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Medvedev in step with Bono



Agence France-Presse/Getty Images

Russian President Dmitry Medvedev speaks with Irish rock star Bono, right, about their joint campaign to fight the spread of polio as they walk Tuesday at Bocharov Ruchei residence on the Black Sea coast. Bono's band U2 is due to play its first ever concert in Russia this week.

Markets fall as home sales tumble in U.S.

Fears that the U.S. recovery may be faltering fueled market nervousness Tuesday.

The worst U.S. home-sales figures since 1999, coming in nearly twice as bad as expected, initiated a flight to safety around the world, as investors swapped equities for the perceived security of Swiss francs and gold.

The weak housing data in the U.S. rattled already-nervous investors, sending shares in Europe lower, with losses accelerating into the close of trading. Holiday-thinned trading desks opened the day in a dour frame of mind after Asian stocks sold off ahead of the European open.

That tender mood received a negative jolt when an industry group reported that existing home sales in the U.S. plunged 27.2%—nearly double the decline analysts had anticipated.

That news sent European shares lower with the Europe Stoxx 600 index losing 1.7%. London fell 1.5%, Frankfurt slid 1.3% and Paris lost 1.8%.

Richard Batty, investment director at **Standard Life Investments**, said European markets have been very sensitive to weakness in U.S. hous-

ing and employment data in recent months amid uncertainty about the sustainability of the U.S. recovery.

The U.S. recovery is seen as particularly crucial in Europe where the economic rebound, especially in Germany, has been export-led. In addition to recent sluggish data out of the U.S., China's growth prospects have also become more uncertain.

Both China and the U.S. are showing signs of weakness even as major central banks keep short-term rates at emergency lows. Moreover, with much of Europe focused on fiscal restraint, policy options to combat a slowing economy may be limited.

With housing data weak and the American employment picture worsening, investors raced to safer investments such as German Bunds, the Swiss franc and gold. Yields on 10-year Bunds approached 2.10% and the euro clipped a fresh low against the franc. Gold rose about 0.5% to stick solidly above \$1,233 an ounce.

"If people had confidence, they wouldn't be pouring money into Treasury securities yielding nothing, and pay-

ing more than \$1,200 for an ounce of gold," said Morris Mark, president of Mark Asset Management.

As stocks sold off, concerns about the fiscal health of economies on the periphery of the euro zone rose. Credit-default insurance for Ireland and Portugal shot higher. In addition, the Irish stock market's ISEQ index lost nearly 5.8%, and the Greek ASE index fell 3.4%.

Some of the dark mood stems from fears about what next week will bring. The U.S. will report an ocean of data, including surveys on the national manufacturing and service sectors, home sales and the August employment report. "Next week has been touted as one of the most important in recent times for economic data," said Gavan Nolan, vice president at market-data firm Markit. "But the last days of August have given the markets something to think about."

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India rejects Vedanta's bauxite mining plan

BY PRASENJIT BHATTACHARYA

NEW DELHI—India's federal government rejected **Vedanta Resources PLC's** proposal to mine the Niyamgiri Hills for bauxite, setting back the company's plans to ramp up aluminum production to meet growing demand.

The rejection creates a double whammy for Vedanta. The London-based company's \$8.5 billion-\$9.6 billion bid for a majority stake in oil producer Cairn India Ltd. could be jeopardized as the Oil Ministry reviews Vedanta's proposed deal with the U.K.'s

Cairn Energy PLC.

Tuesday's rejection could set off alarm bells among other global metals companies, such as Luxembourg-based **ArcelorMittal**, South Korea's **Posco** and India's **Tata Steel Ltd.**, that await clearances for steel plants in eastern India.

Most of India's mineral wealth is located in eastern and central forest areas that are populated with local tribes. The passage of the Forest Rights Act in 2008 has made acquiring such land for industrial projects difficult, requiring the consent of for-

est dwellers.

"The blatant disregard displayed by the [Vedanta] project proponents with regard to rights of tribals dependent on the area for their livelihood...is shocking," Environment Minister Jairam Ramesh said.

While the rejection will hit Vedanta hard, what could be even more damaging was the ministry asking why environmental clearance for the company's existing one-million-ton-a-year aluminum refinery on the foothills of the Niyamgiri Hills shouldn't be withdrawn. The ministry also

suspended review of Vedanta's plans to increase the capacity of the refinery, in eastern India's Orissa state, by six times.

"The government of Orissa is actively considering allocation of alternate sources of bauxite to Vedanta's alumina refinery from the state of Orissa," Vedanta said.

The company said it has invested \$5.4 billion in Orissa's aluminum projects, while its Lanjigarh refinery in Orissa alone has employed 10,000 workers.

Vedanta said it hasn't violated regulations.

Vedanta didn't say if it would challenge the Environment Ministry's ruling in court.

Vedanta's shares closed 7.6% lower in London. Several analysts said that while the mine already had been omitted from their pricing models, the ministry's formal rejection raised concerns that Vedanta may face similar difficulties in developing other bauxite deposits in Orissa.

—Alex MacDonald in London contributed to this article.

- Cairn sees promise off Greenland's western coast.. 17

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Berlusconi holds his reform promises hostage to political bloodsport. Page 11

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

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PAGE TWO

Merkel is in Europe's driving seat

[Agenda]

BY IAIN MARTIN



There are countries that would love a budget deficit for this year as low as 3.5% of GDP.

Britain (11.5%), Spain (9.4%), Greece (8.1%) and France (7.8%) can only dream.

In Germany it's a reality, according to official figures published on Tuesday. Even that modest figure represents a doubling of the country's deficit for the first half of this year, when compared to the same period last year. It rose from €18.7 billion (\$23.7 billion) to €42.8 billion.

However, the sharp rise only serves to illustrate how strong Germany's position was when it went into its worst downturn since the 1930s. Ahead of the global financial crisis it had avoided joining the frenzy of consumer borrowing and had kept public spending on a tight leash. When Chancellor Angela Merkel opted in 2009 for a significant post-crisis German stimulus she did so in the knowledge that her country could afford it.

So, she advocated stimulus for those who could afford it, restraint from countries already up to their necks in debt and subsequent austerity all round, or sensible control of public spending, to clear the way for expansion. This was viewed by the French and U.S. governments as deeply dangerous. Wasn't it tantamount to the rebirth of "voodoo economics"? With Germany recording extraordinary growth figures this month—equivalent to more than 9% on an annualized basis—her former U.S. and European critics could do with a little of that magic.

Mid-downturn, other leaders made a good deal of noise about the need for a stimulus. In 2009 Gordon Brown talked of little else. Unlike Ms. Merkel, he had left himself virtually no room to play



Angela Merkel tries out an Opel Astra at last year's Frankfurt Motor Show.

with because of previous policies. Britain had entered the recession without the advantage of its government having been prudent on the public sector spending front. The idea had taken hold in Mr. Brown's mind that the age-old cycle of "boom and bust" had ended, and that growth was unstoppable. When the U.K. economy did go into reverse it was also particularly exposed in the areas that would be hit hardest: financial services, property and construction.

In the event, Mr. Brown's much talked of stimulus for the U.K. was a puny affair involving a temporary cut in VAT and a bit of industrial pump-priming. When he said stimulus, he really meant that already high public spending continued unabated while tax revenues declined and borrowing shot up. To pay for this, British taxes are about to go up. It is difficult to see that doing anything other than adding to the existing pressure on business and consumers and thus restricting growth prospects.

It is worth remembering how much criticism the Merkel model faced until the publication of those recent growth figures. She clashed repeatedly with President Nicolas Sarkozy of France and the then new U.S. administration. Internationally she was portrayed as being out on a limb.

Of course, economists warn of trouble directly ahead. The

German powerhouse relies on exports, and growth will slow sharply if the recovery in the other parts of Europe and the U.S. falters. If France continues to struggle, the gap between the two countries at the heart of the European project widens. If there is a global double-dip recession, the pressure on deeply indebted countries such as Greece becomes intense, and with it renewed pressure on the single currency. If, if, if...

But Mrs. Merkel is in a strong position and appears vindicated. This autumn she will likely attempt to secure tough checks on EU budgets as the price for agreeing to the bailout of Greece. Only a few months ago, the loss of crucial elections had weakened Mrs. Merkel's domestic position and she looked to be in trouble. Now, in European terms, she's very much in the driving seat.

New Labour, new history

The flood of books charting the decline of New Labour continues. Former Prime Minister Tony Blair is next up, with his memoirs due soon for the start of the British political autumn season. He announced recently that his entire publisher's advance, and any royalties, will go to a charity for injured troops.

It remains to be seen how generous, or otherwise, he will be in his book towards his successor Gordon Brown. He has promised

to be frank, but I wonder. Often it is the memoirs of the supporting actors rather than those in history's leading roles that turn out to be most illuminating and fun. Alan Clark's wickedly amusing diaries of the Thatcher-Major era are the perfect example. Samuel Pepys, an important but second-rank player, bequeathed the best surviving account of life and government in 1660s London.

