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U.A.E. limits BlackBerry services

By Margaret Coker in Abu Dhabi, Tim Falconer in Dubai and Phred Dvorak in Toronto

United Arab Emirates regulators said they would prohibit BlackBerry email, instant-messaging and Web-browsing services starting in October, after what government officials said has been a contract dispute with the device's maker about how it stores electronic data.

The U.A.E. market is relatively small for Canada's **Research In Motion** Ltd., which makes the BlackBerry smartphone. But the suspension of data service comes amid unease by at least one other government, India, over the inability to monitor or review electronic communications on the device in criminal, terrorist or national-security investigations.

And a Saudi Arabian official said Sunday that regulators there ordered telecommunications companies to block BlackBerry IM services later this month, according to Zawya Dow Jones. The official didn't explain the decision.

At the heart of the battle is access to the data transmitted by BlackBerrys. RIM processes the data through a few highly secure Network Operations Centers around the world, meaning that most governments can't access the data easily on their own.

The U.A.E. ban, due to start Oct. 11, was the result of the "failure of ongoing attempts, dating back to 2007, to bring BlackBerry services in the U.A.E. in line with U.A.E. telecommunications regulations," the country's Telecommunications Regulatory Authority said Sunday. The ban doesn't affect telephone and text-messaging services.

"BlackBerry data is immediately exported offshore, where it's managed by a foreign, commercial organization. BlackBerry data services are currently the only data services operating in the U.A.E. where this is the case," the agency said. "Today's decision is based on the fact that, in their current form, certain BlackBerry services allow users to act without any legal accountability."

RIM didn't return requests for comment.

The U.A.E. acted after RIM refused to set up a proxy server in the country as required by its contract with the government-controlled telecom provider, according to a person familiar with the situation.

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Agence France-Presse/Getty Images

A Russian woman holds her baby near the remains of her burnt out home in Voronezh on Sunday. **Updated coverage at europe.wsj.com.**

Russia faces more fires in heatwave

Hundreds of new fires broke out Sunday in Russian forests and fields that have been dried to a crisp by drought and record heat, but firefighters claimed success in bringing some of the wildfires raging around cities under control.

The wildfires that began threatening much of western Russia last week have killed 28 people and damaged 77 towns or villages, the Emergencies Ministry said. Thousands of people have been evacuated from areas in the path of flames. Much of western and central Russia is suffering through a severe drought, thought to be the worst since 1972.

— Associated Press

The Quirk

The border guard ceremony that gives visitors quite a kick. Page 29

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Editorial & Opinion

David Cameron's not-so-plain speaking. Page 12

Big investors are bracing for new hazard: deflation

By Gregory Zuckerman

For months, only the doomsayers dared to mention the d-word. But now some of the world's top investors are warning about the threat of deflation.

Bond-fund heavyweight Bill Gross, investment manager Jeremy Grantham and hedge-fund managers David Tepper and Alan Fournier are among overseers of large pools of money who see deflation as a risk big enough to warrant changing the ways they invest.

They cite limp economic figures and a sense that global policy makers are reluctant, or unable, to take further steps to boost growth as reasons for worry.

Many of these investors don't see extended deflation as a sure bet. Some predict that as deflation becomes more likely the Federal Reserve and government officials will take radical steps to arrest the decline. Fed Chairman Ben Bernanke built his academic career around studying deflation and its effects during the Great Depression and how to combat it. But a higher probability of deflation is spurring some to bulk up on interest-bearing investments like bonds, and favor dividend stocks and cash, while buying protection against possible stock losses.

"Deflation isn't just a topic of intellectual curiosity, it's happening," says Mr. Gross, who runs the $239 billion mutual fund **Pimco Total Return Fund**, citing an annualized 0.1% drop over the past two years in the U.S. consumer-price index. "It's an uncertain world that's tipping toward deflation."

It's a shift from just two months ago, when inflation, not deflation, kept traders up at night, spurring investors to buy gold and dump Treasurys.

Deflation is seen as pernicious and hard to address once it sets in. Falling prices can make businesses and consumers reluctant to spend and

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PAGE TWO

The euro zone may appear smooth on the surface but icebergs lurk below

[Agenda]

By Irwin Stelzer

On the surface, things are looking up in the euro economy. But remember, economies in some ways resemble icebergs. And seven-eighths of icebergs —the lethal, unseen part—are below the surface.

