Money & Investing: European investors should return to the business of stock picking

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A Kuwaiti investment banker accused by the SEC of making more than $1 million in trading profits following the dissemination of false news about two U.S. companies was found dead in his home, local media reports said. Page 3

■ **Hillary Clinton** reassured Moscow that the White House remained committed to resetting relations between the countries. Page 9

■ **French President Sarkozy** was under doctor observation in a Paris hospital, where he was taken after he felt faint while jogging. Page 3

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■ **Ericsson's profit fell** 56% in the second quarter, hurt by restructuring charges and losses at the telecom company's joint ventures. Page 2

■ **Arson investigators** in the U.S. have stepped in to help determine the source of a fire inside an American Airlines jet last month. Page 3

■ **The U.S. government** guarantee on new debt issued by financial firms will save those companies about $24 billion in borrowing costs. Page 19

■ **Microsoft will give** European users of Windows software a choice of Web browsers, yielding to pressure from EU regulators. Page 29

■ **Italy's government won** a key parliamentary confidence vote, paving the way for approval of measures aimed at bolstering the economy.

■ **The U.S. envoy** to the Mideast pledged to seek a quick resumption of peace talks between Israel and Syria over the Golan Heights. Page 11

■ **Taliban militants resumed** attacks in Pakistan's Swat Valley, frustrating army efforts to flush them out as refugees return. Page 10

■ **A suicide bomber killed** six people and injured at least 10 near a concert hall in the capital of Chechnya.

■ **Ousted leader Zelaya** settled in near the Honduran border to pressure the country's interim government to let him retake the presidency.

■ **Raul Castro said** Cuba can't pin all of its problems on a U.S. trade embargo, in a Revolution Day speech.

EDITORIAL & OPINION

Visitors from Beijing
The Sino-U.S. talks cover everything from trade to nukes. Pages 13 and 15.

Breaking news at europe.WSJ.com

U.S. enters fund debate

Washington joins U.K. in lobbying EU for less-stringent regulations

By Alistair MacDonald

As its hedge-fund and private-equity industries worry about new rules, the U.S. is quietly lobbying Europe to change the terms of proposed financial regulation that could place strict new rules on any U.S. hedge- or private-equity fund doing business in the region, according to a senior Treasury official.

The move wades the U.S. into a fierce battle between the U.K. and other parts of Europe over how tough regulation should be. Some nations, led by Germany and France, are calling for wholesale regulation of financial services in the wake of last fall's crisis, but the U.K. says that overly stringent rules would damage its large financial sector and close off U.S. and other funds to European investors.

The U.S. and U.K. are lining up to change the European Union's proposed Alternative Investment Funds Directive, a sweeping bid to overhaul regulation of hedge funds, private equity and other alternative investment funds. In its current form, the directive would, among other things, place limits on how much debt funds can take on; require them to hold capital to cover potential losses and redemptions; and place strict disclosure requirements on private-equity portfolios.

The directive would effectively apply to all funds and financial firms, including those based in the U.S., if they want to raise cash or provide services in Europe. This so-called equivalence test may block some U.S. companies from operating in Europe, given that the European directive goes much further than proposed increases in U.S. fund regulation. The U.S government wants hedge funds to register and provide more information but isn't looking at rules such as leverage caps.

The U.S. signaled its posi-
Please turn to page 31

A returning champion takes center stage at Tour de France

Agence France-Presse/Getty Images

HATS OFF: Alberto Contador, center, poses on Paris's Avenue des Champs-Élysées with Andy Schleck, left, who finished second, and third-place finisher Lance Armstrong at the end of the three-week bicycle race. Mr. Contador also won the race in 2007.

Bonds take page from rally in stocks

By Annelena Lobb and Rob Copeland

While the U.S. stock-market rally is hogging the headlines, corporate bonds are staging their own remarkable surge.

The average junk-rated company is now no longer "distressed," meaning yields have fallen to less than 10 percentage points above the benchmark Treasury bond. Yields on higher-quality companies also are dramatically lower as investors feel less leery about corporate debt. As yields fall, bond prices rise.

Stocks and corporate bonds are benefiting from the same generally upbeat mood this earnings season on signs in quarterly reports that the U.S. economy is winding toward the end of the recession.

Still, it's hard to blame investors for not plowing all their cash into stocks. Some investors are choosing to hedge their bets, preferring corporate bonds over stocks. They say even risky bonds are a smart cushion against uncertainty about the stock-market rally's staying power.

"If you believe in a V-shaped recovery, then you buy stocks. If you believe we're going to bump along, then you have to go with credit," says Kent Wosepka, chief investment officer of active fixed income at the Standish Mellon Asset Management.
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U.S. economic data could herald upturn

By Justin Lahart

The government will report on Friday how the U.S. economy performed in the second quarter, and economists expect it will say the economy contracted at about a 1.5% annual rate, marking the third consecutive decline.

Divergent paths

■ The U.K. economy is shrinking, while Germany sees hope 8

That typically would be seen as bad news—but not after gross domestic product, the value of all goods and services produced by the economy, shrank by 6.3% in the fourth quarter and 5.5% in the first, causing many economists to worry about the possibility of a depression.

"Policy makers seem to have collectively succeeded and we're going to avoid the big 'D,'" says Robert Barbera, an economist at research and trading firm ITG.

Most economists think that consumers and businesses continued to cut back on spending in the second quarter. But consumers trimmed their spending by much less than they did in the fourth quarter, when the financial crisis came to a head. And businesses cut less than they did in the first quarter, when a $170 billion reduction in plant and equipment investment accounted for four-fifths of the decline in GDP.

All this augurs well for the
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Inside

Looming presence

Behind Honduran crisis, the long arm of Hugo Chávez
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Markets

	CLOSE	PCT CHG
DJIA	9093.24	+0.26
Nasdaq	1965.96	-0.39
DJ Stoxx 600	219.67	-0.05
FTSE 100	4576.61	+0.37
DAX	5229.36	-0.34
CAC 40	3366.45	-0.22
Euro	$1.4200	-0.34
Nymex crude	$68.05	+1.33

LEADING THE NEWS

Ericsson buys Nortel unit

Winning bid gives Swedish gear maker major U.S. presence

By Sara Silver

Telefon AB L.M. Ericsson's $1.13 billion purchase of **Nortel Networks** Corp.'s most-profitable unit completes a trio of recent deals that makes Ericsson a formidable player in the lucrative U.S. market for telecommunications equipment.

The Swedish company bought bankrupt Nortel's profitable but declining CDMA business, which sells a key wireless voice technology prevalent in the U.S. The deal also includes a group of 400 researchers working on a high-speed broadband technology called LTE. Nortel, based in Toronto, will ask bankruptcy courts in the U.S. and Canada to approve the sale this week.

Nokia Siemens Networks, a joint venture of **Nokia** Corp. of Finland and **Siemens** AG of Germany, set off the auction process this spring with an unsolicited $650 million bid aimed at increasing its presence in the U.S. market. One of Nortel's largest bondholders, **MatlinPatterson Global Advisers** LLC, entered a higher bid, saying the unit could generate higher returns for creditors if restructured and run as a standalone business.

Ericsson has greatly expanded its presence in North America.

Ericsson and Nokia Siemens faced off late Friday night at a live auction in New York that ended with Ericsson agreeing to pay $480 million more than Nokia Siemens's bid.

"Our goal is to be a major supplier of services and equipment in North America," said Hans Vestberg, who takes over as chief executive officer of Ericsson in January.

Analysts are divided on how fast sales of CDMA equipment, a so-called second-generation technology that originally carried only voice signals, will shrink. Some believe the networks, mostly upgraded to handle data traffic, will be maintained—and highly profitable—for a decade or more.

Others see the decision of Verizon Wireless, a joint venture of **Verizon Communications** Inc. and **Vodafone Group** PLC, and other carriers to soon roll out LTE, a fourth-generation technology, as a sign that CDMA will decline much faster.

Ericsson has greatly expanded its presence among North America's biggest CDMA-based carriers. In addition to the deal with Verizon Wireless, which chose Ericsson in February as principal supplier for the LTE upgrade, Ericsson earlier this month signed a $5 billion, seven-year deal to run the networks of **Sprint Nextel** Corp., the first major U.S. carrier to outsource its network operations.

The combination will leave North America the largest region within Ericsson. Last year, Nortel's CDMA operations generated revenue of about $2 billion.

Ericsson is getting the assets debt free and says the purchase will add to its earnings within a year of closing.

—Ben Dummett and Gustav Sandstrom contributed to this article.

Egypt gas field lures suitors

By Liam Moloney

ROME—Italian energy company **Edison** SpA has received interest from at least three parties for a stake in Egyptian natural-gas field Abu Qir, Chief Executive Umberto Quadrino said Friday.

More are expected to show interest soon, Mr. Quadrino said during a conference call about the company's first-half results. He didn't name the three interested parties.

Mr. Quadrino said the Milan-based company is ready to sell a stake of 25% to 40% in Abu Qir, depending on the offers it receives. Edison won the tender for the field in December in a deal valued at $3.1 billion.

The CEO said he expects the stake sale to be agreed on toward the end of the year or the start of 2010.