In that vein, the early glimpses of the second volume of Chris Mullin's diaries suggest they are a must-read for all those keen to understand what went wrong for New Labour under Gordon Brown. Mr. Mullin was a Labour MP, and by his own admission a not wildly successful minister, but he paints a gossipy picture rich in detail of a prime minister struggling to cope and lashing out. An account, via an unnamed official, of Mr. Brown's visit to the Chinese embassy to sign the condolence book after an earthquake is typical.

"While Gordon and his party were inside, word reached them that David Cameron was waiting outside. Whereupon Gordon, fearing that his limelight was about to be stolen, went into a great sulk, strode out of the embassy, barely acknowledging Cameron. Once in his car he began pummeling the headrest in front of him, causing his protection officer's head to ricochet, bleating about 'treachery' and 'conspiracy' and demanding to be told: 'Who did this to me?' A hapless official tried to placate him. Eventually the official inquired who was in this conspiracy. To which Gordon, without batting an eyelid, replied: 'The Tories, the Chinese and the Foreign Office.'"

Behind the scenes, his worried colleagues said that he was less than ideally suited to the office of prime minister. But in the main they did not move against him before he got the job or after: Why not? That is the question at the centre of the story of the Brown years. I'll wager those looking for the final answer in Mr. Blair's book will be disappointed.

What's News

■ **The budget announced** by the U.K. government in June failed to live up to its claim to be "progressive," and instead much of the burden of cutting the fiscal deficit will fall on poorer households, a British think tank said. 4

■ **Global regulators and bankers** are weighing the merits of establishing a system that would impose losses on bondholders of failing banks before taxpayers have to rescue them. 21

■ **A passenger plane** with more than 90 people aboard crashed in northeastern China, killing at least 42, state media said. 8

■ **Two Islamic militants** attacked a hotel near Somalia's presidential palace, killing as many as 31 people, including members of parliament. 9

■ **WPP said** first-half profit rose 39%, as gains in the U.S. helped the advertising firm post second-quarter revenue increases in all divisions. 18

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'This isn't going to change anytime soon. Let's see what the gods of risk decree tomorrow.'

Katie Martin tries to explain the mayhem hitting global stock markets



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Previous results

Q: Do you think WikiLeaks should keep its financial infrastructure secret?

Yes

26%

No

74%

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NEWS

China traffic jam could last weeks

By SHAI OSTER

BEIJING—A 100-kilometer traffic jam near the Chinese capital that officials say could last until mid-September has become a symbol of the dark side of China's love affair with the automobile.

Officials say traffic has been snarled along the outskirts of Beijing and is stretching toward the border of Inner Mongolia ever since roadwork on the Beijing-Tibet Highway started Aug. 13. The following week, parts of a major road circling Beijing were closed, further tightening overburdened roadways.

As the jam on the highway, also known as National Highway 110, passed the 10-day mark Tuesday, local authorities sent hundreds of police to keep order and to reroute cars and trucks carrying essential supplies, such as food or flammables, around the main bottleneck.

There, vehicles inched along little more than a third of a mile a day. Zhang Minghai, director of Zhangjiakou city's Traffic Management Bureau general office, said in a telephone interview he didn't expect the situation to return to normal until around Sept. 17 when road construction is scheduled to be finished and traffic lanes will open up.

Villagers along Highway 110 took advantage of the jam, selling drivers packets of instant noodles from roadside stands and, when traffic was at a standstill, moving between trucks and cars to hawk their wares.

Truck drivers, when they weren't complaining about the vendors overcharging for the food, kept busy playing card games. Their trucks, for the most part, are basic, blue-colored vehicles with no features added to help pamper drivers through long hauls.

Truck driver Long Jie said his usual trip from the coal boomtown of Baotou in Inner Mongolia to Beijing, which normally takes three days, was now taking him a week or more. The delay, he said, meant he would have to raise his rates above the usual 12,000 yuan, about \$1,765, for a 30-ton truck full of cargo.

Sounding frazzled and tired, Mr. Long, a driver for Baotou Zengcai Shipping Co., said in a telephone interview that the traffic got a little better once he finally made it off the highway.

Though triggered by construc-



A Chinese sanitation worker picks up trash Tuesday on Day 10 of a huge traffic jam, top, while a truck driver stuck for two days washes up.



tion, the root cause for the congestion is chronic overcrowding on key national arteries. Automobile sales in China whizzed past the U.S. for the first time last year, as Chinese bought 13.6 million vehicles, compared with 9.4 million in 2008. China is racing to build new roads to ease the congestion, but that very construction is making traffic problems worse—at least temporarily.

China's roads suffer from extra wear and tear from illegally overloaded trucks, especially along key coal routes. Coal supplies move from Mongolia through the outskirts of the capital on their way to factories. There are few rail lines to handle the extra load. Though the current massive gridlock is unusual, thousands of trucks line up along the main thoroughfares into Beijing

even on the best days.

Beijing is particularly prone to traffic jams because it is a bottleneck point. Drivers from the northwest have to navigate its rings of concentric circular highways to get to coastal ports or to head south. The sixth-ring road is the biggest, and until a new beltway is finished in the next few years, there is no alternative route around the capital.

Also entering the mix is the swell of passenger cars into the city from residents who have had to move farther from the capital to find affordable homes.

Other cities around the world face similar congestion headaches. The worst are in developing countries where the sudden rise of a car-buying middle class outpaces highway construction—unlike in the U.S., which had decades to develop transportation infrastructure to keep up with auto buyers.

A recent study by IBM suggested some of the worst commutes are in Moscow, where drivers reported 2½-hour delays, on average, when asked about the worst traffic jam they faced in three years. Still, Beijing beat out Mexico City, Johannesburg, Moscow and New Delhi to take top spot in the International Business Machines Corp. survey of "commuter pain," which is based on a measure of the economic and emotional toll of commuting.

The mega-jam on the city outskirts comes as officials warn that downtown traffic in Beijing is steadily worsening. State media on Tuesday reported that average driving speeds in the capital could drop below 15 kilometers an hour if residents keep buying at current rates of 2,000 new cars a day.

At that pace, Beijing will have seven million vehicles by 2015, according to the head of the Beijing Transportation Research Center, and transportation will slow to what it was decades ago when China was known as the Bicycle Kingdom.

Beijing's roads now have capacity to handle 6.7 million vehicles—and that is assuming current restrictions stay in place, such as the one requiring private cars to keep off the road for one day a week. Still, Beijing has half the number of cars of a comparably sized city, such as Tokyo.

The capital greatly expanded its bus lines and subway in preparation for the 2008 Summer Olympics, and work continues to open even more stations. But public transport remains crowded and many who can afford it prefer to drive cars.

Longer term, city planners are pinning their hopes on expanded mass transit, adding subway, light rail and mode dedicated bus lanes.

—Gao Sen and Sue Feng contributed to this article.

China, South Africa bolster business ties

BEIJING—China and South Africa signed a raft of commercial deals in mining, finance, nuclear energy and other sectors during a visit by South African President Jacob Zuma, as Beijing strengthens its commercial ties with Africa's largest economy.

The list of more than 10 deals, the total value of which wasn't announced, reflects China's focus on expanding its resources and energy reach in South Africa to fuel continued growth in China's booming economy, which is on pace to surpass Japan's this year as the second largest after the U.S. China's demand for resources has lent great support to South Africa's economy as well as boosting its currency, the rand, in recent years.

Chinese Vice Commerce Minister Gao Hucheng said Beijing will encourage domestic companies to invest in South Africa's mining and re-

sources sectors as well as higher value-added sectors. But senior South African officials also indicated some discontent with the trade relationship. They called on China not to focus exclusively on investing in raw materials and other "primary goods," and to buy more value-added goods from South Africa to help promote more balanced trade.

"We want to work together with China to try to address that so we have a more equitable balance of trade, in terms of the composition of trade as well as in terms of the actual value," South African Trade and Industry Minister Rob Davies said at a briefing.

Mr. Davies also said South Africa sees China as something of a model for its currency policy. China's defense of its competitive currency as part of its industrial development is

a "lesson" for South Africa, he said, adding that the rand is too volatile. There is a consensus that South Africa needs a more competitive and stable currency, Mr. Davies said, but the rand "has appreciated too much" in the wake of Europe's debt crisis this year and the government isn't hoping to see a further appreciation.

China is South Africa's top trading partner, and South Africa's economy—more developed than many others in the region—has been a focal point of a broader Chinese push into the continent aimed at securing resources and expanding China's international clout. But South Africa has been frustrated by its sizable trade deficit with China.

South Africa bought 70.8 billion rand (\$9.58 billion) of Chinese goods last year, 13% of its total imports, while exporting 48.7 billion

rand worth to China, about 11% of the total. China is the top overseas market for South African base metals, and the second-biggest destination for South African copper exports, after South Korea, at nearly 24%.

Among deals announced Tuesday, **China Metallurgical Group Corp.** said it will construct an iron-titanium mine in South Africa. The mine will have annual production of 1.2 million tons of pig iron and 680,000 tons of titanium dioxide, Xu Yongjie, a vice president of MCC International Inc., a China Metallurgical unit, said on the sidelines of the China-South Africa Business Forum.

China Metallurgical's framework agreement, signed with **Kermas Mining Fund LP**, sets the Chinese company as the main contractor for building the mine, Mr. Xu said.