No denying that the view from the surface is pleasant. Euro zone economic sentiment, reports the European Commission, hit a 28-month high in July. Little wonder: Markit reports that the area's retail sales rose in July for the second consecutive month and at the fastest rate in two years, driving employment in that sector up for the first time since March 2008. The area's output picked up in both the service and manufacturing sectors, with manufacturing leading the way.

As usual, Germany is the locomotive. With its consumers holding to their historical stinginess, exports remain the main driver, causing unemployment in July to drop for the 13th consecutive month. At 7.6% it is lower than it has been since November 2008—the 20,000 drop in unemployment brought the total to just about where it was before the recession hit.

France is doing its bit. According to Markit, an expanding service sector is increasing French private sector output "at a strong pace," and employment growth in that sector rose in July for the third consecutive month. Outside the euro zone Britain seems to be adding a bit of optimism to European-wide sentiment: The U.K. economy grew 1.1% in the second quarter from the first quarter—or an annual rate of about 5%—twice what forecasters had predicted and the fastest rate in more than four years.

Getty Images

German exports remain the euro zone's driving force.

So much for what is obvious to the analyst's naked eye. Look below the surface and we see something very different. Spain provides a good example. Most of the news has been about that country's so-called successful return to the international bond market (never mind the premium paid over German bunds). A surface glance suggests that Prime Minister José Luis Rodríguez Zapatero's Damascene conversion to austerity has Spain on the path to fiscal rectitude. Unfortunately, dig down and we find that Spain's 17 regional governments spend twice what the national government does, are nearly $200 billion in debt according to Bloomberg, and will have to tap the markets for $57 billion this year, for which they will pay an even stiffer premium than the national government. That means that the growth-reducing effect of Mr. Zapatero's austerity plan will be aggravated by cuts at the regional level.

It is now clear that contrary to claims by their sponsors the banking stress tests were hardly stressful.

There are other examples of what Jennifer McKeown, senior European economist at Capital Economics, calls "stark divergences between countries." To cite just two: While retail sales in France and Germany rose in the second quarter, sales in Italy fell. And while Germany heads towards fuller employment, the unemployment rate in the euro zone as a whole hovers around 10%.

These divergences conceal a fundamental, unsolved problem in the euro zone economy—its outsize dependence on the German export machine. That machine is now at risk of a real slowdown. Markets in the periphery of Europe are shrinking as austerity replaces deficit-financed bingeing on imports. Asian markets are showing signs of slowing, especially in China, an important outlet for German goods. And the American recovery is losing momentum, further reducing demand for imported goods. Add to that the 8% rise of the euro against the dollar in July, and you have a German economy more rather than less likely to slow in the second half of the year, and with it all of euroland.

Then there are Europe's banks. It is now clear that contrary to claims by their sponsors the stress tests were hardly stressful, that overvalued assets remain on balance sheets, and that dicey sovereign debt was ignored. Barclays estimates that if sovereign debt had been properly considered, 22, not the reported seven banks would have failed the tests, and that the sector needs to raise €12.6 billion ($16.4 billion) in capital, a lot more than the €3.5 billion estimated by the eurocracy. It is far from certain that investors will make such capital available on bearable terms, in which case more bailouts by already-grumpy German taxpayers will be needed.

So, look below the surface of the glowing reports on the stress tests and it is clear that the piper has yet to be paid. Which didn't deter the European Central Bank last week from tightening the terms on which it will lend to banks in need of funds, further dampening growth prospects.

The basic structural deficiency of the common currency area—a single currency with multiple national fiscal policies—is too often mentioned to warrant expanded treatment here. It might well constitute the largest part of the submerged portion of the iceberg towards which the good ship euroland is headed. Unless the iceberg melts, in which case, according to Canadian Geographic magazine, "it makes a fizzing sound... [which] comes from the popping of compressed air bubbles." Not all that different from a financial meltdown.

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

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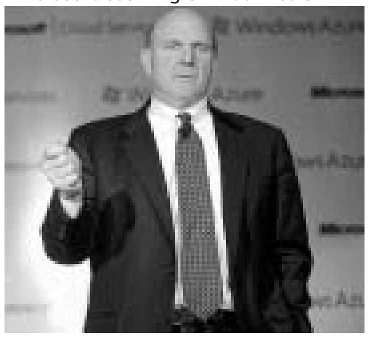

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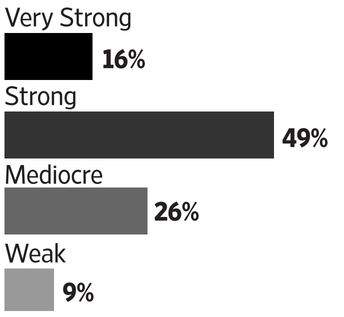

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NEWS

Studies question a new MS theory

By Thomas M. Burton

Research has emerged casting doubt on a popular new theory that multiple sclerosis is caused or worsened by blockages in the jugular veins.