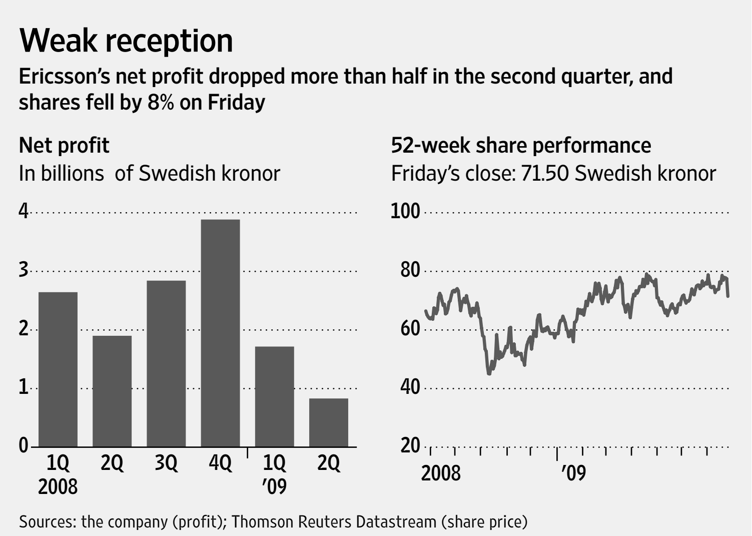
Edison, which is controlled by **A2A** SpA and **Electricité de France** SA, said its first-half net profit rose 20% to €122 million ($173 million) from €102 million a year earlier, when its earnings were hit by tax charges. Revenue declined 7.8% to €4.82 billion.

Mr. Quadrino said Edison isn't planning to tap into the bond market again after last week's sale of bonds worth €700 million. Edison received requests valued at more than €7.2 billion for its bonds last week. The energy company doesn't exclude returning to the bond market if the conditions are right, Mr. Quadrino said.

CORRECTIONS & AMPLIFICATIONS

AT&T Inc. saw consumers disconnect 772,000 landlines in the second quarter. A Global Business Brief Friday about the company's earnings incorrectly gave the number of disconnections as 3.3 million.

A transaction announced in September in which **Citigroup** Inc. planned to buy **Wachovia** Corp.'s banking operations was incorrectly described in an International Investor article July 17 as a merger agreement.



Sources: the company (profit); Thomson Reuters Datastream (share price)

Ericsson profit falls 56% as charges hurt results

By Gustav Sandstrom

STOCKHOLM—**Telefon AB L.M. Ericsson** posted a 56% drop in second-quarter profit, weighed down by restructuring charges and losses at its joint ventures.

The company, which until now has been relatively resilient amid the economic downturn, said the slowdown has started to hit some of its markets.


Carl-Henric Svanberg

"The effects of the global economic climate on the mobile infrastructure market are now more notable, especially in markets with currencies under pressure and a tougher credit environment," said Chief Executive Carl-Henric Svanberg. "At the same time the consumer demand for new services and broadband capabilities are quickly accelerating," he added.

Ericsson, the world's largest telecommunications-network company by sales, said profit fell to 831 million Swedish kronor ($111.3 million) from 1.9 billion kronor. Sales increased 7% to 52.14 billion kronor.

The results were dragged down by restructuring charges of 3.6 billion kronor; a loss of €213 million ($303 million) at Sony Ericsson, its handset joint venture with **Sony** Corp. of Japan; and a loss of $213 million at ST-Ericsson, its semiconductor tie-up with **STMicroelectronics**.

Ericsson's second-quarter restructuring charges related to a previously announced cost-cutting plan. The company is aiming for annual cost reductions of 10 billion kronor by the second half of 2010.

The report was mixed, said Redeye analyst Greger Johansson. Mr. Johansson noted the strong results from the service segment, but flagged weakness at the dominant networks unit. He said Ericsson is now feeling the pinch of the economic slump in some markets, where previously it had said these effects were limited.

Still, he said the much weaker-than-expected net profit mainly reflected one-time charges and weak results at Ericsson's joint ventures, and shouldn't therefore be too worrying for investors.

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LEADING THE NEWS

Kuwaiti banker being probed is found dead

SEC said fake news fueled big profits on stock trading

BY MARGARET COKER

A Kuwaiti investment banker accused by the Securities and Exchange Commission of making more than $1 million in trading profits following the dissemination of false news about two U.S. companies was found dead in his home in Kuwait, according to local media reports Sunday.

In the civil lawsuit filed in U.S. District Court in New York on Thursday, Hazem Al Braikan, chief executive of **Al Raya Investment** Co., and three related entities of "highly profitable" and "suspicious" trades based on a fake press release claiming that a Middle Eastern investment group planned to buy **Harman International Industries** Inc., an electronic-systems maker in Stamford, Conn.

The accusations already were a hot topic in Kuwait. Mr. Al Braikan, believed to be in his thirties, denied the allegations in a statement published Sunday morning.

In the late afternoon, pan-Arab news channel Al Arabiya and a local Kuwaiti channel reported that police had found Mr. al Braikan dead in his home in an upscale neighborhood. The Associated Press, citing unnamed security officials, reported that the trader had been found in his bed with a gunshot wound to his head.

Kuwaiti police wouldn't comment on the death or whether they plan to investigate. Telephone calls Sunday to Al Raya's corporate offices in Kuwait and Mr. Al Braikan's cell phone weren't answered.

Al Raya is a little-known Islamic banking services firm started up last year in Kuwait. It launched operations in June 2008. At the time, Citigroup held a 10% share in the firm.

Citigroup declined to comment Sunday. Spokesman at the SEC and Harman also declined to comment.

The SEC says Al Raya, Bahrain-based United Gulf Bank BSC and Kuwait's **KIPCO Asset Management Co.** traded shares based on two false reports of impending takeovers. Mr. Al Braikan held positions in each of those companies.

The SEC said one such announcement announcing that a Middle Eastern firm had made an offer to acquire Harman had been faxed to regional media outlets July 19 and subsequently reported by the Kuwaiti newspaper Al Rai.

The SEC lawsuit says that in the week prior to the Harman takeover hoax, Mr. Al Braikan bought $3.6 million worth of shares of Harman stock, some of which were purchased on margin. On June 20, the day after the phony takeover bid was published, he and his affiliated companies liquidated their positions, the SEC says.

Regarding shares of Texton, KAMCO made more than $377,000 by selling stock on April 9 after a false takeover bid was announced for that company, the lawsuit said, adding that Al Raya, meanwhile, garnered $147,000 in the same manner.

The three companies named in the SEC suit are part of the Kuwait Projects Co. (KIPCO) group , a holding company run by the son of Kuwait's ruler, Sheikh Sabah al Sabah.

KAMCO and United Gulf Bank said in statements released on Friday they made no gain from trading in Harman and Textron.

Al-Raya Investment Co. and Mr. Al Braikan denied any wrongdoing in a statement published Sunday in Kuwaiti newspapers.

—Oliver Klaus and Robin Sidel contributed to this article.

Reuters (left); European Pressphoto Agency (right)

Security personnel stands at the entrance of the home, left, of Kuwaiti financier Hazem Al Braikan after he was found dead.

Sarkozy is hospitalized following jog

BY DAVID GAUTHIER-VILLARS

PARIS—French President Nicolas Sarkozy was placed in a hospital for medical observation overnight Sunday after he felt faint while jogging near his weekend retreat, his office said.

The 54-year-old president felt dizzy and was forced to lie down during a jog in the alleys of the Château de Versailles near Paris, but never lost consciousness, the Elysée presidential palace said in a statement.

Mr. Sarkozy, who has earned the nickname "Energizer bunny" because of his whirlwind activities, underwent blood, brain and heart tests in the hospital. The results were all normal, the statement said.

Mr. Sarkozy's office said the president had been jogging for 45 minutes when he felt bad. He was transported to the Val-de-Grâce military hospital in Paris by helicopter and was to remain there at least until Monday. The exact cause of his malaise wasn't disclosed.

The well-being of French presidents, who have a history of glossing over their health problems, is closely watched in part because the head of state has the sole power to decide whether to use the country's nuclear weapons.

President François Mitterrand, who was diagnosed with cancer soon after his first election in 1981, released statements saying he was in good health almost until the end of his second mandate. In 2005, when President Jacques Chirac was hospitalized for a week, he didn't warn Premier Dominique de Villepin that he was about to undergo an operation.

Nicolas Sarkozy

On Wednesday, Mr. Sarkozy had followed an Alpine stage of the Tour de France cycling race and said he was impatient to get on his bicycle during his holiday break in August.

The French constitution provides for the head of the Senate to temporarily succeed the president when the latter dies or is incapacitated.

Iran's president backs down on appointment

BY MARGARET COKER AND ROSHANAK TAGHAVI

Iran's President Mahmoud Ahmadinejad heeded an order from the country's supreme leader and rescinded a decision to make one of his relatives the country's vice president.

The move on Friday, reported by Iran's state news agency, followed a weeklong standoff between Mr. Ahmadinejad and Ayatollah Ali Khamanei, who last month gave his blessing to the president's re-election despite allegations by opposition candidates and clericsthat the vote was marred by fraud.

On Saturday, however, Mr. Ahmadinejad appointed the relative, Esfandiar Rahim Mashaie, as his chief of staff, the Associated Press said, setting up another potential tussle with conservatives.

The president's office also announced Sunday the dismissal of Intelligence Minister Gholam Hossein Mohseni Ejehi, who was reported to have differed with Mr. Ahmadinejad over the appointment.

