Germany and France.

"That's the troika, and they're leading the process to explore different ways and compromises," Mr. Mistral said. "When there is a will there is a path, and lawyers will find a way to design government intervention when the political will is found. But it will be difficult to find an adjustment program that is credible in I.M.F. terms and also bearable by the Greeks."

Greece is a prime example of the disease in the euro zone, Mr. Tilford said, made worse by political mismanagement, the global recession that has hit tax receipts and the impossibility of devaluing a shared currency. The irresponsibility and weak growth of the southern neighbors are hard to change without more economic flexibility and economic and political integration in the European Union, but there is little appetite now for structural change, he said, especially among the northern members, which mistrust those in the south.

Portugal is the poorest country in the euro zone and has been stagnating for years, with very weak growth, low productivity, rising unemployment and increasing debt, proving that membership in the euro "is not a panacea," Mr. Tilford said. In addition, Portugal has something of a political crisis, with a minority Socialist government trying to pass a regional finance bill that will not add to Portugal's deficit.

Spain has relatively low debt, but high unemployment and weak banks, and very weak productivity growth. After the bursting of the housing bubble, it can no longer rely on construction and inflated asset prices. These aspects, together with the larger size of the Spanish economy, had led Nouriel Roubini, a professor at New York University, to suggest that Spain is a bigger threat than Greece for the euro zone.

Numbers for Italy look reasonably good, but to some they look too good, suggesting that Italy is also fudging its statistics, especially on the size of its budget deficit.

At the same time, the more northern countries, like Germany and the Netherlands, are still playing "beggar thy neighbor" by their reluctance to stimulate their own domestic purchasing, which could help weaker countries to export.

"The southerners can do their best to cut costs and be competitive," Mr. Tilford said. "But they need the others to create more domestic demand and be less export dependent."

Jean-Paul Fitoussi, professor of economics at the Institute of Political Studies in Paris, said that European leaders "have handled this crisis very badly," feeding market speculation and greed.

"This is much to do about nothing," he added, "but the nothing can ruin the whole project. I don't think the euro is in danger. But the leaders are taking too much time."

Cost of insuring debt is growing in Europe

DEBT, FROM PAGE 1

Monetary Fund, that it stood ready and willing to help Greece if asked to do so.

But the billions of dollars being traded in the market for credit default swaps on government bonds suggested that investors were not retreating from their expectation that the gap between Europe's laggard periphery and its recovering core — Germany, France and the smaller countries of Northern Europe — would keep widening.

In particular, investors were turning their attention to the possibility of a backlash against the Greek government's austerity plan, which will be tested by a series of strikes expected to begin in Athens next week.

Similarly, a political dispute in Portugal is heading for a parliamentary showdown that could force the government in Lisbon to admit that it will be able to keep its promise to hold the budget deficit this year to 8 percent of gross domestic product.

On Friday, another gloomy economic report from Madrid showed that economic activity was down a sharp 3 percent for the final quarter of 2009 from the year before, meaning that Spain remained one of the few major countries still in the grip of recession.

The speculator's bet is a simple one.

In an era in which government budget deficits have soared in response to the financial crisis, the same bond vigilantes that forced President Bill Clinton to balance the American budget in the 1990s have turned their attention to the countries on Europe's southern flank.

In effect, they have challenged those relatively weak governments to raise taxes and impose harsh spending cuts on a restive populace to bring down their deficits from over 10 percent of G.D.P. to close to the target of 3 percent called for in the treaty that created the euro.

While such moves are highly unpopular politically, a failure to do so could send government borrowing costs soaring, enriching those who are betting that Greece, Portugal, Spain and perhaps even Italy will not be able to follow through on their commitments.

Joseph Stiglitz, the international economist who is an adviser to the Greek government, sees the investor demands on these countries as lacking in merit. Indeed, he points to the inherent contradiction in allowing the richer countries in Europe to borrow heavily to pull themselves out of recession while the poorer countries are forced to take a knife to the very programs intended to soften the blow of a downturn.