In separate studies from Germany and Sweden, to be published Monday in the Annals of Neurology, researchers report they found no such trend of blockages in patients' jugular veins, which carry blood away from the brain back to the heart. The theory, championed by an Italian vascular surgeon and some doctors in the U.S., has inspired thousands of MS patients to get tested and, in some cases, to get treatment such as the insertion of metal stents in jugular veins to keep them open.

"Our results challenge the hypothesis that cerebral venous congestion plays a significant role in the [disease process] of MS," wrote Florian Doepp, a neurologist at Humboldt University in Berlin, and colleagues. They did ultrasound and other imaging exams on 56 MS patients and 20 normal control-group patients. "Our results suggest the cerebral venous drainage in patients with MS is not restricted," they wrote.

A smaller study from Umea University in Sweden looked at 21 MS patients and 20 healthy patients and concluded, "We found no differences regarding internal jugular venous outflow."

MS is generally thought of as an autoimmune disease, meaning that a patient's body attacks its own cells. Symptoms vary widely but often involve progressive weakness and pain and can include speech disorders and spasticity.

The theory about jugular-vein blockage originated from Paolo Zamboni of the University of Ferrara in Italy. Dr. Zamboni's reports have spread rapidly among patients through the Internet, propelling thousands of MS patients to get examined or treated.

At Stanford University in California last year, a doctor treated 40 MS patients with balloon angioplasty or stents to open veins. Some patients reported symptom improvement. After one patient died and another underwent emergency surgery for a stent that floated into his heart, the university shut down the program but says it is considering further research.

Currently, a study at the State University of New York at Buffalo is examining 1,000 patients after about 10,000 sought to participate in the research.

Dr. Zamboni said he stands by his findings. He said he hasn't read the Swedish report, but he questions some methodology in the German research. He said his own multiyear survey of 500 MS patients has found that 90% have vein blockage, compared with only 2% of 1,000 control-group patients who are healthy or have other neurological diseases.

The reports from Germany and Sweden won't be the final word. The National Multiple Sclerosis Society, along with its sister group in Canada, have funded more than $2.4 million in studies to evaluate the vein-blockage theory.

Happy couple: Chelsea Clinton marries Marc Mezvinsky

Reuters

Chelsea Clinton wed longtime boyfriend Marc Mezvinsky in the small town of Rhinebeck in upstate New York. Bill and Hillary Clinton said they felt 'great pride' at seeing their daughter married. For more photos, visit europe.WSJ.com

U.A.E. limits BlackBerrys

Continued from first page

uation. A local server would allow the government easier access to the encrypted communications data sent by BlackBerry users in the country, the person said.

Part of RIM's 2007 contract with telecom provider **Emirates Telecommunications** Corp., a majority of which is owned by the government, required the Canadian company to find a technological solution to the government's data-security concerns, according to the person familiar with the situation. RIM resisted this solution, the person said.

RIM last month then offered to allow the government access to the communications of 3,000 U.A.E.-based BlackBerry clients, including email, text messages and IM communications, the person said. The person didn't know how the number of 3,000 was determined or who would be included.

The U.A.E. government declined this offer, the person said.

The government doesn't plan to ban smartphones made by the company's two global competitors, **Nokia** Corp. and **Apple** Inc., said the person familiar with the situation.

RIM, based in Waterloo, Ontario, is unusual among wireless telecoms in that messages sent to and from BlackBerrys are processed at one of RIM's Network Operations Centers. The messages are encrypted on the device before being sent and remain encrypted until they reach their destination. But with only a few NOCs world-wide, with the main one in Canada, governments can't easily get access to the data.

Another person familiar with the matter said a key worry for U.A.E. officials was that BlackBerry's instant-messenger service was effectively untraceable. That could be a problem if RIM resisted handing over data sought by the U.A.E. in a criminal or terrorist probe. "If the U.A.E. government needs this information, for criminal cases, they are unable to access it because the culprits used BlackBerry messenger service," the person said.