At the same time, however, a group of hard-line students asked Iranian lawmakers to summon Mr. Ahmadinejad to parliament to question why he waited almost a week to obey Mr. Khamenei's order to rescind the appointment, the AP reported.

The semiofficial Mehr news agency also reported Sunday that three other ministers had been fired, including Culture Minister Mohammad Hossein Saffar Harandi, who walked out of a Cabinet meeting Wednesday to protest Mr. Mashaie appointment. However, the president's office denied the Mehr report and state-run Press TV later said the other dismissals had been revoked.

As the final arbiter on matters of state, Mr. Khamanei was expected to prevail in the matter. And the perception that he has cemented his power over government is seen as a crucial boost for his reputation, battered over his management of the election controversy.

At the same time, the incident as well as the public defiance of Mr. Ahmadinejad by members of his political base also raises questions about the unity of the country's ruling elite.

Mr. Mashaie, whose daughter is married to Mr. Ahmadinejad's son, headed Iran's cultural heritage foundation during the president's first term. The two men are considered close friends, despite a controversy over friendly comments about Israel that Mr. Mashaie made last year.

Also on Sunday, the AP quoted opposition leader Mir Hossein Mousavi's top aide, Ali Reza Beheshti, as saying that Mr. Mousavi and fellow pro-reform presidential candidate Mahdi Karroubi sent a request to the Interior Ministry to hold a memorial service in Tehran's Mosalla mosque Thursday to commemorate the end of the 40-day mourning cycle for at least 10 people killed on June 20.

Arson investigators probe fire inside American Airlines jet

BY ANDY PASZTOR

Federal arson investigators in the U.S. have been called in to help determine the source of a fire inside the cabin of an American Airlines jet last month en route to Zurich from New York, according to government and industry officials.

The Boeing 767 aircraft made an emergency landing in Halifax, Canada, after flight attendants used several fire extinguishers to put out a lavatory blaze, without any injuries.

Six weeks later, investigators are still trying to determine the cause. It isn't clear whether foul play was involved. Investigators are declining to comment on the specifics, but the conduct of the investigation—particularly the emphasis on safeguarding evidence—highlights concerns about possible wrongdoing.

The probe is unusual and has created a stir among air-safety experts, these officials said, because the airline initially asked U.S. law enforcement to get involved when mechanics failed to find the source of the flames.

Accident investigators from the National Transportation Safety Board and agents from the Bureau of Alcohol, Tobacco, Firearms and Explosives haven't pinpointed the likely ignition source on the June 9 flight. Findings are likely to be released in the next few weeks, though the extent of damage to portions of the lavatory could make definitive conclusions difficult to reach.

At the outset, the investigation was delayed by bureaucratic tussles over the role of the two agencies, according to people familiar with the details. The NTSB ended up in charge of the overall effort. The safety board has recently investigated an array of airborne fire or smoke incidents, including electrical shorts affecting cockpit windshields on various aircraft models.

From the moment the jet was ferried back to a U.S. maintenance base, it wasn't treated as a run-of-the-mill electrical short. Because it was "something we had never seen before," American alerted law-enforcement officials with "the expertise to come in and look at it," an airline spokesman said Friday.

American mechanics didn't find any indications of problems with circuit breakers or other electrical or mechanical parts, according to the airline. American became suspicious when fire damage was discovered toward the ceiling, according to people familiar with the details. As a result, the airline contacted the Federal Bureau of Investigation, which then handed over that part of the probe to arson investigators from the ATF.

Under U.S. law, the FBI and other law-enforcement agencies have authority to take over airline accident or incident investigations only if the Justice Department determines there is probable cause a crime has been committed.

In another unusual twist, the twin-engine Boeing 767 remained grounded for several weeks while mechanics removed and replaced large portions of the damaged lavatory. The water heater, for example, "didn't show any obvious signs of failure" and was sent to the manufacturer for further analysis, a Federal Aviation Administration spokesman said last week.

ATF officials declined to comment. A spokesman for the safety board, which recently finished interviewing flight attendants, said, "We aren't prepared at this time to discuss a probable cause...but hope to have something to say later this summer."

As an interim step, American, a unit of **AMR** Co., has instructed employees to take extra precautions that paper goods and other supplies stored in lavatories don't spill into compartments containing the water heater.

CORPORATE NEWS

Refiners hit as heavy crude loses benefit

Reduced supply has driven the fuel's prices higher, squeezing refining margins in comparison to lighter oils

By Ana Campoy

U.S. refiners that turned to cheaper, dirtier crude oil in recent years in a bid to boost profits are seeing the strategy backfire as supplies of the oil dwindle.

In past years, many of the nation's refiners invested in pricey equipment to process so-called heavy crude, a more viscous grade of oil that usually contains more contaminants such as sulfur and nickel. The heavy oil cost much less than more desirable, lighter crude, so refiners could boost profit margins by processing the cheaper oil.

But in recent months, a barrel of heavy crude has been selling for nearly as much as a barrel of light crude. "That cost advantage has all but disappeared," said Bill Day, a spokesman for **Valero Energy** Corp., the nation's largest refiner.

The change in the heavy crude market is adding to the woes of U.S. refiners already hurt by feeble demand for gasoline and diesel as consumers and industry cut back in the recession. As fuel inventories pile up, refiners are also facing increasing competition from new, more cost-efficient refineries in Asia.

Valero expects Tuesday to post a second-quarter loss of about 50 cents a share partly due to the shrinking heavy-crude oil discount. Houston oil producer **ConocoPhillips**, too, warned that its refining earnings will be hurt for the same reason. Other heavy-crude refiners, such as **Frontier Oil** Corp. and **Tesoro** Corp., are likely to be affected as well, analysts say.

Associated Press

Valero says the cost advantage of refining heavy crude has 'all but disappeared.' Above, Valero's Paulsboro Refinery in New Jersey.

In an attempt to shore up oil prices, members of the Organization of Petroleum Exporting Countries have been scaling back oil production, and much of the cuts have been in heavy crude. OPEC has agreed to reduce production of all grades by 4.2 million barrels a day.

"The heaviest are the least-profitable grades for them so they are the first grades they like to cut," said Antoine Halff, analyst with brokerage firm Newedge.

Heavy-oil supplies from Mexico, another big oil producer, are also less plentiful because of aging fields and lack of investment. Overall heavy-crude supply figures aren't available.

As a result, the difference in price between light and heavy oil has collapsed in recent months. Earlier this month, a barrel of Maya crude, a heavy grade from Mexico, sold for $62.62 a barrel, 2% or $1.22 more than a barrel of West Texas Intermediate, the light, sweet crude widely used as a benchmark for oil prices, data from energy consulting firm Muse, Stancil & Co. showed.

During the first half of last year, when WTI rapidly climbed above $100 a barrel, Maya was 17% cheaper.

More recently, the gap in price between Maya and WTI has widened again as oil prices have risen, and last week the Mexican heavy crude sold for an average 13% less than WTI.

In addition, processing the heavier varieties requires more energy and is more expensive, so refiners are trying to cut their heavy-crude runs to a minimum.

Valero shut down its heavy-crude-processing refinery in Aruba earlier this month, citing poor economics. The company said it will revisit its decision in two or three months.

Refiners also have been running their plants at lower rates—last week, only 85.8% of the nation's refining capacity was in use, according to the Energy Information Administration, the lowest level for this time of year since 1991, when the government started compiling figures for July.

Independent oil refiner Frontier shifted to lighter crude and reduced production rates at units that break down heavy oil for part of the second quarter. More recently, though, the price difference between the heavy Canadian oil it usually processes and lighter crudes has widened again, and the company is gradually reversing those measures, said spokeswoman Kristine Boyd.

Rio executive found success in a rising China

By Gordon Fairclough

SHANGHAI—For years, Stern Hu, the Australian mining executive detained here for allegedly stealing state secrets, has worked at the intersection of powerful economic and political forces.

On one side: his Anglo-Australian employer **Rio Tinto**, one of the world's biggest iron-ore producers, and a company whose success lately has been driven largely by China's voracious appetite for commodities.

On the other: China's steel mills and its government, frustrated by their lack of bargaining power in annual price talks miners and deeply concerned about their dependence on foreigners for raw materials.

Mr. Hu, manager of Rio Tinto's iron-ore operations in China, and three colleagues who are Chinese citizens, are being held by the State Security Bureau in the Detention House of Shanghai, a red-brick compound next to farm fields on a small road not far from the city's financial center. Authorities allege they bribed steel-mill operators to obtain secrets related to iron-ore price talks, damaging China's "economic security."

No formal charges have been filed against Mr. Hu, who was detained July 5. Rio Tinto says allegations that its employees were involved in bribery are "wholly without foundation." Australian officials have called for China to move quickly with the case.

Mr. Hu couldn't be reached to comment. In China, suspects in state-secrets cases aren't accorded the right to meet with a lawyer while being investigated.

The detentions come amid China's mounting dissatisfaction with its lack of bargaining power in annual price talks with miners, and deep concern about its dependence on foreigners for economically vital raw materials.

For Mr. Hu, that would have complicated his job considerably. Mr. Hu, who is in his 50s, has been in charge of managing Rio Tinto's relationships with China's biggest state-owned steel mills.

Mr. Hu in many ways personifies China's recent history of marketization and opening to the outside world.