Separately, an official at **China**

National Nuclear Corp. said it is in talks to build a nuclear-power plant in South Africa. A deal on that would mark the latest sign that China is gearing up to export nuclear technology at the same time as it rapidly expands its domestic reactor fleet. The talks involve the potential transfer of nuclear technology to South Africa, although nothing concrete was expected to be signed during President Zuma's visit, the official said.

China is working to become self-sufficient in advanced nuclear technology so that it doesn't need to award multibillion-dollar contracts to foreign companies to build domestic plants in the future. It is also looking at selling nuclear technology overseas in countries such as Vietnam, Belarus and Argentina.

—Aaron Back, Yajun Zhang, and Owen Fletcher.

EUROPE NEWS

German deficit surges despite strong growth

BY GEOFFREY T. SMITH

FRANKFURT—Germany's fastest rate of growth in 20 years in the second quarter of 2010 couldn't stop the country's budget deficit from more than doubling in the first half, data showed Tuesday.

The Federal Statistics Office, Destatis, said the general government budget deficit for the first six months of the year rose to €42.8 billion (\$54.2 billion), or 3.5% of gross domestic product.

Those figures include a stark reminder of the cost of bailing out some of the country's banks after their disastrous losses during the financial crisis: around €900 million of the deficit was due to the assumption of bad debts from Düsseldorf-based WestLB, which are now on the balance sheet of the state-owned bank rescue fund, Soffin.

A year earlier, the deficit had been only €18.7 billion. However, it is still comfortably below original finance ministry estimates of a 2010 deficit of around 5% of GDP, due to the economy having rebounded faster and further than the government had at first expected this year.

Destatis said overall government revenue fell 1.5% to €526.1 billion, including a 2.8% drop in tax revenue to €278 billion. Revenue was also affected by a 29% drop in the profit transferred from the Deutsche Bundesbank, to €9.3 billion.

Meanwhile, spending rose 3% to €568.9 billion, due mainly to increased social spending and labor-market subsidies as a result of last year's recession.

The increase in spending was depressed slightly by the sale of mobile-telephony frequencies, which are accounted for as "negative spending." Without this effect,

spending would have risen by 3.8%.

Separately, Destatis confirmed its initial estimate of GDP for the second quarter as having risen 2.2% from the first quarter and 3.7% from a year earlier, in seasonally and calendar-adjusted terms. It also affirmed its revision of first-quarter growth of 0.5% on a quarterly basis and 2% in annual terms.

Breaking down its figures for the first time, Destatis said the largest contributions to growth came from gross investment and net exports, which both contributed 0.8 percentage point. Germany's key export

quarter, at 40.3 million. "The German economy's recovery has become much more broad-based," Economy Minister Rainer Brüderle said in a statement.

Together, trade, investment and private consumption offset a sharp decline in the contribution to growth from inventories, which added only 0.1 percentage point to GDP after a surge in stockbuilding in the first quarter. The contribution from public consumption also weakened to 0.1 percentage point from 0.4 percentage point three months earlier.

Measured individually, private consumption rose 0.6% on the quarter, while gross investment grew 4.7%. These two components have been highlighted by officials and analysts as the best indicator of whether the recovery is self-sustaining, rather than being dependent on stimulus measures from the government and the European Central Bank.

Both official and private forecasts accept that the pace of growth is likely to slow in the second half of the year, partly because of a slowdown in global demand, but also because the second quarter's figure contained an extraordinary 0.5 percentage point contribution from construction, as companies caught up for lost time on projects that were delayed by the harsh winter.

However, Alexander Koch, an analyst with Unicredit in Munich, said in a research note that he still expects construction and business investment to perform well in the second half—the first because of continued support from state infrastructure spending and the second because higher capacity utilization rates in industry are encouraging more investment.

The deficit figures are a stark reminder of the cost of bailing out some German banks after they racked up disastrous losses during the financial crisis.

sector enjoyed a double benefit of rising global trade and investment, which benefited its capital-goods industries, along with a decline in the euro's exchange rate, making those goods more affordable across the world.

In addition, and for the first time in a year, private consumption made a positive contribution to growth, adding 0.3 percentage point. Consumption has been the weakest element of the recovery since the end of the recession 15 months ago, due to rising unemployment and increased precautionary saving by households.

However, Destatis said Tuesday that employment was 0.2% higher than a year earlier in the second

Euro zone sees signs of recovery at factories

BY PAUL HANNON

LONDON—Factory orders in the 16 countries that share the euro continued to rise in June, indicating that the recovery in industrial production is likely to continue in coming months.

The European Union's statistics agency Eurostat said Tuesday that new industrial orders rose 2.5% from May, and were up 22.6% from June 2009.

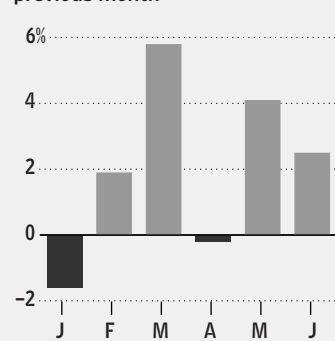
Also, Eurostat raised its figures for May, up from an earlier reported surge in orders. It now calculates that orders rose by 4.1% on a monthly basis and 23.0% on a year-to-year basis, having previously estimated that orders rose by 3.8% on the month and 22.7% on the year.

The strength of the increase was a surprise, with economists surveyed by Dow Jones Newswires last week estimating that orders rose by 1.5% from May.

The surge in orders indicates that the expansion in euro-zone manufacturing output is likely to

Recovery continues

New orders reported by euro-zone manufacturers rose again in June. Change from previous month



Source: Eurostat

continue. A survey of purchasing managers in the sector released Monday showed output rose in August, but at the slowest pace in six months.

However, the rise in new orders

was more narrowly focused than in recent months, with manufacturers of capital goods—or equipment used to make other goods—being the chief beneficiaries. And while orders for capital goods surged by 5.3% from May, orders for durable consumer goods fell by 1.1% and orders for nondurable consumer goods fell by 1.8%.

Excluding orders for heavy transport equipment, which tend to be bunched and so distort underlying trends, overall new orders rose by 1.6% from May.

The rise in new orders was spread across the euro zone, with German manufacturers reporting an increase of 3.9%, while French manufacturers reported a rise of 3.1%, Dutch manufacturers an increase of 8.9% and Greek manufacturers a rise of 4.3%. However, Irish manufacturers reported a fall of 4.7%.

Across all 27 members of the EU, new orders rose by 2.4% from May and 22.5% from June 2009. In the U.K., orders rose by 2.6% from May and were up 19.4% from June 2009.



European Pressphoto Agency

Chancellor of the Exchequer George Osborne earlier this month

Budget cuts to hit poorest hard in U.K.

BY NATASHA BRERETON

LONDON—The budget announced by the U.K. government in June failed to live up to its claim to be "progressive," and instead much of the burden of cutting the fiscal deficit will fall on poorer households, a high-profile British think tank said Wednesday.

Analysis by the Institute for Fiscal Studies showed that low-income households made up of people of working age lose the most from Chancellor of the Exchequer George Osborne's cuts, while households of working age with no children in the upper half of the income distribution lose the least.

The findings are likely to aggravate tensions between the Conservatives and their junior coalition partner, the Liberal Democrats, who had made a key election pledge to create a fairer tax system.

The research "shows that, once all of the benefit cuts are considered, the tax and benefit changes announced in the emergency budget are clearly regressive as, on average, they hit the poorest households more than those in the upper-middle of the income distribution in cash, let alone percentage, terms," the think tank said.

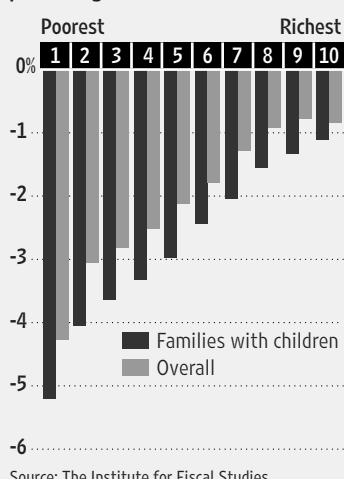
The figures show that the poorest 10% of U.K. families with children will suffer a 5.2% loss in net income due to measures to be implemented by April 2014—almost five times the 1.1% loss that the richest 10% will experience.

Overall, the poorest 10% of Britons will endure a 4.3% fall in net income as a result of the reforms, compared with a 0.85% decline for the richest 10%.

The latest measures come in addition to plans detailed by the previous Labour government, which placed the heaviest burden on the richest households. But the study's findings contrast with the government's promise of a "progressive" budget that would evenly divide the burden of austerity measures.

Budget impact

Effect of tax and benefit reforms announced in the June 2010 U.K. budget by income group. Loss as a percentage of net income



Source: The Institute for Fiscal Studies

"The effects of these decisions will stay with us for years, if not decades to come," Mr. Cameron said shortly after June's poll, stressing that the government needed to "take the whole country" with it. "We must go about the urgent task of cutting our deficit in way that is open and fair," he said at the time.