The U.A.E. worries that because of jurisdictional issues, its courts couldn't compel RIM to turn over secure data from its overseas servers even in the case of national-security situations, one of the people familiar with the situation said.

Last week, a senior Indian official said BlackBerry's encryption makes monitoring of its network impossible and creates a security threat. The Indian government, which is negotiating with RIM about the issue, has warned the company that its operations will be closed unless the company addresses the concerns.

BlackBerry, which commands around 20% of the global smartphone market, has an estimated 500,000 users in the U.A.E.

The U.A.E.'s carriers—Emirates Telecommunications, known as Etisalat, and **Emirates Integrated Telecommunications** Co.—said they would comply with the ban.

EUROPE NEWS

IHA Fotograf Servisi (2)

Generals and Prime Minister Erdogan, center left, at December's Supreme Military Council. The military wants its candidate, Gen. Isik Kosaner, below, to be chief.

Between East and West

Events that could shift the balance of power between the Islamist-leaning ruling AKP party and the secularist establishment, which has a power base in the military and judiciary:

- **Aug. 4.** Supreme Military Council chooses a new command.
- **Sept. 12.** Constitutional referendum. Amendments would expand Constitutional Court to 17 members from 11, and the Supreme Board of Judges and Prosecutors to 22 members from 7.
- **December.** Hearings expected to begin in the "Sledgehammer" case in which 196 people, most of them serving or retired military officers, are accused of a plotting a coup against the government.
- **July 2011.** Deadline for the government to hold national elections.

Turkey to pick military head

By Marc Champion

ISTANBUL—Turkey's top generals and government began meeting this past weekend to choose a new military command, in what promises to be a crucial front in a divisive battle over this country's political future.

For four straight days starting Sunday, Turkey's defense minister, 15 four-star generals and for a time Prime Minister Recep Tayyip Erdogan are meeting in a windowless conference room to hash out who the military promotes and who it dismisses.

The twice-yearly meetings of the Supreme Military Council, or YAS, are always closely watched in Turkey. But this conclave is unusually important, say retired generals, politicians and analysts, because it comes as Turkey's Islamist-leaning government is trying to break the back of the military and judicial establishment that effectively ruled Turkey for decades and carried out four coups since 1960.

The key issue is whether the military will be able to secure its old-school secularist candidate, land-forces commander Gen. Isik Kosaner, as the next chief of the general staff. Equally important is whether the military will get to choose the top aides he wants, including from dozens of officers and generals awaiting trial for an alleged 2003 plot to topple the government.

The conclave kicks off a tense political season that stands to determine who wins a continuing battle to redefine this key U.S. ally that straddles Europe and the Mideast.

In a Sept. 12 referendum, Turks will vote on constitutional changes proposed by the ruling Justice and Development Party, or AKP. The amendments, if approved, would further clip the military and transform the make-up of the Constitutional Court, another powerful bastion of secularist opposition to Turkey's Islamic-leaning government. The referendum is widely seen as a dry-run for national elections next year that could return the AKP to power for a third term.

"If [the government] can succeed in cutting off the arms of Gen. Kosaner, and can get a 'Yes' vote in the referendum, then there will be a new Turkey," says Cüneyt Ülsever, a columnist with Hürriyet newspaper who was a prominent supporter of the AKP during its first term, but has since become a skeptic.

To many liberals and religious conservatives alike, that new Turkey is overdue and would simply remove a "military tutelage" system that for decades crippled the country's economic and democratic development. The European Union has long pushed for Turkey to reduce the military's political power and supports amendments to a constitution that is widely viewed as flawed.

Mr. Ülsever and others, however, believe that if the AKP is successful in taming the military and judiciary, the changes would replace one form of abusive "custody" of individual freedoms with another and could threaten Turkey's secular foundations—a view the AKP and its supporters ridicule. Turkey's government has come under criticism, including from the EU, for reducing media freedoms as well as for the widespread, if court authorized, wiretapping of opponents

The contest to reshape the North Atlantic Treaty Organization's second-largest military is already under way. Last Friday, the general staff issued a statement saying that the law prevented them from promoting officers accused in criminal cases only if they were in custody. Hours later, a court issued orders to re-arrest 102 officers awaiting trial in the 2003 coup plot, including some two dozen serving generals. Lawyers for the defendants appealed.

If those officers can't be promoted, many will have to be dismissed due to internal military rules, according to retired Gen. Nejat Eslen. "That would have a serious impact on the structure of the military. It would be a new period," Gen. Eslen said.