Mr. Hu, who was born in the northern port city of Tianjin, was among the first generation of students admitted to universities when they reopened after the chaos of the Cultural Revolution. He graduated from Peking University with a degree in history and then studied at the Chinese Academy of Social Sciences—and still maintains a scholarly mien, according to industry analysts who say he regularly attended research conferences. As a graduate student, Mr. Hu cowrote a book, "The Art of Entrepreneur Leadership," according to Chinese business magazine Caijing.

In the mid-1980s, he went to work at the China International Trust & Investment Co., now known as Citic Group. Citic pioneered business contacts between a cautiously reforming communist state and the capitalist outside world with the aim of obtaining foreign technology, capital and resources.

Mr. Hu left Citic after several years to join an Australian technology company in Beijing. Then, in the mid-1990s, he joined Rio as its main iron-ore salesman for northern China. In 1997, he became an Australian citizen.

"He was not quite typical for an iron-ore salesman," recalls Philip Kirchlechner, an Australia-based consultant who at the time was leading Rio Tinto's iron-ore sales effort for southern China from the Shanghai office. Unlike others in the business, "He was not into drinking," Mr. Kirchlechner says. "No alcohol, no smoking."

Mr. Hu's abstemious habits didn't hold him back. "He was energetic, diligent, conscientious," says Mr. Kirchlechner. "He was always very eager to make a sale."

In the late 1990s, after the Asian financial crisis hit, that wasn't always easy. "We really had to go out there, visit the mills, take people to dinner, build relationships," says Mr. Kirchlechner. Mr. Hu, he says, was able to use his north China heritage to establish strong bonds with the region's steel-mill executives.

The two men also spent considerable time trying to forecast steel mills' buying behavior. "We wanted to understand future iron-ore demand. It's perfectly legitimate, I think," Mr. Kirchlechner says. He says there was regular information-sharing between the mills and their suppliers that benefited both sides.

Mr. Kirchlechner left Shanghai in 2001, and around that time Mr. Hu became head of iron-ore sales for all of China. Mr. Hu and his wife and two children settled in Shanghai, just before the global iron-ore business was transformed by China's economic rise. In 2003, China surpassed Japan as the largest importer of iron ore.

Spurred in part by rising demand, iron-ore prices marched upward, driving sales and profits for Rio Tinto and other big miners. But China's steel mills continued to follow pricing deals reached first in other countries. Some in China complained Rio Tinto and Anglo-Australian miner BHP Billiton weren't doing enough to boost capacity to meet Chinese demand and keep ore prices from jumping.

Last year, according to figures compiled by Mr. Kirchlechner, China spent more than $57 billion on iron ore and the freight costs of bringing it to China—equivalent to more than 1% of the nation's gross domestic product. In 2002, it spent less than $3 billion on iron ore.

Ensuring flows of the natural resources required to feed China's industrial-development machine has become a major preoccupation for the government.

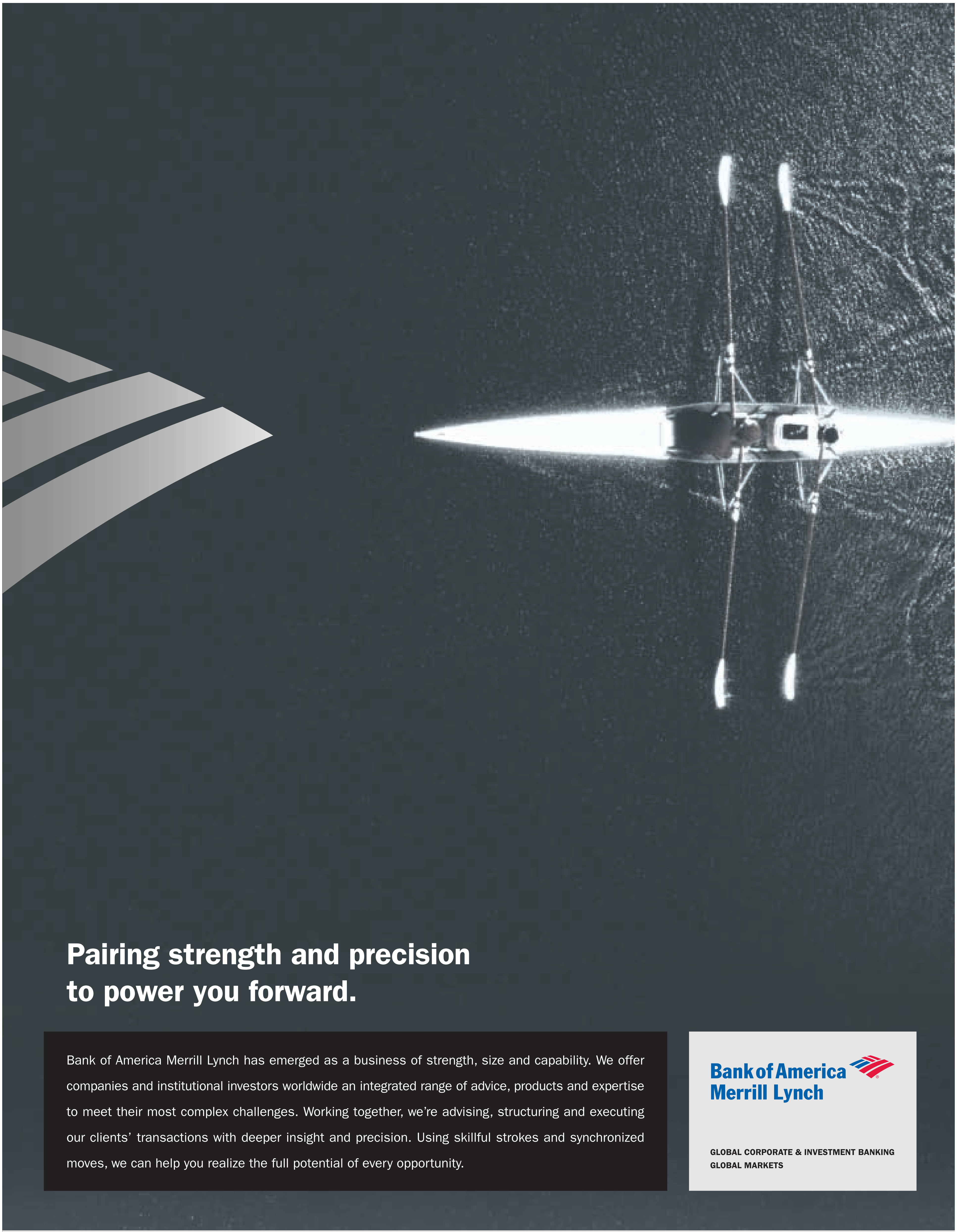
"Economic security is viewed as a component of regime and state security in China in a way that it isn't in more advanced industrial countries," says M. Taylor Fravel, a political scientist at the Massachusetts Institute of Technology who studies Chinese national-security issues. "The incessant need to modernize and develop creates huge incentives to get the technology and inputs they need."

Reuters

An undated photograph of Stern Hu, who joined Rio Tinto in the mid-'90s.

Rio Tinto has sparked controversy in recent years, with complaints by some in China's steel industry that it was trying to take advantage of contract terms and price fluctuations to maximize profits. Rio Tinto says it adheres to contract terms.

This year, Rio Tinto rebuffed an effort by **Aluminum Corp. of China** to increase its stake in the miner. And this year's annual price negotiations between Rio Tinto and steel makers have been especially contentious, analysts say, with China holding out for bigger concessions from Rio Tinto and other ore suppliers than other countries have gotten. So far, Rio Tinto has refused.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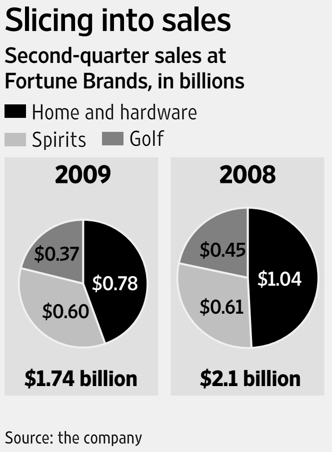
Fortune Brands earnings slip 27%

Golf, home products drag down results; forecast is trimmed

By Kerry Grace Benn And Anjali Cordeiro

Fortune Brands Inc.'s second-quarter earnings fell 27% on continued weakness in its home-products businesses and slow sales of golf products, but the conglomerate's earnings beat expectations.

The company also lowered the top end of its full-year earnings outlook, with Chairman and Chief Executive Bruce Carbonari saying the prior projection assumed an improvement in the company's markets that hasn't occurred.




Bloomberg News

Fortune Brands' Moen faucets, on sale at Home Depot

Fortune Brands' home and hardware segment sells products such as Moen faucets and Kitchen Craft cabinetry. The business—which provides about 45% of the company's revenue—has been hit hard by the U.S. housing slump.

Sales in the the home and hardware segment dropped 25% though the unit swung to a profit, as expected, due to lowered costs and other restructuring moves by the Deerfield, Ill., company.

In a conference call Friday, executives offered a cautious view on the home business. They said the industry is on track to fall 25% in 2009, and the new-construction market is likely to decline more than 40%, greater than previously expected.

Another big player in the home-products business, **Black & Decker** Corp., said its second-quarter profit plunged 60%. Sales of power tools and accessories, by far its largest segment, fell 21%.

Fortune's spirit and wine sales, meantime, slid 1.3% while earnings rose 1.2%. Golf sales and earnings fell 19% and 36%, respectively. The company posted overall profit of $99.8 million, down from $136 million in the year-earlier quarter.