"If you tighten the way the markets seem to want, you will get a political response that is nonviable," he said, drawing a comparison to Iceland, where discontent forced its president to abrogate a controversial agreement to repay foreign creditors. "These are democracies — not dictatorships."

Mr. Stiglitz proposes that Europe's richer countries like Germany and France take the lead in aiding Greece — for the sake of the European whole, however shaken it might be.

But that may be easier said than done.

The charter establishing the euro, while supposedly ruling out any bailouts by the European Central Bank or member governments, failed to establish any mechanism for providing funds to countries in financial trouble. That is the kind of role normally taken on by the International Monetary Fund.

E.U. nations outside the euro zone, like Romania, Latvia and Hungary, have received support from the I.M.F., which then imposed fiscal requirements to insure the loans would be repaid.

But for those countries using the euro, its governing pact was thought to be sufficient to keep countries in line. Greece's consistent and premeditated pattern of skirting the fiscal standards set by the European Commission has dashed those beliefs.

Miranda Xafa, a former executive board member of the I.M.F., believes that the time has come for Europe to acknowledge that it has neither the technical expertise to monitor government behavior nor the ability to quickly raise rescue funds. Only the I.M.F., she argues, is capable of truly doing that job.

"Greece's economic fundamentals are by far the worst in the euro zone," she said. "The I.M.F. coming in would also help the other countries and restore confidence."

But in Brussels, turning to the I.M.F. is seen as conceding that the monetary union cannot care for its own.

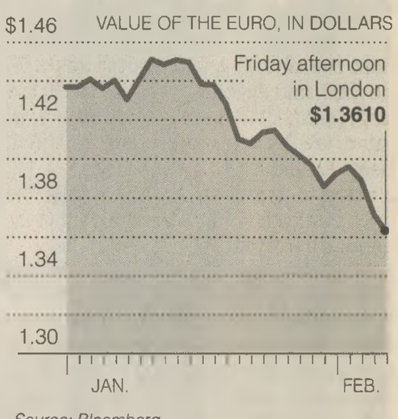
Jonathan Tepper, a partner at Variant Perception, a research house that caters to hedge funds, argues that the economic problems in Europe's debt-ridden south are deep and will not disappear without a long and painful readjustment.

"People are just dumping debt," he said. "It is pure risk aversion that is pushing spreads higher."

For the Greek, Spanish and Portugal governments, which still need to raise billions from these very markets over the next few months, that is bad news indeed.

Euro skepticism

The euro has fallen in value against the dollar on worries that the economic bloc lacks a clear policy for dealing with the fiscal problems of its weaker members.



Source: Bloomberg

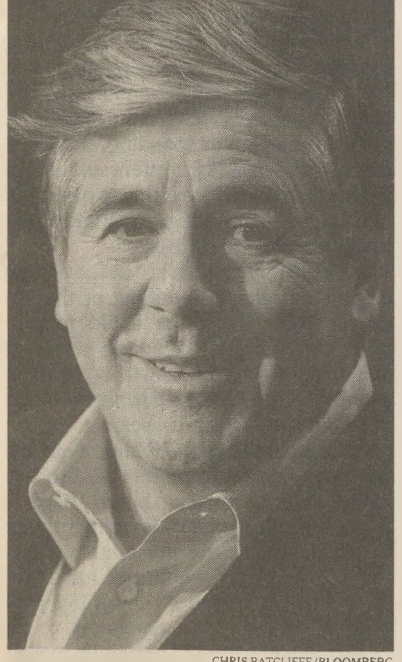
Taking some hard knocks

The slide in European stock markets has been deepest in the euro-zone countries burdened with high budget deficits.

PERCENTAGE CHANGE IN MAIN STOCK MARKET INDEXES THIS YEAR

Source: Bloomberg

Credit default swaps return, posing risk for Greece and other countries



CHRIS RATCLIFFE/BLOOMBERG

Josef Ackermann, chief of Deutsche Bank, said its exposure to Greek risk was not big.