The tightening laid out in the June 22 budget, which detailed a combined £113 billion (\$175 billion) of spending cuts and tax increases by 2015, came in response to threats from ratings agencies to remove the U.K.'s triple-A credit rating if the new government didn't take steps to put its finances on a sustainable path. But even so, the measures surprised analysts with their austerity.

The IFS said its research used data published by the government since the budget and attempted to reflect the impact of all the announced cuts. Analysis in the budget documentation had indicated that the changes due to come into force by 2013 would hit the richest more than the poorest, it noted.

EUROPE NEWS

Early elections are looming in Italy

BY CHRISTOPHER EMSDEN

ROME—Early elections in Italy look increasingly likely as Prime Minister Silvio Berlusconi struggles with a worsening split in his center-right coalition.

Parliament should be dissolved and a vote called before the end of the year, said Umberto Bossi, leader of the Northern League, an ally of Mr. Berlusconi's People of Freedom party. The League holds 59 of the 630 lower-house seats and fared well in regional elections this spring, indicating potential strength in a national vote. "Berlusconi is being too cautious," Mr. Bossi told a rally north of Milan late Monday.

Italy's summer political drama would typically be dismissed. But as the quarrels focus more on substantive policy disagreements and fundamental personal rivalries, analysts say, some change is all but inevitable.

Even a key figure in Mr. Berlusconi's party says the vote, currently scheduled for the spring of 2013, may need to be called sooner. "There's a 50% chance the legislature will continue and a 50% chance we are heading for early elections," said Maurizio Gasparri, Senate whip for Mr. Berlusconi's People of Freedom, Mr. Berlusconi's party.

While Italy's political woes don't center on economic issues, concerns about the economy could undermine the tight fiscal policy that has allowed the country to remain the only one in Europe's periphery to avoid a credit-rating downgrade, though its public-debt load—at 118% of gross domestic product—is even higher than Greece's.

The political crisis began when the ruling party censured Gianfranco Fini in July for public criticism of the prime minister. Mr. Fini, 58, formerly head of the right-wing National Alliance movement, broke with the coalition and took 34 deputies with him, leaving Mr. Berlusconi with only 291 sure supporters in the 630-member Parliament.

The dissent officially stems from Mr. Fini's disagreement with Mr. Berlusconi's insistence on judicial reforms that critics say are designed to protect the prime minister from corruption charges. It may also reflect Mr. Fini's sense that his prospects of succeeding 73-year-old Mr. Berlusconi at the helm of Italy's conservative moment have grown dim.

Mr. Berlusconi is being tried in connection with a corruption case involving bribes allegedly paid to U.K. lawyer David Mills. His party is promoting legislation that would require trials in Italy's notoriously slow justice system to be completed in a "reasonable" amount of time—a move that would likely affect thousands of other continuing trials.

Hopes for a diplomatic solution



Prime Minister Silvio Berlusconi, shown Friday arriving at his residence at Grazioli palace in Rome, is facing increasing pressure to call elections.



Northern League head Umberto Bossi

to the disagreement between Messrs. Berlusconi and Fini were doused this week when FareFuturo, a think tank founded by Mr. Fini, published an editorial saying "nobody can convince us that Berlusconi doesn't feed on stupid propaganda, slogans, yes-men, blackmail and lies," and that democracy and freedom itself were at risk.

The government didn't officially comment on the editorial. The publication prompted a slew of proposals from Italy's scattered opposition, many calling for some form of alliance aimed simply at ousting Mr.

Under pressure

Italian Prime Minister Silvio Berlusconi has to stay on his toes

- A recent poll shows that confidence in the prime minister's government has dropped to a record low—though confidence in the opposition is also declining.
- Another poll shows that older voters are particularly unhappy with Mr. Berlusconi's performance.
- Brokering a deal with a small centrist party could jeopardize support from larger ally the Northern League for Mr. Berlusconi's People of Freedom party.
- Former ally Gianfranco Fini on Sept. 5 will address a party conference, this time as leader of a breakaway group of 34 deputies.
- Mr. Berlusconi's meeting with Libyan leader Col. Moammar Gadhafi, which has been scheduled for Aug. 30, could spark controversy in Italy.
- A judge recently rejected a proposed divorce settlement for Mr. Berlusconi's wife, Veronica Lario, as inadequate.

Source: WSJ research



Former ally Gianfranco Fini

Berlusconi rather than any new government agenda.

Renato Mannheimer, head of the ISPO polling institute, told a local website Tuesday that if an election were called soon, People of Freedom and the Northern League would win the lower house and probably the Senate. Mr. Fini's group and the center-left Democratic Party would both fare badly, he added.

No polls have been conducted yet this month, but attention has shifted from the personal rivalry between Messrs. Berlusconi and Fini to arguments reflecting Italy's pe-

renial north-south divide. The regions are as different as Germany and Greece in terms of public budgets and the labor market.

Prominent in that sparring have been Mr. Bossi and Pierferdinando Casini, head of the centrist UDC party. The UDC, currently in opposition, has 36 lower-house deputies who could in theory replace Mr. Fini's rebels in giving the government a parliamentary majority.

For Mr. Bossi, such a deal would be anathema: The UDC has consistently opposed a program to devolve some government powers to

the regions that is his regionalist party's main agenda. Mr. Casini's UDC, for its part, has claimed that Finance Minister Giulio Tremonti—chief architect of the fiscal federalism law—is conspiring with the Northern League to succeed Mr. Berlusconi as prime minister.

Mr. Tremonti has been widely credited with keeping control over the public coffers and steering Italy clear of the euro-zone sovereign debt crisis. Any maneuvering to oust him would shake markets.

—Jennifer Clark in Milan contributed to this article.

Lawyer presses claims against Assange

BY JOHAN ANDERBERG AND JEANNE WHALEN

A lawyer representing two Swedish women says WikiLeaks founder Julian Assange sexually molested his clients, and dismissed as "pure nonsense" the idea that their complaints are part of a smear campaign against Mr. Assange.

"All this talk about the CIA or

Pentagon being behind this, it simply has no substance," Claes Borgstrom of Borgstrom & Bodstrom, Stockholm, said in a phone interview. He was referring to Twitter posts and interviews in which Mr. Assange has denied any wrongdoing and called the allegations a "dirty trick" meant to smear him. Mr. Assange has suggested the Pentagon may be involved. A Pentagon spokes-

man called this idea "absurd."

Mr. Assange's lawyer, Leif Silbersky, said in an interview that his client was innocent, and a "victim of an abuse of law."

The back-and-forth is the latest example of the intensifying scrutiny of Mr. Assange since WikiLeaks last month released 76,000 classified U.S. military documents about the war in Afghanistan.

The focus on Mr. Assange took an unexpected turn Saturday, when the Swedish Prosecution Authority said it was seeking to arrest Mr. Assange over rape and molestation allegations. Hours later, prosecutors dropped the arrest warrant and the rape probe. They say they are still looking into the molestation allegation.

Mr. Silbersky was highly critical

of how prosecutors have handled the case. "Both my client and his company have suffered major damage from all the attention," he said.

Mr. Borgstrom said the allegations were made by two Swedish women, who asked him to represent them a few days ago. Both met Mr. Assange for the first time when he arrived in Sweden recently to give a lecture, Mr. Borgstrom said.

U.S. NEWS

Billionaire sets museum plans in Los Angeles

BY LAUREN A.E. SCHUKER

LOS ANGELES—Billionaire Eli Broad said Monday he would invest at least \$300 million to build a new museum to house his contemporary art collection, part of an evolving revival of the city's downtown.

The decision came after three years of speculation over where Mr. Broad—one of the city's most prominent philanthropists along with his wife, Edythe—would choose to place the museum.

The museum will house the couple's collection of 2,000 works by artists including Jasper Johns, Jeff Koons, Jean-Michel Basquiat and Salvador Dali, which is worth an estimated \$1.5 billion.

Mr. Broad, 77 years old, made his fortune in homebuilding and retirement services after founding KB Home and SunAmerica Inc. and is known as a tough negotiator, especially in the art world.

In 2008, he decided against donating his collection outright to the Los Angeles County Museum of Art's new contemporary art facility, after he financed the \$56 million it cost to build it, saying he would instead lend artwork.

Before choosing a location, Mr. Broad courted competing offers from several cities, including Santa Monica, Beverly Hills and Los Angeles.

He initially looked downtown but his desired site wasn't available, so he focused on the west side of Los Angeles.

In recent months, however, he re-focused on downtown because it was close to other cultural institutions, such as the Walt Disney Concert Hall and the Museum of Contemporary Art, or MOCA, which are next to Mr. Broad's site. Close by are other entertainment arenas, such as L.A. LIVE and the Staples Center sports complex.

Mr. Broad had requested to lease a 2.5-acre parcel on Grand Avenue, owned by the county, for \$1 a year. The low-ball offer set off opposition, but then last month Mr. Broad relented, agreeing to pay \$7.7 million for a 99-year lease.

"Our heart is on Grand Avenue in downtown Los Angeles," Mr. Broad said in a statement. In an interview Monday, he added, "I have always believed that every great city in history needs a vibrant center. We lose the ocean breezes not being in Santa Monica, but I think Grand Avenue is

going to be the civic and cultural center of a region of 15 million people, and we are thrilled to be a part of it."