Governments pledge support for plane project

By David Pearson

PARIS—The seven North Atlantic Treaty Organization governments behind the Airbus A400M military transport aircraft program pledged Friday to continue looking for negotiated solutions to the troubled program through the end of the year.

Defense ministers from the A400M core customer countries, meeting in Le Castellet, in southern France, renewed their support for the program and said they will continue to negotiate with Airbus Military, which is overseeing the program.

In March, the governments agreed to a three-month moratorium effectively preventing them from backing out of the program to build the airlifter. They agreed in June to extend the freeze to the end of July.

European Aeronautics Defence & Space Co. issued a statement saying it "welcomes the ministers' statement that the A400M is still their preferred choice for future air transport," and their agreement to enter into detailed negotiations with its unit Airbus up to the end of the year.

EADS has been forced to set aside more than €2 billion ($2.84 billion) in provisions against costs stemming from the program delay. It also said EADS and its Airbus subsidiary "are fully committed to finding an agreement that is technically and contractually acceptable to both sides."

Airbus expects the A400M to make its maiden flight around the turn of the year.

The €20 billion program is already running three years late due to development problems chiefly related to the aircraft's engine management system.

The states and the European arms procurement agency, OCCAR, are at loggerheads and are trying to renegotiate the terms of the contract. The moratorium allows the states to preserve their contractual rights, the French Defense Ministry said in a statement.

Airbus has said the plane is now expected to make its maiden flight around the turn of the year. Deliveries to the air forces of France, Germany, the U.K., Spain, Belgium, Luxembourg and Turkey won't start until three years later.

The armed forces of France and the U.K. are eager to get their planes quickly to replace their aging fleets of tactical airlifters and put them to use for their troops in foreign war zones such as Afghanistan.

EADS officials acknowledge that the initial contract with OCCAR signed in 2003 was deeply flawed, as it was crafted like a commercial contract and not a military one, with EADS assuming all the risks for potential overruns. The six-and-a-half-year development time allotted was also much too short for such a complex military program, with the work shared among the seven customer countries.

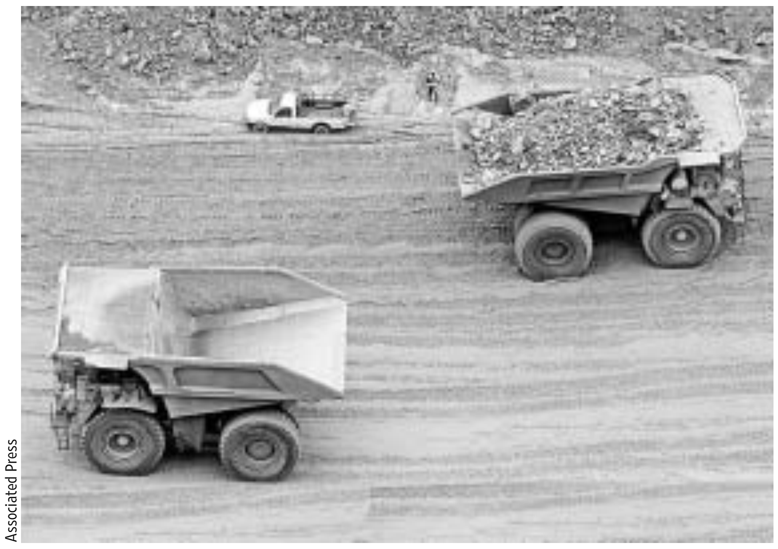
The A400M is an all-new aircraft powered by four turboprop engines that were developed specially for the aircraft. It has multiple capabilities: it can be adapted to carry troops, to refuel aircraft in flight, to transport military vehicles and carry out humanitarian missions.

CORPORATE NEWS

De Beers stays optimistic

Stronger demand for jewelry is forecast despite drop in profit

By Vanessa O'Connell



Debswana diamond mine, a joint venture of De Beers and Botswana. De Beers said its sales of rough stones have begun to pick up in recent months.

De Beers SA, the world's top diamond producer, posted a 57% decline in sales of rough diamonds in the first half, evidence of the recession's impact on the $77.5 billion global retail market for diamond jewelry.

On Friday, De Beers, a privately held company, also reported a 99% drop in first-half profit to $3 million. But the company said its sales of rough stones have begun to pick up in recent months, and it forecast stronger demand for diamond jewelry later this year.

"We're on the way back," Stephen Lussier, De Beers's executive director, said in an interview. "The story is looking considerably better than it was three or four months ago."

It estimates retail sales of diamond jewelry globally are down just 5% to 10%.

De Beers posted a second-quarter profit of $189 million on sales of $1.3 billion, following a first-quarter loss of $186 million on sales of just $400 million. The first-half sales were down from $3.7 billion a year earlier.

De Beers generally reports only year-end and half-year results. It said it was presenting the quarterly sales and earnings to show how its performance has improved.

De Beers produces and markets 40% of the world's uncut and unpolished diamonds by value, extracting them from 14 mines in Canada, South Africa, Botswana and Namibia.

It sells the diamonds to 78 "siteholders," or clients, which are primarily diamond-cutting companies. They polish the rough stones into gems and sell them to retail stores. Recently, the siteholders have suffered from a pullback in lending by banks, as well as a sharp downturn in demand.

Mr. Lussier blamed excess inventory in the diamond pipeline for the hit to De Beers's rough diamond sales in the first quarter, but he said that in recent months the inventory has been cleared.

Earlier this year, De Beers temporarily ceased production at many of its mines, resulting in a 73% drop in first-half output. It anticipates that output this year will be half of last year's 48.1 million total carats.

While most of the mines have resumed production, Damtshaa—which De Beers operates through a joint venture with the government of Botswana—is expected to remain shut for the rest of the year, the company said.

Despite the recent plunge in its sale of rough stones, De Beers estimates retail sales of diamond jewelry globally are down just 5% to 10% overall.

De Beers also has 42 jewelry stores world-wide in a retailing joint venture with French luxury-goods company **LVMH Moët Hennessy Louis Vuitton**.

Mr. Lussier said that venture is "in the same difficult environment as Cartier and Tiffany and others," but it has seen strong growth in unit sales, particularly in engagement rings and other bridal jewelry.

Demand for diamonds priced at $100,000 and up continues to be weak. Only in the past six to nine weeks has De Beers begun to see renewed interest in high-priced items, Mr. Lussier said.

In the U.S. retail market, which accounts for about half of all jewelry sales, the rate of the sales decline is slowing, he said, while in Asia, "we're back into growth."

Underscoring the uncertain outlook for De Beers earlier this year, the firm recently received two significant loans from its three shareholders—Anglo American PLC, which owns 45%, the Oppenheimer family, with 40%, and the Botswana government, which owns 15%.

In February, the shareholders provided De Beers with $500 million, following a $300 million loan late last year. On Friday, the firm said it had $622 million net cash.

Merck KGaA takes hit on drug

By Natascha Divac

FRANKFURT—A European Union panel Friday dealt a blow to **Merck KGaA**'s hopes to extend the use of Erbitux, its leading oncology drug, to lung cancer.

The bad news, coupled with lackluster second-quarter earnings, sent shares in the German pharmaceutical and chemicals conglomerate sharply lower.

Erbitux, approved for some types of bowel cancer and head and neck cancer, generated sales of €565 million ($802 million) last year. Merck had hoped the treatment could reach €1 billion in sales by 2010 or 2011. Analysts now say hitting that goal will probably be delayed.

The Committee for Medicinal Products for Human, part of the European Medicines Agency, issued a so-called negative opinion on the use of Erbitux in non-small-cell lung cancer, saying benefits of using the drug to treat the disease didn't outweigh its risks. It added that Erbitux's benefits were modest in terms of survival times.

Regulatory reaction

Merck KGaA's 52-week share performance on the Frankfurt Stock Exchange

Friday's close: €62.62, down 15%

Source: Thomson Reuters Datastream

Merck, which markets the drug in Europe, said it is considering appealing the decision and added it requested that the committee reexamine data demonstrating clinically relevant benefits for patients.

LBBW analyst Hanns Frohnmeyer had expected Erbitux to be launched as a lung-cancer treatment by the end of this year, with sales of €600 million in 2012. Even if Merck's appeal is successful, "we expect a one-year delay of the launch," he said.

Investors were also disappointed by Merck's earnings. The company's net profit fell to €108.5 million in the three months ended June 30 from €207.4 million a year earlier, well below analysts' expectations for €128 million. Revenue, including royalty income, was steady at €1.9 billion.

Chief Executive Karl-Ludwig Kley said the global economic crisis is hurting Merck, but "to a lesser extent than many companies."

Merck shares closed down 15% at €62.62 in a flat German market. The stock has lost 20% of its value over the past 12 months.

Merck isn't affiliated with U.S.-based drug company Merck & Co.

—Allison Connolly contributed to this article.

GLOBAL BUSINESS BRIEFS

TeliaSonera AB

TeliaSonera boosts outlook as earnings increase 8.2%

TeliaSonera AB Friday raised its earnings margin estimates for the full year and said it aimed to keep costs below last year's level as it posted an 8.2% rise in second-quarter net profit. In April, TeliaSonera, the Nordic region's largest telecom operator, cut its 2009 guidance, forecasting sales at around the same level or slightly below 2008. TeliaSonera cut costs by 5.8% in the second quarter compared with last year. "We expect that our efforts to lower addressable costs and capital expenditure will offset the negative impact from declining gross domestic product and rising unemployment in our markets," said Chief Executive Lars Nyberg. Net profit rose to 4.47 billion Swedish kroner ($594.9 million) and sales increased 8.7% to 27.48 billion kroner.