The YAS meeting is expected to run through Wednesday at the Ankara headquarters of the general staff. According to Ismet Sezgin, who as defense minister from 1997 to 1999 attended numerous YAS meetings, officials will eat lunch and dinner together, drink together and, with one vote per man, choose each candidate for each job.

Gen. Kosaner, the 64-year-old military favorite for chief of the general staff, led a platoon of commandos in Turkey's 1974 intervention in Cyprus. He has a reputation as a tough secularist. Many officers in Turkey's military are looking for him to take a tougher line than outgoing Chief of the General Staff Ilker Basbug against what they see as government efforts to discredit and weaken the military, say several people familiar with thinking among Turkey's officer corps.

Many in the military see the government's so-called Sledgehammer case, which alleges that 196 people planned a coup at an annual war-gaming seminar of the 1st Army in 2003, as a direct and fabricated assault on the military's authority. Some of those accused in the plot—which allegedly included plans to blow up mosques and shoot down a Greek plane to sow chaos—are now involved in combating the recent wave of guerrilla attacks by the Kurdish Workers Party.

Though Gen. Kosaner has a hard-line reputation, he isn't expected to be blocked by the government at the YAS meeting, say retired generals, analysts and politicians. As land-forces chief, he has been quiet for the past two years. The military has "wrapped him in cotton wool to make sure the AKP can't find a pretext to block him," says Gareth Jenkins, a Turkey-based analyst with close contacts to the military.

Defense ministry and general staff spokesmen declined to comment on the meetings.

Russia breaks up protest and arrests leaders

By Richard Boudreaux

MOSCOW—Russian authorities used a large police presence and the roar of car engines Saturday evening to stifle a protest for freedom of assembly and the resignation of Prime Minister Vladimir Putin.

Police arrested two opposition leaders and nearly 100 followers in Moscow and St. Petersburg.

About 200 activists in Moscow found the proposed site of their protest, Triumfalnaya Square, fenced off for a competition among souped-up stock cars. City officials had given a permit for the square to a sports-car federation to block the anti-Kremlin rally.

Police officers surrounded the square and parked about 30 police buses nearby.

Most protesters crowded into a block-long pedestrian arcade between the Tchaikovsky Concert Hall and the barrier around the square. They shouted "Freedom!" and "Russia without Putin!" and held up signs reading "31," a reference to the Constitution's Article 31, which protects the right to peaceful assembly. One protester wore a soccer jersey with the number 31.

Their chants were barely audible. They were drowned out by the stock cars, which raced in pairs across the asphalt, spewing exhaust and kicking up dust with treacherous skidding maneuvers.

Cameron's remarks still rankle in Pakistan

By Tom Wright

NEW DELHI—Pakistan's military spy chief canceled a trip to the U.K. because of Prime Minister David Cameron's remarks about his country's role in sponsoring terrorism, a senior Pakistani intelligence official said.

Lt. Gen. Ahmed Shuja Pasha, head of the Inter-Services Intelligence agency, was set to accompany President Asif Ali Zardari on a five-day visit to the U.K. beginning Thursday.

Mr. Zardari faces intense domestic pressure to also cancel his trip, but he decided to go because of the "bigger issues involved," which include the long-term strategic relationship between the two countries, a Pakistani government official said.

A spokesman for the British High Commission in Islamabad said only that Mr. Zardari's visit was proceeding as scheduled. He denied local media reports that the U.K.'s High Commissioner had been summoned last week by Pakistan's government, saying the meeting had been arranged previously.

Protesters burned an effigy of Mr. Cameron on Saturday in Karachi, the Associated Press said.

Mr. Cameron, during a state visit to India, said Wednesday that Pakistan couldn't "look both ways" in receiving billions of dollars in aid from Western nations while continuing to "promote the export of terror, whether to India or Afghanistan or anywhere else in the world."

On Thursday, Mr. Cameron stood by his remarks, despite complaints lodged by Pakistan. Mr. Cameron did note, however, that Pakistan's government is also engaged in a war against Taliban militants.

Global pressure on Pakistan to crack down on Islamist militant groups operating from its soil has mounted since the release last weekend by WikiLeaks, a document-publishing Internet site, of thousands of classified U.S. military field reports from Afghanistan.

A handful of those documents detailed alleged links between the ISI, Pakistan's spy agency, and the Taliban in Afghanistan between 2004 and 2009.