Mr. Broad said he hoped his museum would help propel the Grand Avenue Project, an expensive initiative aimed at reviving the area with stores, hotels and restaurants.

For the past decade, L.A.'s downtown has been the focus of renewal efforts by real-estate developers who have converted old warehouses and dilapidated office buildings into lofts, high-end condos and new entertainment spaces in an effort to attract working professionals with disposable income.

But the credit crunch has stalled some of those developments, hitting local landowners hard.

In addition to paying the lease, Mr. Broad has agreed to foot the museum's construction bill of between \$80 million and \$100 million and to put \$200 million into an endowment to cover its annual operating expenses. He has also commissioned architectural firm Diller Scofidio + Renfro to design the new institution, tentatively named the Broad Collection.

Construction on the 120,000-square-foot museum and its surrounding site is scheduled to begin in October and be complete by 2012.

Jeffrey Deitch, who took over as director of MOCA in June, said that opening another museum on Grand Avenue would further increase excitement about the area as a cultural mecca in a city commonly criticized for having no real center.

"Between the Broad Museum and MOCA, one of the greatest concentrations of contemporary art in America will now exist on Grand Avenue," said Mr. Deitch, a veteran art dealer who moved from New York to Los Angeles earlier this year to take over the helm of MOCA, which has struggled financially in recent years. "In the two months I've been in Los Angeles, I am more and more enthusiastic about downtown—the young creative community is now centered on the east side, in neighborhoods that surround downtown."

Mr. Deitch compared the collection of cultural institutions now gathering on Grand Avenue to similar sites in Dallas and New York.

"In Manhattan, you have museum mile, with the Guggenheim, the Neue Galerie, and the Met all a few blocks from one another," he said. "In L.A., we now have Grand Avenue."



Getty Images

Billionaire Eli Broad, in New York in June 2008, is known as a tough negotiator, especially in the art world.

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The Eli and Edythe L. Broad Collection

The planned museum is expected to house this 1967 Jasper Johns collage.

U.S. NEWS



Getty Images

Sales of existing homes, like this one in Miami, were off 27.2% in July after the expiration of a government tax credit.

U.S. home sales plummet

By SUDEEP REDDY
AND NICK TIMIRAOS

U.S. home sales plummeted in July as potential buyers stayed on the sidelines, spurring fears of renewed weakness in housing prices and the broader economy.

Sales of previously owned homes fell 27.2% to a seasonally adjusted annual rate of 3.83 million, the National Association of Realtors said Tuesday, the lowest level since the industry group started its tally in 1999.

The expiration of a home-buyer tax credit in the spring was expected to damp buying, though less severely. The sales drop—together with a corresponding rise in the inventory of unsold homes—also means another leg down in housing prices is on the horizon, say economists. House prices had stabilized last year after declining since 2006.

High unemployment and meager wage growth already are making many Americans reluctant to commit to major purchases, so a return of falling home equity could further depress confidence and consumer spending.

“At this point in the recovery, every little bit counts,” said economist Paul Dales of Capital Economics. “A double dip in the housing market and house prices would not be enough to generate another recession. It would certainly help to hold back the recovery.” He expects home

prices to fall to fall another 5% after the 30% decline during the recession.

The data sent stocks tumbling early in the day, briefly pushing the Dow Jones Industrial Average below 10,000 for the first time since early July. Investors rushed into safer assets as they reassessed the economic outlook. A rally in the Treasury market pushed the yield on the 10-year note down to 2.50%, while oil prices and other key commodities such as copper fell on expectations for weaker demand.

The renewed worry about housing comes as economists downgrade their forecasts for the economy this year and early next year. Traditionally, the housing sector, along with purchases of durable goods such as furniture, would help pull the economy out of a recession as lower interest rates spur higher demand. But this time, potential home buyers either don't have the jobs or savings to jump in or are wary of another housing-market decline. “Consumers and housing are in no position to lead us out,” said Nigel Gault, chief U.S. economist at IHS Global Insight. “We've gone through the inventory-cycle boost. The stimulus boost is fading. We're falling back on whatever underlying strength there is in the private sector, in exports and business-equipment spending, and there's not a lot.”

A sharp drop in mortgage rates in recent months appears to be do-

ing little to stimulate demand. The average rate on a 30-year fixed-rate mortgage has fallen to less than 4.5%, plumbing new records, but demand for new loans is weak. Many borrowers face challenges qualifying for loans because they have lost their jobs or aren't making as much money. Some are simply growing more cautious.

Analysts say the big risk to the market is that consumers lose any urgency to buy homes because of new concerns that prices are poised to fall. While tax credits to spur home sales helped stabilize housing markets across the country over much of the past year, the expiration of that stimulus in April has revealed lingering problems that have restrained housing.

Buyers who signed contracts by April 30 have until the end of next month to close on those sales and receive credits worth as much as \$8,000. Sales of homes priced between \$100,000 and \$250,000, which would have received the biggest benefit from the tax credit, were off 35% in July from a year ago.

The number of unsold homes on the market grew by 2.5% to nearly four million in July. At the current sales pace, it would take 12.5 months to clear that inventory.

The median sale price increased 0.7% from one year ago to \$182,600 in July, but that was down 0.2% from June.

Cell-research ruling puts labs in limbo

By GAUTAM NAIK

Experiments using human embryonic stem cells are in a state of limbo across the country, following a judge's injunction on Monday to block any such research funded by the federal government.

The University of Wisconsin, home to 21 such projects, doesn't plan to start any new federally funded experiments for now—though it won't throw out existing ones until it becomes clear that it is legally required to do so.

George Daley, a stem-cell scientist at Children's Hospital Boston, is being more cautious. He has asked his researchers involved in human-embryo work to immediately stop using any laboratory equipment acquired with federal money.

“In my own lab we've been using some of the newly created stem lines” as well as lab gear purchased with federal funds, said Arnold Kriegstein, who heads stem-cell research at the University of California, San Francisco. “I would hate to think that's all at risk now.”

It isn't clear how much the federal government spends annually on human-embryo-related experiments. The U.S. National Institutes of Health, which funds stem-cell research, didn't immediately respond to questions.

Stem cells have long been controversial. Those derived from embryos can develop into any type of tissue and are considered especially promising for research into an array of ailments, from spinal injuries and diabetes to Parkinson's disease.

Opponents maintain that such research, which leads to the destruction of the embryo, is tantamount to taking a life.

Embryo research in the U.S. got a boost in March 2009 when President Barack Obama expanded federal funding for such projects, prompting the NIH to begin funding research on a bigger scale. It also emboldened some of the big pharmaceutical companies, who had long been wary of the ethical issues surrounding such research, to start testing drugs on tissues derived from human embryos.

Now the field has entered a wait-and-see mode. On Monday, a U.S. judge blocked the federal government from funding research involving human embryonic stem cells. If the ruling stands, U.S. labs could be forced to disband existing federally funded experiments and not provide money for new ones.

“It will put us at a huge competitive disadvantage to other countries,” said Tim Kamp, director of the University of Wisconsin Stem Cell and Regenerative Medicine Center.

The University of Wisconsin has 34 approved projects involving human-embryonic cells, of which 21 are funded by the government, supporting the work of 18 scientists in disciplines from cardiology to chemistry. Total federal funding for human-embryo research at the university is about \$5 million annually.

Dr. Kamp is a cardiologist trying to understand heart function by studying the electrical properties in heart cells. Since it can be hard to obtain human cardiac cells, he's deriving cells from embryos, a project funded by the NIH. But the future of his experiment is uncertain.

“Most people are hesitating to go into their incubators and dump out their cell cultures, which may be the result of years of work,” said Dr. Kamp.

The judge's ruling could also have a knock-on effect on a more recent development in stem-cell science. Researchers have discovered that it's possible to turn mature cells—from skin, for example—into an embryo-like state. Because these reprogrammed cells aren't created by embryo destruction, they are seen as a non-controversial source of fresh tissue.

In recent years, dozens of labs across the country have begun to work on re-programmed cells. However, many scientists use human-embryonic cells as a “control”—a way to judge whether reprogrammed cells have the same biological properties as naturally occurring versions. The judge's ruling could affect such experiments, too.

Despite the advent of reprogrammed cells, embryo-derived cells remain the “gold standard” for experiments, researchers say. Dr. Daley and his colleagues recently compared the behavior of cells taken from embryos afflicted with a disease called Fragile-X with embryo-like cells reprogrammed from the skin of patients with the disease.

Fragile-X is the most common form of inherited mental retardation and is caused by a mutation in a single gene. Dr. Daley found the gene is active in true embryonic cells but not in embryo-like cells. “So if you wanted to study Fragile-X, you have to study the embryonic stem cells,” not the ones derived from reprogramming, says Dr. Daley.

GOP leader urges ax for economy team

By JOHN D. MCKINNON
AND SHAYNDI RAICE

WASHINGTON—House Minority Leader John Boehner Tuesday called on President Barack Obama to fire his economic team, the latest move by the Ohio Republican to take a leading role in his party's midterm election campaign.