Saab AB

Swedish aerospace and defense company Saab AB said Friday that its second-quarter profit fell 14%, blaming weaker demand, project delays and order cancellations. The results weren't as bad as expected, however, causing the company's shares to rally. Profit in the April to June period fell to 294 million Swedish kronor ($39.4 million) from 341 million kronor in the year-earlier period. Sales rose 5% to 6.3 billion kronor amid favorable exchange rates.Despite the tougher market conditions, Stockholm-based Saab said it expects sales for the full year to be higher than in 2008, although operating margins are likely to fall. In its forecast for the full year, Saab said its development depends on Swedish defense plans and that it will also continue to be affected by the global economy.

Fiat SpA

The European Commission Friday cleared Italian car maker **Fiat** SpA to buy a 20% stake in **Chrysler Group** LLC of the U.S. Fiat is taking a stake in Chrysler in exchange for access to foreign markets and technology to make small cars. It aims to use Chrysler to return to the U.S. market, where its namesake auto brand has long been absent. It also sees Chrysler as a way to help it increase its production capacity toward the minimum it says is needed to survive the industry crisis. Fiat currently produces about two million cars a year and, together with alliance partner Chrysler, will make about four million. The commission, the European Union's executive arm, said it didn't see competition concerns with the deal, which it said would give Fiat the ability "to exercise sole control" at Chrysler.

British Airways PLC

British Airways PLC's premium-class subsidiary, OpenSkies, on Friday said it is suspending its service between Amsterdam and New York, starting Aug. 16, citing a significant drop in demand. OpenSkies will instead focus on the Paris-to-New York route, it said. Despite the difficult market conditions for premium travel, OpenSkies said it had doubled its market share in the Paris-to-New York business-class route to 25% in the past year. OpenSkies customers who currently hold tickets for the Amsterdam-to-New York route will now have a choice of a refund or flying with British Airways via London.

Schlumberger Ltd.

Schlumberger Ltd.'s second-quarter profit fell 57% on sluggish activity in the hard-hit North American oil sector. The oil-services giant's North American operations seem to have reached "some stability" after the precipitous fall it experienced in the first half of the year, said Chief Executive Andrew Gould. But a major boost in onshore activity by natural gas-producing companies is unlikely during the rest of the year as storage levels remain high. This means that prices for Schlumberger's services in the region "will remain depressed," he said. Schlumberger, the largest oilfield-services company by sales, reported a profit of $613 million, or 51 cents a share, down from $1.42 billion, or $1.16 a share, a year earlier. The latest quarter included 17 cents a share in restructuring-related charges. Revenue fell 18% to $5.53 billion.

Nufarm Ltd.

Nufarm Ltd. of Australia said it received a preliminary approach by China's **Sinochem** Corp. for a potential takeover, the latest in a series of overtures by Chinese state-owned entities to acquire assets in Australia. Nufarm, which makes and distributes agricultural chemicals, has a market capitalization of 2.43 billion Australian dollars, or roughly US$2 billion, based on Friday's closing prices. Sinochem on Sunday confirmed the talks. Buying Nufarm would expand Sinochem's share of the market for herbicides and pesticides in the global market, securing critical supplies for China, the world's largest and fastest-growing consumer of grains.

Ranbaxy Laboratories Ltd.

Ranbaxy Laboratories Ltd. on Friday reported a higher-than-expected consolidated profit in the second quarter, as a stronger rupee helped the generic-drug maker record foreign-exchange gains. The India-based company also retained its financial guidance for the year, even as it said it expects to meet soon with U.S. Food and Drug Administration officials to move forward on the resolution of pending regulatory issues. Consolidated profit for the quarter ended June 30 rose to 6.93 billion rupees ($144 million) from 229 million rupees a year earlier, helped by foreign-exchange gains of 8.07 billion rupees, Ranbaxy said. Ranbaxy, a unit of **Daiichi Sankyo** Co. of Japan, had reported losses in the past three quarters, hit by unfavorable currency bets, regulatory issues and the economic slowdown.

Jet Airways (India) Ltd.

Jet Airways (India) Ltd. said Friday it swung to a fiscal-first-quarter loss as a decline in global air travel offset gains from lower fuel costs. The Indian airline posted a net loss of 2.25 billion rupees ($46.5 million) for the three months ended June 30, compared with a net profit of 1.43 billion rupees a year earlier. Revenue fell 26% from a year earlier to 20.85 billion rupees. Separately, the company's directors approved a proposal to raise as much as $400 million, though the method for the fundraising hasn't been finalized. The company's international operations contributed about 57% of its operating revenue during the quarter, up from 48% a year earlier. Jet Airways carried 2.59 million passengers in the first quarter, an 18% decline from the year-earlier period.

—Compiled from staff and wire service reports.

Data jolt hopes for European recovery

U.K. economy fell sharply last quarter, while stepped-up business activity in July brightened German outlook

The fortunes of two of Europe's biggest economies are shifting: The U.K. economy posted a steep drop last quarter, dashing hopes of a quick recovery, while industry surveys in Germany implied the country's recession could end sooner than expected.

*By **Marcus Walker** in Berlin and **Alistair MacDonald** in London*

U.K. gross domestic product fell by 0.8% in the second quarter from the first, and dropped 5.6% year-over-year, the largest annual decline since quarterly records began in 1955. The data punctured recent optimism that the U.K. was rebounding from its worst recession of the postwar era.

Meanwhile, the closely watched Ifo and purchasing managers index surveys in Germany showed that companies' activity is starting to pick up, after collapsing since the autumn. Global demand, especially from Asian countries with large government stimulus plans, is benefiting export-dependent Germany more than other European countries, analysts say.

"There's certainly a real contrast between the German and U.K. data," says Howard Archer, chief European economist at IHS Global Insight in London. "The U.K.'s GDP number is a shock, and a reality check to people who thought the U.K.'s recession might even have ended."

By contrast, says Mr. Archer, "it does seem that German manufacturing is coming back from the huge plunges since late last year."

Briton John Lambert, who owns a car dealership and a construction business, wasn't surprised by the GDP news. "People keep talking about the green shoots of recovery, but this is going to be a long haul," he says.

Over the past two years Mr. Lambert made the first layoffs of his 30-year career, letting half of his eight-strong car-sales team go. To compensate, he is putting in longer hours, while waiting—along with businesses across the U.K.—for lending and spending to pick up. "There is only so much harder you can work, and I can't cut any more," he says.

Mr. Lambert's predicament differs from that of German firm Karl Mayer GmbH, a family-owned maker of machines for the textiles industry, which is ramping up production after having little to do all winter and spring.

The company, based near Frankfurt, won 68 new machinery orders from China in the past month, reflecting an increase in Chinese business investment and consumer spending after Beijing's sweeping efforts to stimulate demand.

Karl Mayer recently laid off 350 workers—a quarter of its staff in Germany—after turnover fell by two-thirds early this year. "Some of the workers are questioning why we just made these layoffs," says staff representative Manfred Hohm. "Now we're working overtime again."

Germany's Ifo business-climate index rose to 85.9 in July, the fourth consecutive rise. Crucially, firms' current activity is up as well as expectations for the months ahead, especially at export-dependent manufacturing companies, the Munich-based Ifo economics institute said.

The PMI for Germany rose to 48.9 in July, up from 44 in June, hitting the highest level since before the collapse of Lehman Brothers in the fall.

Other recent German data including exports and new orders in industry show that Germany's economy, the world's fourth largest, is stabilizing quickly after recording a 3.8% drop in GDP in the first quarter from the fourth of last year.

Economists say they expect Germany's second-quarter GDP data, due for release on Aug. 13, to show only a slight contraction, with growth returning as soon as the third quarter.

Most of Germany's neighbors in Europe are on a slower path to recovery. The PMI survey for the 16-nation euro currency zone—which includes Germany but not the U.K.—rose more modestly to 46.8 in July from 44.6 in June. France's services sector and consumer confidence have taken hits recently, surveys show.

Eastern Europe continues to be a concern, with the European Bank for Reconstruction and Development warning Friday that those economies face a rise in nonperforming loans and corporate defaults severe enough to destabilize their shaky banking systems.

Euro-zone member Spain's unemployment rose to 17.9% in the second quarter, the highest unemployment rate in Europe. The increase of half a percentage point last quarter was much smaller than the surges in joblessness in previous quarters, indicating that Spain's labor market is starting to stabilize, thanks partly to public works, which are aiding the battered construction sector, analysts said.

The U.K. and Germany are both expected to return to growth in the second half of this year. But both countries' recoveries—and their prospects in the medium term—are fragile, economists say.

The U.K. is still thought to be better positioned to recover than most of the euro zone. The pound is down almost 10% against the euro and 17% against the dollar since July 2008, which should help exporters. The Bank of England's key interest rate, at 0.5%, is lower than the European Central Bank's 1%.

Businesses in both the U.K. and Germany complain of banks' reluctance to lend, but fears of a possible credit crunch are higher in Germany because the U.K. government has done more to help banks overcome losses on U.S. mortgage-related and other toxic securities.