FRANKFURT

Regulators are worried that unmonitored trading could add to debt woes

BY JACK EWING

If the phrase "credit default swap" rings a bell, it should. C.D.S., in shorthand, is the same financial instrument that caused so much trouble at the insurer American International Group, prompting a government bailout to avoid an international chain reaction of bank failures.

Now credit default swaps are back in the news, this time in the context of Greece and other highly indebted European countries. Their renewed prominence is making some regulators and economists nervous about the risk that credit default swaps bring to an already volatile situation.

The European Central Bank, in its December Financial Stability Review, noted that some dealers of credit default swaps, or "counterparties," might not have enough collateral to cover unexpectedly large losses — the same problem that nearly destroyed A.I.G.

"Counterparty risks remain substantial," the report said.

Prices of the swaps, which are a form of insurance against defaults by bond issuers, soared in January as investors grew nervous about whether Greece, Portugal and Spain would be able to repay their government debts. The cost of hedging against default on Greek government bonds, for example, has risen 40 percent since the beginning of the year, according to Markit, a data provider in London.

Trading volume has also soared as hedge funds and other investors have used credit default swaps as a way of betting on market sentiment toward the troubled European debtor countries. An investor who bought a C.D.S. on Greek debt at the beginning of January could resell it Friday at a 40 percent premium.

Trading in credit default swaps on West European government debt has climbed 58 percent in the last four weeks, to almost $61 billion, according to Markit.

For anyone who owns Greek, Portuguese or Spanish bonds, credit default swaps are "a very efficient way of hedging risk," said Gavan Nolan, a credit analyst at Markit. Though the swaps pay off only in case of default, the swings in price also allow buyers to hedge against fluctuations in the price of the underlying bonds.

The problem is that trading in credit default swaps on government debt takes place directly between buyers and sellers, which typically are large investment banks. So regulators and other observers have no way of telling whether a swaps-dealing institution is getting in over its head. "You don't really have a bird's-eye view of things," said David Schnautz, an analyst with Commerzbank in Frankfurt who follows the market for credit default swaps. "This could be a problem if you have an unhealthy distribution of risk among institutions."

"You don't really have a bird's-eye view of things."

Banks are reluctant to talk about their swaps business. A spokesman for Deutsche Bank in Frankfurt said it was active in the market, as are all big investment banks, but declined to give details.

Josef Ackermann, chief executive of Deutsche Bank, said Thursday at a press conference that it was not heavily exposed to risk from Greece, though he did not specifically mention swaps.

The European Central Bank and other regulators have promoted an antidote to the risk in credit default swaps: Require them to be traded through derivatives clearinghouses like ICE Clear Europe in London or Eurex in Frankfurt. The clearinghouses would act as counterparties, reducing risk, and regulators would also have much better information about who is buying and selling.

IntercontinentalExchange, the parent of ICE Clear Europe, already acts as the platform for some forms of credit default swap trading in the United States and Europe, a business it got into with encouragement from regulators in the United States and other countries. But so far, neither ICE nor Eurex is handling swaps on European government debt, and neither has publicly set a date to begin doing so.

Daniel Gros, director of the Center for European Policy Studies in Brussels, said he thought that the volume of credit default swaps on European government debt was still not big enough to endanger the whole financial system.

But he sees another drawback. spread on credit default swaps for government debt has become a benchmark that raises the cost of borrowing for companies in troubled countries, Mr. Gros said. That means a perfectly healthy Spanish company could find that it needs to pay a higher interest rate on its corporate bonds simply because the credit default swap market has turned against Spanish government debt.

On Friday the so-called spread on a credit default swap for Spanish debt was 162, meaning it cost €162,000 to insure debt of €10 million, or about $13.6 million. For a swap for Portuguese debt the spread was 219; for Greece, 398; and for Iceland, 645, according to Markit. By contrast, the spread against German debt was 45.

"The credit default swap spreads feed into borrowing costs of companies," Mr. Gros said. "My concern is not that the Greek government cannot finance itself. I'm more concerned about the Greek economy."