Mr. Boehner would be in line to take over as House Speaker should Republicans capture 39 or more seats held by Democrats. In recent weeks, Mr. Boehner has been stepping up attacks on the Obama administration and promising that Republicans will soon roll out a more

detailed governing agenda.

On Tuesday, Mr. Boehner sharpened his attacks on the administration's economic policy by calling on Mr. Obama to seek the resignations of Treasury Secretary Timothy Geithner, National Economic Council Director Lawrence Summers and other economic advisers.

“We do not have the luxury of waiting months for the president to pick scapegoats for his failing stimulus policies,” Mr. Boehner said in a speech before the City Club of Cleveland. “We've tried 19 months of government-as-community-organizer. It hasn't worked.”

With Mr. Obama on vacation on

Martha's Vineyard, Vice President Joe Biden led the Democrats' counterattack, saying that Republicans wanted to return to the policies of former President George W. Bush that Mr. Biden blamed for recent economic upheaval.

“Mr. Boehner is nostalgic for those good old days, but the American people are not,” Mr. Biden said.

Democratic campaign groups have begun targeting Mr. Boehner, saying he is too close to big business and Wall Street.

A Boehner spokesman said Democrats “are desperate because they can't defend their job-killing record.”



Associated Press

Top Republican John Boehner is leading the charge in his party's campaign.

WORLD NEWS

Aquino defends response in drama

BY PATRICK BARTA
AND BRITTANY HITE

Criticism of the Philippine government's handling of Monday's deadly hostage crisis intensified as officials scrambled to defend their actions during the 12-hour standoff, in the first major international test for its new president.

President Benigno Aquino III, scion of one of the nation's most famous political families, was elected in May partially on a promise to improve law and order in a country notorious for sporadic violence, kidnappings and unrest. At a news conference Tuesday he expressed regret over the incident, said it was "high time" for the police force to improve its capacity to deal with violent activities and called for a full investigation.

But he also defended himself and the police from critics who questioned whether authorities could have responded more decisively in Monday's standoff, which ended with the deaths of eight Hong Kong tourists as well as the hostage taker, a dismissed police officer named Rolando Mendoza, prompting protests from officials in Hong Kong.

"I don't need to publicize what I have been doing," Mr. Aquino said to questions, adding that much of his time Monday was spent trying to prevent other officials from interfering with the police, as well as dealing with unrelated issues such as outbreaks of dengue fever and the country's budget.

Rushing to use force early in the day, while the hostages all appeared safe, would have been unwise because it could have complicated a situation that seemed to be under control at the time, Mr. Aquino said. Later, Mr. Mendoza used the tourists as human shields, making it harder for police to launch a full assault, he added.

Paul Quaglia, a director at Bangkok-based security consulting firm PSA Asia, said the shortcomings in Monday's mission were all the more surprising given that Philippine police have trained in the past for hostage situations, which are relatively common in the country. "It's the execution that fell short," he said.

Mr. Mendoza, armed with an M-16 assault rifle, on Monday hi-



President Benigno Aquino III inspects the bus carrying Hong Kong tourists that was hijacked by an ex-policeman in Manila.

jackied a bus in central Manila and later in the day apparently opened fire on its passengers, who were mostly Hong Kong tourists. He was shot in the head and killed by police Monday night.

The standoff began during the day and continued into the night while the bus was surrounded by police and media. At one point, Mr. Mendoza was seen in broad daylight waving to onlookers from an open door on the bus.

China urged the Philippine government to take concrete measures to ensure the safety and security of Chinese citizens, and it sent Foreign Ministry officials to the Philippines Tuesday to deal with the aftermath, according to the state-run Xinhua news agency. Beijing also issued a travel warning to Chinese citizens, urging caution.

In Hong Kong, city leader Donald Tsang demanded an explanation from Philippine officials over how the incident unfolded. The city—a special administrative region of China—also issued a "black travel alert" for the Philippines that warned that "residents should avoid all travel to the country."

Hong Kong government flags were flown at half-mast in a sign of mourning, and activity on the Hong Kong Stock Exchange ceased for a minute on the morning as traders observed a moment of silence.

"Inquiry Needed into Tragedy in Manila," declared the editorial page of the South China Morning Post, Hong Kong's largest English-language newspaper. On Twitter, one person referred to the Philippine SWAT team involved as "Sorry We Aren't Trained."

In a statement issued Tuesday afternoon, Philippine National Police officials agreed that Monday's events warranted a "full-dress investigation" that could determine "whether or not there were lapses" on the part of the police. The statement added that authorities had "noted" reports of "poor handling of the hostage negotiation," and "inadequate capability, skills, equipment and planning of the assault team."

Authorities were still struggling to figure out why the incident went so wrong. Earlier Monday, the situation seemed to be under control. Police successfully cordoned off the area and established communica-

tions with Mr. Mendoza, who had been removed from his post as a senior inspector last year after being found guilty of extortion.

Mr. Mendoza agreed to release nine people, including three children. But matters worsened after authorities passed along to Mr. Mendoza a letter from the government's ombudsman, an independent arbitrator, promising to review Mr. Mendoza's request to be reinstated to his job. It is unclear why the letter didn't satisfy him, but about that time he became more agitated and threatened to kill a hostage. After some gunfire, authorities decided it was time to storm the bus.

Eight passengers were rescued alive, though one died later in a hospital. Seven others were dead in the bus, along with Mr. Mendoza, who was shot by a police sniper.

Mr. Aquino said a number of factors made it more difficult to resolve the situation. For instance, he said Mr. Mendoza was able to follow media coverage of police movements via a television and radio on the bus.

—Josephine Cuneta
contributed to this article

Plane crash in China kills 42

BY JASON DEAN
AND JAMES T. AREDDY

BEIJING—A passenger plane with more than 90 people aboard crashed in northeastern China killing at least 42 people, state media said, in an accident that follows years of improved aviation safety in the country.

The state-run Xinhua news agency said the crash occurred around 10:10 p.m. local time Tuesday in Heilongjiang, a province that borders Russia.

The Henan Airlines plane took off shortly before 9 p.m. from the provincial capital of Harbin, and crashed after a failed landing at the airport in Yichun city about 155 miles to the northeast, Xinhua said, citing provincial civil-aviation officials.

A senior Heilongjiang public-security official, interviewed by phone on the air by Chinese state television, said authorities believe they have accounted for all the passengers and crew, with 42 dead and 49 rescued. The official didn't identify any cause of the crash.

Xinhua said that the plane was still on fire at around 11:30 p.m., and that more than 20 injured people had been received by local hospitals.

China experienced a spate of deadly airline crashes in the 1990s that took hundreds of lives and caused Chinese airlines to rank among the world's most dangerous. The companies were plagued by pilot errors, poor maintenance and erratic government oversight.

China's government tightened safety monitoring of its carriers—almost all of which are government-owned—and working with aviation-safety officials in the U.S. and elsewhere to improve its system. In recent years, Chinese airlines have by some measures boasted a better safety record than their U.S. and European counterparts.

Xinhua identified the model of plane that crashed as an E-90, but didn't identify the maker. Among the planes Henan Airlines flies are regional jets made by both Canada's Bombardier Inc. and Brazil's Embraer-*Empresa Brasileira de Aeronautica*, or Embraer.

Henan Airlines, formerly known as Kumpeng Airlines and based in central China, began service in October 2007. It was originally a joint venture with Mesa Air Group Inc. of Phoenix, but the U.S. company sold its 49% stake to its partner Shenzhen Airlines in 2009. Henan Airlines changed its name in December 2009, amid reports a stake would be sold to the provincial government. It also moved its provincial headquarters to the provincial capital Zhengzhou.

Henan Airlines couldn't be reached for comment late Tuesday.

Henan Airlines has positioned itself as a major regional carrier.

Chinese news reports say the carrier incurred losses since its launch in 2007 and the Henan government's stake would help keep it flying. This year, Chinese media reports have said that the carrier was seeing passenger totals sag amid February's opening of a high-speed railway on its key Zhengzhou-Xian route.

—Andy Pasztor
contributed to this article.

Independents hold the key in Australia

BY RACHEL PANNETT
AND ENDA CURRAN

CANBERRA—With the future of Australia's government hanging in the balance, three swing-vote lawmakers met Tuesday to explore

whether they have enough common ground to band together and help give one party the keys to Canberra.

But analysts said the three and others who could tip the scales to Prime Minister Julia Gillard's ruling Labor Party or Tony Abbott's opposition Liberal-National coalition have significant differences that could make any alliance fragile, potentially prompting another round of elections in coming months.

The private talks between Robert Katter, Robert Oakeshott and Tony Windsor came as Labor and the Liberal-National coalition scramble to win support for their respective bids to end the near-deadlock in Parliament. The latest election tally gives Labor 71 seats and the coalition 72 in the 150-seat lower house, short of the 76 seats either needs to form a majority government. Independents and Greens hold as many as five seats between them, while two seats are in doubt.

Messrs. Katter, Oakeshott and



Independents meet in Canberra.

Windsor didn't specify issues up for discussion at the meeting, whose outcome remained unclear early Wednesday in Australia.