"Germany is offering banks help but the conditions are so restrictive that banks don't want to use it," said Jürgen Michels, an economist at Citigroup in London. "The clean-up and re-capitalization of the German banking sector will take longer, and that will be a drag on the economy," he says.

Also, British companies raise more of their money from capital markets, which have rebounded this year.

The U.K.'s consumers, banks and government are saddled with more debt than many other European countries or the U.S., and unwinding that debt will take demand out of the economy.

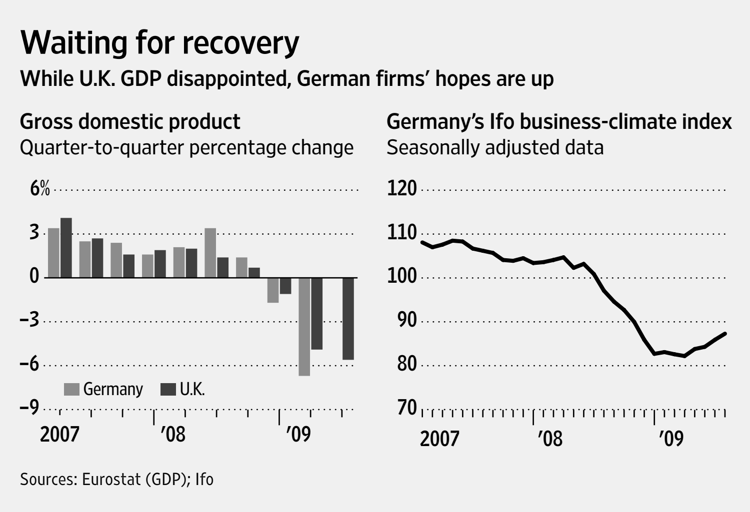
Germany's fiscal-stimulus measures, equivalent to 3.5% of GDP over two years, are much larger than the U.K.'s, which run only 1.5% of GDP, according to the International Monetary Fund.

Germany's manufacturing focus meant it was hit harder than the U.K. by the downturn in global trade. But German households and businesses entered the recession in relatively strong financial shape, because fewer of them binged on credit during the bubble years.

—Laurence Norman in London and Loretta Chao in Beijing contributed to this article.

Associated Press

German surveys show business activity is picking up after falling since last fall. Above, a technician at a Siemens Energy factory.



Eastern Europe faces threat of more defaults

BY JOE PARKINSON AND JOEL SHERWOOD

Eastern European economies face a rise in nonperforming loans and corporate defaults severe enough to destabilize their already shaky banking systems, the European Bank for Reconstruction and Development warned Friday.

EBRD President Thomas Mirow warned former communist bloc countries of a possible second wave of financial crisis, according to the text of his speech in Vienna marking the 20th anniversary of the fall of the Iron Curtain.

The warning came as Latvia, a prominent casualty of the region's financial turmoil, stepped up efforts to deliver reforms requested by the International Monetary Fund. Latvian Prime Minister Vladis Dombrovskis said Friday he has told his cabinet to look for $1 billion in cuts to next year's budget. That is a reduction of 10.7% from 2009 spending, according to Ieva Aile, communications head at the prime minister's office.

Nonperforming loans are rising across the EBRD countries and have doubled in the past year in Turkey, Romania, Ukraine and Albania, according to the EBRD. Recent data from national central banks show commercial banks in Romania are no longer collecting interest on more than 8% of the loans they've extended, and the figure is nearing 5% in Turkey, where credit cards are already defaulting at a double-digit pace.

"The immediate challenges we face are a severe rise in nonperforming loans and possible corporate defaults, resulting in rising unemployment, knock-on effects on other companies and on bank balance sheets," said Mr. Mirow.

Thomas Mirow

Many of the once fast-growing ex-communist economies lately have been hit by collapsing demand and vanishing foreign investment flows, leaving large foreign-currency debts and current-account deficits. Already, many have turned to the IMF in the crisis, which so far has toppled governments in Latvia, Hungary and Bulgaria.

To prevent a recurrence, Mr. Mirow said Eastern European countries need to restructure private debt, reduce foreign-exchange exposure and adequately capitalize banks.

He cautioned that, although the region's economies have stabilized in recent months, the impact of the "unprecedented market crisis" still poses major risks. "This is a severe challenge which we must not underestimate, neither economically nor politically, and we must not allow a sense of complacency to take hold," he said.

In Latvia, Mr. Dombrovskis' directive comes just a month after the Riga government agreed to cut spending for this year by the same amount to keep international aid flowing in.

—Christopher Emsden contributed to this article.

Spain's despair rises as jobs fail

Homes now lacking a working member exceed one million

BY JONATHAN HOUSE

MONTEPRINCIPE, Spain—Luis Sanchez, 41 years old, can't sell his home in a gated community with swimming pools nestled among pine trees that he bought three years ago at the peak of the long boom that followed Spain's adoption of the euro in 1999.

Having ridden the boom to wealth in jobs ranging from stockbroker and financial director, Mr. Sanchez now finds himself jobless with an unmanageable mortgage. He isn't planning a vacation this year, has negotiated lower fees at his children's schools, and is avoiding restaurants.

Mr. Sanchez's predicament is echoed across Spain, as anxiety grows at the end of a boom that hinged on speculative housing investment and cheap credit. The low morale that comes from high debt and joblessness is a reason Spain could take longer than other countries to pull out of recession.

Government data out Friday showed that more than one million households in Spain have no working members. The country's unemployment rate more than doubled on the year to 17.92% in the second quarter, by far the highest rate among the 30 nations in the Organization for Economic Cooperation and Development, following the collapse of Spain's labor-intensive construction industry. In comparison, the U.S. had a 9.4% unemployment rate in May, according to the most recent OECD data.

Other large European countries have yet to feel the degree of pain Spain is suffering from the global economic downturn.

The Sanchez family put up their home for sale in this gated community outside Madrid more than six months ago, but it has not sold.

Spain's joblessness has room to grow even further. As builders struggle to unload more than one million unsold homes, they will continue to cut jobs. Economists say consumer spending will be damped for years.

As a result, Spanish GDP will contract around 3.2% this year and 1% next year, the European Commission forecasts. It projects that all other European countries will post at least one quarter of growth in 2010, but Spain won't. "Spain will be one of the last countries to exit recession," said Ben May of Capital Economics in London. "When it does, it's very optimistic to expect it to return to the growth it had before."

Spain's fall to earth removes an important engine of European growth. From 1999 to 2007, Spanish GDP grew at 3.7% a year, 1.5 percentage points more than the average of the countries using the euro. Spain also created more than one-third of all eurozone jobs and absorbed four million immigrants during the period.

The government of Prime Minister José Luis Rodriguez Zapatero has introduced an €8 billion ($11.37 billion) local infrastructure plan designed to create temporary jobs and extend unemployment benefits. But the effort has pushed Spain's accounts deep into the red.

Critics say Mr. Zapatero has shied away from structural reforms. Business leaders want labor-market deregulation to make it easier to lay off workers, saying this would make it easier for them to hire some of the millions losing their jobs. The crash comes after three decades of spectacular success, when the country climbed out of poverty of the years of Francisco Franco's dictatorship.

Mr. Sanchez's father, Antonio, grew up in Morocco. In 1941, his family fled Spain's turmoil and food shortages after the Civil War that brought Franco to power. But after Franco's death in 1975, Spain embraced democracy and joined the European Union. "The gap with the rest of Europe was rapidly closing," says the older Mr. Sanchez.

In 1999, Spain adopted the euro currency, ushering in a period of low interest rates that helped fuel the biggest growth spurt in the country's modern history. Income per capita surpassed that of Italy, and Mr. Zapatero boasted it would soon surpass that of France and Germany. Households and companies borrowed freely and invested in real estate. Luis Sanchez seized on modern Spain's opportunities, taking a law degree, studying in Seattle for a year, and then becoming a stockbroker.

Mr. Sanchez bought his home—a white, Andalusian-style villa with a pool, a garden and flower-lined walkways—in 2006. Now, with a large mortgage and no job, he says he thinks he is unlikely to be able to afford a house like that again.

He doesn't yet know where his family will end up, but says he is prepared to move out of Spain if necessary. "Living standards in Spain had reached European levels, but the gains were fictitious," he says.

Poll observers slam Kyrgyz leader's landslide

BY ALAN CULLISON

MOSCOW—European observers issued a stiff censure of presidential elections in Kyrgyzstan, where President Kurmanbek Bakiyev claimed a landslide victory that would cement his hold on power over the mountainous Central Asian nation.

But the European disapproval is unlikely to alter the vote's outcome. Both Russia and the U.S. have been courting Kyrgyzstan as an ally in a struggle for influence in the region. Since he came to power in 2005, Mr. Bakiyev has turned Kyrgyzstan—once a hoped-for island of democracy in Central Asia—into an authoritarian state with a system of political controls starkly similar to Russia's.

The U.S. Embassy in Kyrgyzstan's capital, Bishkek, declined to comment on Thursday's election, which by official figures appeared to give Mr. Bakiyev more than 85% of the vote. A Moscow-dominated mission of election observers, meanwhile, called the voting "open and free."

The European assessment, delivered Friday by observers from the Organization for Security and Cooperation in Europe, was unusually harsh, and criticized the Kyrgyz government for lopsided media coverage before the polling, as well as ballot-stuffing and other irregularities. The severity of the marks was "quite rare," an OSCE spokesman said.