All three want to boost spending on services and infrastructure in rural and regional areas but disagree on climate change, political-asylum seekers and a proposed new tax on mining, making it difficult for them

to agree on a joint program for an alliance with either a Labor or coalition government. The three were also once members of the National Party but left on less-than-friendly terms, and that could possibly derail talks with Mr. Abbott.

David Burchell, a political expert at the University of Western Sydney, said another election is likely soon, regardless of whether the new government forms ties with all or only some of the independents.

"If you were a betting person, you would probably say the government is not going to last longer than 18 months," Mr. Burchell said.

Mr. Katter could be the wild card. Hailing from the tropical, sugar-and-banana-growing electorate of Kennedy in Queensland's far north, he is vehemently opposed to Labor's planned tax on miners' profits, wants to open up the supermarket sector to more competition, and legislate the production of ethanol to boost grain prices.

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WORLD NEWS

Somalia hotel attack kills at least 31

By SARAH CHILDRESS

NAIROBI, Kenya—Two Islamic militants attacked a hotel less than a mile from Somalia's presidential palace on Tuesday, killing at least 31 people, including members of parliament, in a fresh blow to a Western-backed government already reeling from an insurgency allied with al Qaeda.

On Tuesday morning, two fighters wearing Somali government uniforms entered the Muna Hotel—home to several members of parliament—and began firing randomly, according to Abdirahman Omar Osman, the minister of information. As government security forces rushed to the scene, the fighters blew themselves up, Mr. Osman said.

At least 31 people, including six members of parliament, were killed in the attack. "They have no regard for civilians," Mr. Osman said of al Shabaab, the Somali militant group blamed for the attack. He said government security forces had since secured the hotel.

Despite Tuesday's brazen assault, the Somali government doesn't appear in imminent danger of collapse. In the hours following the attack, African troops in Mogadishu drove militants back further from the presidential palace and reclaimed some posts. On Friday, the Ugandan military began sending reinforcements to bolster the African Union mission, in an effort to push al Shabaab out of Mogadishu.

The Muna Hotel attack comes the morning after al Shabaab declared a "final war" against the Somali government. Late Monday, militants attacked positions for the African Union mission in Somalia,



Somali government forces monitor the area outside the Muna Hotel in Mogadishu Tuesday after an attack by militants.

which defends the government. The troops countered by shelling militant positions.

The fighting presents perhaps the stiffest challenge Somalia's one year-old government has faced—and for President Sheikh Sharif Sheikh Ahmed's backers, an ominous sign of his hold on power.

The Somali government receives financial support from the U.S. and Europe, mainly for help training Somali troops. Meanwhile, African

countries such as Uganda and Burundi have dispatched thousands of soldiers to fight the al Shabaab insurgency. That African Union mission in Somalia, known as Amisom, recently pledged to increase troops from the current levels of 6,000.

"Clearly the government is teetering, and clearly the government would fall were Amisom to leave," said Ernst Jan Hogendoorn, the International Crisis Group's project director for the Horn of Africa, based

in Nairobi. But Mr. Hogendoorn doubted al Shabaab had the capacity yet to overrun the African troops, since it plotted a suicide-bomb attack rather than a full-frontal assault.

Even so, the Somali government confronts an uncertain future. When he came to power a year ago as part of a transitional government elected by the parliament, President Sharif was considered the strongest bet to bring peace to his turbulent country.

Mr. Sharif, a former teacher who is in his 40s, had connections to several factions in the country, and pledged to bring groups together through dialogue.

But his regime's near-total reliance on African troops for survival has only underscored his government's weakness. Aside from security concerns, the Somali government has been paralyzed by cash shortages. State coffers hold only a fraction of the \$110 million it has budgeted to run the government to operate, according to the government budget.

Mr. Sharif, in an interview this year, said his administration lacked the financial resources to train and pay security forces and civil servants.

At the same time, al Shabaab has grown from a ragtag militancy to a determined foe. Al Shabaab is believed to have as many as 12,000 members scattered across its area of control—which is most of southern and central Somalia and vast swaths of Mogadishu.

It has ruled these areas with a brutal hand. Al Shabaab has taken to amputating limbs and executing people for infractions such as theft.

The militant group is believed to have benefited from links to al Qaeda. Earlier this year, al Shabaab declared its allegiance to the global terror group and has absorbed flows of foreign fighters from South Asia and the Middle East, Western and Somali officials have said. These al Qaeda-linked fighters are believed to have brought techniques, such as suicide bombs, which hadn't previously been used in Somalia.

—Abdinasir Mohamed in Mogadishu, Somalia, contributed to this article.

Pakistan's economy faces big flood impact

By DAVID ROMAN

The flooding in Pakistan will inflict serious damage on its economy, posing another challenge for a cash-strapped government struggling to keep a recovery on track amid high inflation and a relentless Islamist insurgency.

Assistance from the International Monetary Fund and Western countries will likely help Pakistan avoid another brush with bankruptcy as it tries to cope with the damage, which by some estimates may reach \$43 billion. But the flood will weigh heavily on economic growth this year and leave a long-term mark on the economy.

"The hit on the growth rate is going to be very severe," said Philip Wyatt, a senior economist at UBS. "We can see a loss of one or two points of economic growth, depending on the damage." In the fiscal year ended June 30, Pakistan's economy grew 4.1%.

Moody's Investors Service, which had expected Pakistan's economic growth to expand to 4.5% this fiscal year, may lower its estimate to 3% to 3.5%, analyst Aninda Mitra said.

The flood began in July and at one point covered one-fifth of the South Asian nation, or land roughly equivalent to the size of Uruguay. It has damaged crops sown over 1.93 million acres, or 776,996 hectares. Cotton output will shrink to 11.76 million bales from the 14 million bales estimated at the start of the

season by Pakistan's Food and Agriculture Ministry. Cotton is an important raw material for the key textile export sector, one of Pakistan's few sources of export income.

According to the United Nations, the disaster has affected close to 20 million people, killing 1,500 and leaving 1.2 million homes damaged or destroyed.

The Associated Press quoted the United Nations as saying that about 800,000 people have been cut off by the floods and are only reachable by air. The U.N. said it needs more helicopters to ferry aid.

Coping with the social and economic costs of the catastrophe will strain the government's finances. The budget deficit was already on track to reach 4.5% of gross domestic product before the crisis but now could widen to as much as 6% to 7% of GDP, said Mr. Mitra of Moody's. That is a grim prospect for a country that had external debt totaling \$55.63 billion as of June 30.

President Asif Ali Zardari's government has been reaching out to other countries for help. A delegation met with IMF officials Monday in Washington. Donors including the U.K. and the European Union have so far pledged almost \$500 million in additional help.

Moody's is unlikely to upgrade Pakistan's credit rating in coming months due to the devastation from the floods and other challenges, but the country's current B3 rating "adequately captures the risk" of the



Workers repair a road damaged by the flood in Punjab province on Tuesday.

likely economic slowdown and is unlikely to be downgraded further, said Mr. Mitra. A B3 rating is just one notch above the C level, which applies to countries in effective sovereign default, and makes it hard for a country to issue bonds in the international market.

The natural disaster is the latest setback for the Pakistan economy, which after several years of strong growth almost ground to a halt in 2008, hurt by budget overruns, a loss in export competitiveness due to high inflation, and an insurgency that

continues unabated. On Monday, while emergency workers worked to shore up levees in two southern cities, at least 36 people were killed in three separate bomb attacks across the country, and 12 suspected militants were killed in U.S. drone attacks near the Afghan border.

Concerns about the economic fallout have kept pressure on Pakistan's financial markets, though the impact has been moderate.

The cost of insuring against a default or restructuring of Pakistan's bonds remains at very elevated lev-

els, but has been relatively steady in recent weeks, a sign that investors anticipate IMF and U.S. support to prevent any fiscal crisis. The spread on Pakistan five-year credit default swaps was quoted at 1,099 basis points Tuesday, roughly on par with those of other high-risk sovereign bond issuers like Venezuela, but well below early-2009 highs of over 2,100 basis points during the global financial crisis.

Pakistan's benchmark stock index, KSE-100, has fallen 7% so far in August, but is up 4% so far this year, roughly in line with other emerging market indexes.

The Pakistan rupee, one of Asia's weakest currencies in recent years, has fallen in recent days, but has found support above its record low against the dollar of 85.84 rupees hit on Aug. 2, helped by expectations that remittances from overseas Pakistanis, which have averaged around 10% of GDP in recent years, may rise to help families at home cope with the floods.

But analysts expect the rupee to remain under pressure in coming months due to Pakistan's current account deficit and high inflation rate, which ran at 12.3% in July. The floods are likely to push up food prices and transportation costs for other goods, likely eliminating any chance that inflation might fall below 10% this year, said Mr. Wyatt at UBS.

—Dow Jones Newswires in Islamabad contributed to this article.

WORLD NEWS

Obama administration counts on CIA man for relations with Kabul

By SIOBHAN GORMAN

The Obama administration has turned to the Central Intelligence Agency's station chief in Afghanistan to troubleshoot Washington's precarious relationship with President Hamid Karzai, propelling the undercover officer into a critical role normally reserved for diplomats and military chiefs.