Kyrgyzstan hosts a U.S. air base that is a linchpin to the resupply of U.S.-led troops in Afghanistan, and lately the Kyrgyz president has used Russian resentment of the U.S. presence to play Washington and Moscow off against one another.

After accepting a massive aid package from Russia this year, Mr. Bakiyev announced he was closing the U.S. base. In June, he backpedaled and said he would allow another one to be reopened at much higher rent.

This month, Mr. Bakiyev's government said it may let Russia open another air base of its own—its second in Kyrgyzstan—in the country's restive south that would be home to a rapid deployment force the Kremlin has said could rival that of the North Atlantic Treaty Organization.

Mr. Bakiyev has steadily amassed power in the country, appointing friends and family to top posts in government and the security services. His political opponents were weakened by attacks, arrests and disappearances in the run-up to voting. Rival candidates had little chance to advertise in the state-run media, the OSCE said. More than half of the OSCE observers came back with a "negative" or "very negative" assessment of the count at polling stations, said Jens-

President Bakiyev at a news conference after voting in Bishkek on Thursday.

Hagen Eschenbaecher, a spokesman for the observers.

The main opposition candidate, Almazbek Atambayev, dismissed Thursday's election as fraudulent and called for a rerun. The government's election commission called the voting fair and said there would be no rerun.

Mr. Atambayev's campaign manager, Bakyt Beshimov, said he hoped that the U.S. would echo the OSCE disapproval of the election. But Mr. Beshimov said he doesn't expect any harsh criticism from Washington because "the U.S. only seems to care about the base."

The U.S. opened air bases in Kyrgyzstan and Uzbekistan soon after the al Qaeda attacks on New York and Washington in 2001, using both as launchpads for the invasion of Afghanistan and the resupply of troops there. While Russia at first supported the bases, it began calling for their closure after a chill in relations and the U.S.-led invasion of Iraq, which Russia opposed.

The U.S. lost use of its base in Uzbekistan in 2005 after Washington criticized that government's bloody repression of protests in the city of Andijan. As the U.S. base in Kyrgyzstan became the hub for ferrying troops and supplies into Afghanistan, Mr. Bakiyev pressured the U.S. for higher rent.

Mr. Bakiyev said that he was closing that base earlier this year in Moscow at a Kremlin news conference where Russian President Dmitry Medvedev promised his government $2.1 billion in aid. Mr. Bakiyev reversed course in June and said he would allow the U.S. to continue to operate out of a transit center near the closed military base, where the U.S. would pay an annual $60 million in rent, more than triple the amount paid for the air base.

Russia, which supports the U.S. war effort in Afghanistan, said it didn't oppose the U.S. efforts to keep a base in Kyrgyzstan.

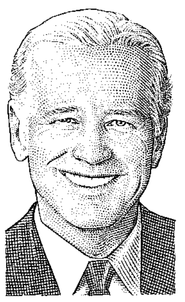
Clinton assures Moscow of effort to 'reset' ties

BY PETER SPIEGEL AND ALAN CULLISON

U.S. Secretary of State Hillary Clinton said the Obama administration considered Russia a "great power" and wanted it to be a strong and prosperous country, in an apparent effort to reassure Moscow that the White House remains committed to efforts to "reset" bilateral relations.

Mrs. Clinton made the remarks in response to a question about Vice President Joe Biden's suggestion, during a Wall Street Journal interview published on Saturday, that Russia's weakening economy was likely to make it more amenable to cooperate with the West on national security issues.

"We view Russia as a great power," Ms. Clinton said on NBC News's "Meet the Press" on Sunday. "Every country faces challenges. We have our challenges, Russia has their challenges. There are certain issues that Russia has to deal with on its own."

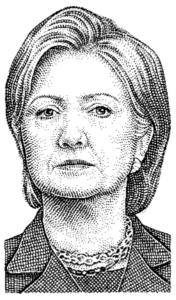


Joe Biden

She said the Obama administration didn't believe it has an upper hand in its ties with Moscow, and noted that Mr. Biden had been the first senior administration member to publicly call for a "reset" in the two countries' relationship, in an address in Munich, Germany, in February.

Mr. Biden's comments to the Journal raised concerns in Moscow, which questioned whether he was speaking for the U.S. government. "The question is: Who is shaping the U.S. foreign policy—the president or the respectable members of his team?" asked presidential aide Sergei Prikhodko. He said it was "perplexing" that Mr. Biden delivered the comments just as the U.S. was talking about a reset in relations.

On Sunday, Russian President Dmitry Medvedev criticized the U.S. over its continued support of membership in the North Atlantic Treaty Organization for the former Soviet republics of Ukraine and Georgia, saying the alliance "is not ready" to absorb them. Mr. Biden visited both states during his trip through the region last week, and reaffirmed U.S. support for both to join the alliance.



Hillary Clinton

"We don't think it's right to drag certain countries into military and political alliances against the will of their people," Mr. Medvedev said on Russia's NTV television.

Mrs. Clinton reiterated the administration's view that the countries have a right to join any alliance they choose. She said differences with Moscow over the issue wouldn't halt White House efforts to reach out to Russia.

"The Russians know we have continuing questions about some of their policies, and they have continuing questions about some of ours," she said.

Taliban resume attacks

Swat Valley refugees are returning home to renewed violence

Taliban militants driven from the Swat Valley by Pakistan's army in recent months are again infiltrating the region's towns and villages, kidnapping and beheading perceived enemies and ambushing soldiers, as hundreds of thousands of refugees return home.

By ***Matthew Rosenberg*** *in Peshawar, Pakistan, and* ***Zahid Hussain*** *in Mingora, Pakistan*

Whether the latest violence represents the last gasp of a dying insurgency or the first sign of the militants' recovery is hard to tell. But the renewed violence is a sharp reminder that the offensive for the strategic valley, which won effusive praise from the U.S. and European nations, remains far from complete.

One of the most recent incidents took place around midnight Thursday, when eight bearded men with Kalashnikovs and dressed in army uniforms came looking for Jahan Zada, the head clerk of a small-town police station in Swat. Three took up positions on the roof of the boxy, two-story brick home, said a neighbor who witnessed the incident. The other five kicked down the front door.

"That's when we knew they were Taliban," said the witness, who asked that he be identified as Junaid. "They dragged him out and took him away."

Within hours, four of the alleged Taliban kidnappers were killed by security forces, officials say. Mr. Zada is still missing.

Pakistan's military declared the valley secure two weeks ago, after weeks of intense fighting against the Taliban in what has been viewed as the start of a major pushback by Pakistani forces against the militants' spread. The military has since been encouraging the more than two million people who fled the area to return. But some of the militants who melted away in the face of the offensive are reemerging, while others remain holed up in mountainside redoubts.

Pakistan's military spokesman, Maj. Gen Athar Abbas, said that until the military has a better handle on the valley, it is unlikely to open another front in the tribal areas along the Afghan border, the Taliban's most important strongholds in Pakistan and the rear base for militants fighting U.S. and allied forces in Afghanistan.

In the past week, three civilians have been beheaded by the Taliban in and around Mingora, the valley's main town. Mr. Zada was kidnapped in a nearby town, Sangota. In another nearby village, the janitor at a police station was killed, say military officers, diplomats and aid workers.

The army, meanwhile, is engaged in near-daily firefights with pockets of Taliban resisters. Most clashes are small, but dozens of militants have been killed in recent days, along with a few soldiers, the army says.

"The situation is still uncertain," said Shazeb Ali, 28 years old, who returned to his home and mobile-phone shop in Mingora two weeks ago. "We can hear the sound of firing some distance away."

The violence in Swat is making it difficult to rebuild: Pakistani officials and Western diplomats say authorities are having trouble recruiting police and administrators because candidates fear being targeted.

The violence is also making it hard to re-establish some semblance of the valley's social order, which was upended by nearly two years of unrest in which the Taliban imposed a harsh brand of Islamic law and fomented a peasants' rebellion by chasing off the small class of landlords who controlled most of the valley's business. A faltering reconstruction could leave the strategic valley again exposed for what would be the third Taliban takeover since 2007.

The military says it has decimated the Swat Taliban's command-and-control abilities and its logistics infrastructure, and soldiers now control the main roads, towns and villages on the banks of the Swat River. But the "Taliban are still entrenched in some mountainous areas," said Brig. Tahir Hameed Rana, a commander in Mingora.

The valley's Taliban commanders, especially its leader, Maulana Fazlullah, also remain at large, which "is, frankly speaking, our biggest failure," said Gen. Abbas, the spokesman. "We're going to continue these raids and these snatch-and-grab operations until we have them," he said. "We can't allow them to continue instilling fear in the population."

Military commanders say they are banking on residents to help root out Taliban holdouts. Gen. Abbas cited an example of residents of a small mountainside village, Shamo Zai, leading soldiers to a graveyard where the Taliban had stashed weapons.

Authorities in Peshawar said Sunday they had arrested Sufi Mohammed, the radical cleric who negotiated the failed Swat peace deal on behalf of the Taliban, and two of his sons for allegedly encouraging violence and terrorism.There was no immediate comment from Mr. Mohammed's spokesman.

—Rehmat Mehsud in Islamabad contributed to this article.

Associated Press

Pakistani soldiers in the town of Mingora on Sunday stand beside weapons, computers, vehicles and other items confiscated from militants in the Swat Valley.