The station chief has become a pivotal behind-the-scenes power broker in Kabul, according to U.S. officials as well as current and former diplomats and military figures. In April, when Mr. Karzai lashed out against his Western partners, it was the station chief who was tapped by the White House to calm the Afghan president.

The station chief's position became more crucial following the June firing of Gen. Stanley McChrystal, perhaps the only other senior American who had a close relationship with Mr. Karzai, U.S. officials say.

The unusual diplomatic channel is in part a measure of how fragile U.S. relations with the mercurial Afghan president are. "Karzai needs constant reassurance," said one of the station chief's former colleagues, and the chief is his "security blanket."

The CIA's prominent role in Afghanistan is fraught, the spy agency having clashed at times with the official diplomatic mission. That has complicated the civilian component of the U.S. military surge.

In particular, the station chief's role has led to tensions with the U.S. ambassador to Afghanistan, Karl Eikenberry. Officials said the ambassador objected last fall to the return to Kabul of the station chief, who had held the same post earlier in the war. Mr. Eikenberry declined to comment, as did the State Department.

The relationship with Mr. Karzai isn't handled on a daily basis by the station chief; rather, he is called on at critical times. With the administration trying to get all of its leaders in Afghanistan on the same page following Gen. McChrystal's dismissal, others including Mr. Eikenberry and new Allied commander Gen. David Petraeus, as well as senior North Atlantic Treaty Organization officials, also are working to build closer relations with Mr. Karzai. Some officials worry the U.S. dependence on personal relationships to deal with Kabul is insufficient. It's "becoming a substitute for a political approach to the Afghan government that is really missing," said one former military official.

The Obama administration said that it isn't overly reliant on per-



President Hamid Karzai on a visit to Arlington National Cemetery in May.

sonal relationships, and that its focus is on establishing broad shared policy goals. "If we have agreement about the strategic direction and the goals we're trying to achieve, we can weather those periods of tension," a senior administration official said.

The CIA said it doesn't discuss individual officers serving overseas. "Our chiefs are chosen for their operational skill, leadership ability, and area knowledge," said George Little, a CIA spokesman.

The station chief, a former Marine in his 50s, is known to some colleagues by his nickname, "Spider." The CIA didn't make him available for an interview.

Besides his relationship with Mr. Karzai, he serves the more traditional role of running CIA operations in Afghanistan, a growing component of the war. The CIA is expanding its presence there by 20% to 25%, in its largest surge since Vietnam. The several hundred officers assigned to Afghanistan outnumber those in Iraq at the height of that war.

The station chief has had a close

relationship with his military counterparts. He and Gen. McChrystal forged ties in Iraq and Afghanistan, colleagues say.

The chief met Mr. Karzai before the Afghan war, when U.S. officials were working with Mr. Karzai and other Afghan tribal leaders against the Taliban. Mr. Karzai was in Pakistan, where the chief and his intelligence colleagues were trying to hunt down Osama bin Laden and al Qaeda. After Sept. 11, 2001, as the CIA prepared for the U.S. invasion to rout al Qaeda's Taliban protectors, the chief was assigned the job of working with Mr. Karzai.

"He's spent time with Karzai like no one else has," said a former senior intelligence official.

In the chaos of battle in December 2001, a U.S. military officer accidentally ordered a bomb drop on a meeting between Mr. Karzai and other tribal leaders. The chief leapt on Mr. Karzai to shield him, U.S. and Afghan officials say. He was credited with saving the soon-to-be Afghan president, cementing their relationship.

A senior Afghan official said Mr.

Karzai and his staff appreciate the chief's straightforward approach. The official recalled frank early discussions between Afghan and CIA officials about complicated issues such as the need to work with criminals and powerful warlords.

The chief was part of a team that launched Operation Anaconda, a 2002 offensive against al Qaeda involving CIA operatives, U.S. Special Forces and Afghan fighters. When Afghan forces came under fire, the chief led them to safety, said former colleagues, earning an agency award for heroism. That operation also bolstered the relationship with Mr. Karzai.

The chief left the Marines in the 1970s to join the CIA's paramilitary operations unit, known as the Ground Branch of the Special Activities Division. Agency veterans say the unit was active in the 1980s in Central America and helped train Afghans then fighting Soviet forces. He served as a base chief in Bosnia and later spent time in Iraq.

In 2004 he began his first stint as station chief in Kabul, where the focus was hunting down high-value targets. He also began his role of smoothing out rough patches with Afghanistan's president.

"Karzai goes through these moods, and [the station chief] was one of the people who could get through to him," said a former Western military official.

The CIA rotates station chiefs frequently. When Kabul was due for a new one last fall, the leading candidate didn't pass muster with the State Department or Mr. Karzai, people familiar with the matter said. Mr. Karzai pushed for the return of the former station chief, then in the U.S. and considering retirement. The CIA's appointment went through despite the opposition of Ambassador Eikenberry, officials said.

The station chief returned to Afghanistan for an unusual second tour in late 2009 just before a CIA disaster—seven officers killed by a Jordanian informant who turned out to be a double agent and suicide bomber. The chief isn't considered responsible for missteps in handling the agent, say people familiar with the CIA's review of the incident.

Winning Mr. Karzai's cooperation is central to U.S. strategy, especially when controversies arise over issues such as corruption and handling reconciliation with Taliban members. The Afghan president doesn't trust many of the U.S. officials assigned to his nation. The station chief now is expected to play a key role smoothing the way for Gen. Petraeus.

—Julian E. Barnes
contributed to this article.

Residents flee city of fighters in Yemen

By OLIVER HOLMES

SANA'A, Yemen—As many as 80,000 people have fled the south Yemen city of Loder, after the central government tightened a siege that has already left more than 30 people dead, according to the interior ministry.

Over the weekend, the government distributed pamphlets urging civilians to leave the city, which officials allege is a stronghold for al Qaeda-linked militants and fighters connected with the separatist Southern Movement. A Yemeni security official said most civilians had left the city, as well as some militants. Witnesses said hordes of people left Loder over the weekend.

It is unclear what plans the Yemeni government has for the city, but the scale of the exodus suggests it is gearing up for a major offensive. The military has claimed a number of victories in skirmishes in and around the city in recent days. Col. Adul Razzaq al Marwani, a Yemeni security official stationed nearby, said a senior Saudi al Qaeda leader had been killed during recent clashes around Loder.

The army also reported the death of 27-year-old Adel Saleh Haradaba, who officials believe to be al Qaeda's second-in-command in Loder. But several previous claims by Yemen of al Qaeda deaths during its most recent offensive against the group have proved to be incorrect.

The interior ministry said Tuesday that five al Qaeda members have been killed and three injured since Thursday and that large stashes of weapons, including rockets and antitank weapons, were discovered during raids. Some of the militants are believed to be foreign, including some from Saudi Arabia and Pakistan, according to officials.

Security officers say Loder, situated in the restive province of Abyan, is home to about 200 al Qaeda members and 200 militants affiliated with the Southern Movement, a loose coalition of groups demanding increased autonomy for former South Yemen.

The strength of the alliance between the two groups is uncertain. Some Southern Movement groups say they aren't affiliated with al Qaeda and often raise the American flag at separatist rallies.

The siege of Loder is a departure for the Sana'a government, which has previously focused on targeted attacks and small-scale operations against al Qaeda leaders. Sana'a stepped up its offensive against al Qaeda last year amid Western and Arab allies' concerns that fighters from elsewhere were seeking safe haven in Yemen.

The push against al Qaeda intensified after a Nigerian man, accused of attempting to blow up a Detroit-bound flight on Christmas Day, said he received training in Yemen. Yemen's al Qaeda affiliate later claimed responsibility for the attack.

Assassinations and grenade attacks in Abyan have increased over the past two months. On Friday, militants fired a rocket-propelled grenade into an armored car, killing 11 soldiers.

U.S. troop level in Iraq falls below 50,000

By SAM DAGHER

BAGHDAD—The U.S. military in Iraq said Tuesday that the number of U.S. soldiers in the country has now fallen below 50,000, a milestone accomplished ahead of the formal end of its combat mission slated for Aug. 31.

The Obama administration promised to draw down forces to 50,000 noncombatants by the end of this

month. According to the terms of a bilateral security pact between Iraq and the U.S., all U.S. troops are to be out of Iraq by the end of 2011.

The shift in the U.S. mission in Iraq is taking place amid continued violence—albeit at levels significantly lower than the early years after 2003 U.S.-led invasion—and amid a political crisis that has hampered the formation of a new government since the March 7 polls.

Still, Washington has in recent days painted the deadline as a moment of great import. Speaking Tuesday from the president's vacation venue of Martha's Vineyard, Mass., White House counterterrorism and homeland security adviser John Brennan said the Iraq drawdown—a week ahead of schedule—"demonstrates the capability of the Iraqi security forces, who have increasingly moved into the lead in

providing security for the country."

In its statement Tuesday, the military affirmed that the U.S. troops remaining in Iraq "until the end of our mission in December 2011" would train and assist Iraqi security forces and continue to work in partnership with them in "counterterrorism operations" as well as support efforts by the U.S. State Department and nongovernmental organizations to build Iraqi "civil capacity."