Although many U.S. officials have said the intelligence in the documents is likely to be unreliable, politicians in India, the U.S., the U.K. and Afghanistan have seized on their contents to press Pakistan to do more in combating militants.

President Barack Obama, in public remarks this week, played down the documents, saying they didn't contain any new information.

White House officials have stressed that U.S. cooperation with Pakistan, including on intelligence sharing, has improved this year, especially as Pakistan's government and military faces increased attacks from Islamist militants.

Pakistan's government denies the allegations in the WikiLeak documents, adding that it has lost more than 2,000 soldiers in the past few years in its fight against Pakistan Taliban extremists.

■ India and Pakistan clash in toning down border crossing ceremony 29

EUROPE NEWS

Germany mourns victims of Love Parade tragedy

Agence France-Presse/Getty Images

People in Duisburg, in western Germany, hold a banner reading 'Duisburg is mourning' during a funeral march Sunday for the 21 people killed in a stampede at a techno music festival on July 24.

Hungary sets own path on economy

By Gordon Fairclough

BUDAPEST—Inside the Ministry for National Economy here, a sign proclaims a "revolution" in Hungarian politics and declares that the country has regained its "ability for autonomy."

The notice signals the new Hungarian government's determination to set its own economic agenda, even if that costs it the support of the International Monetary Fund and European Union.

That support is the subject of a standoff between Budapest and the two organizations, which recently halted bailout-loan talks, saying Hungary wasn't doing enough to make durable cuts in state spending. The IMF has said it is willing to resume negotiations. But Hungarian Prime Minister Viktor Orbán has indicated that his country intends to go it alone.

Mr. Orbán, who took office in late May after a landslide election victory, has made it clear that he believes Hungary can survive without more IMF and EU aid, if the alternative is having to compromise on his plans to boost economic growth and create jobs.

"It's an economic freedom fight," said a senior official in Mr. Orbán's administration. "We are getting back the financial independence of the country."

Hungary's rebellion against the budget-cutting approach of the IMF and EU is an unwelcome development for leaders of the two organizations, who also are trying to enforce austerity programs for other governments, such as Greece's, that have been bailed out after amassing large public debts.

"It could be a very important precedent for other countries," says Mark Weisbrot, an economist at the Center for Economic and Policy Research in Washington and a critic of the IMF.

Hungary insists it will adhere to the 2010 budget-deficit target—3.8% of gross domestic product—set under the terms of its loan agreement with the IMF and EU. But how it goes about it shouldn't be the IMF's concern, Hungarian officials say.

They also have expressed some doubts about whether it is reasonable to expect their government to cut its deficit to 3% of GDP—the level mandated under EU rules—in 2011, as it has been asked to do. Many of the EU's 27 members now exceed the 3% limit.

"The 3% goal is in question, and not only by us," said the senior Orbán administration official. If deficit constraints are too tight, it "narrows your freedom of maneuver to do structural reforms," which the new government considers essential. "The EU shouldn't be an institution that is constraining us," he said.

Mr. Orbán, a populist politician who made a name for himself by calling for the removal of Russian troops from Hungary in the early days of the country's transition from communism to democracy, is promoting what his aides call a "patriotic economic policy."

Standing up to the IMF and EU resonates in a country that, for much of its history, has battled outsiders—from Austrians in the 17th century to Soviets in the 20th—to preserve its independence.

"No one should decide for us what we should do with the Hungarian economy. A state should be sovereign," said Ágnes Náray-Szabó, a

Agence France-Presse/Getty Images

Premier Viktor Orbán believes Hungary can thrive without new IMF or EU aid.

26-year-old high school teacher who says she thinks Mr. Orbán and his Fidesz party have been doing a good job.

The IMF and EU together rescued Hungary from insolvency in 2008 with a €20 billion ($26.09 billion) loan package. The country, whose national debt is equivalent to about 80% of its annual GDP, was unable to raise funds on its own amid the credit crunch of the global financial crisis.

Government officials appeared especially irked by IMF and EU criticism of a hefty new bank tax which they imposed in an effort to plug the hole in the budget. The IMF and EU said the tax, which aims to raise nearly $1 billion in revenue this year, could discourage lending and stifle economic recovery.

Mr. Orbán himself played a critical role in the failed talks with the IMF and EU, said a person familiar with the negotiations. "Even the smallest details have to go to the prime minister," the person said. Mr. Orbán essentially rejected all the IMF and EU proposals, the person said.

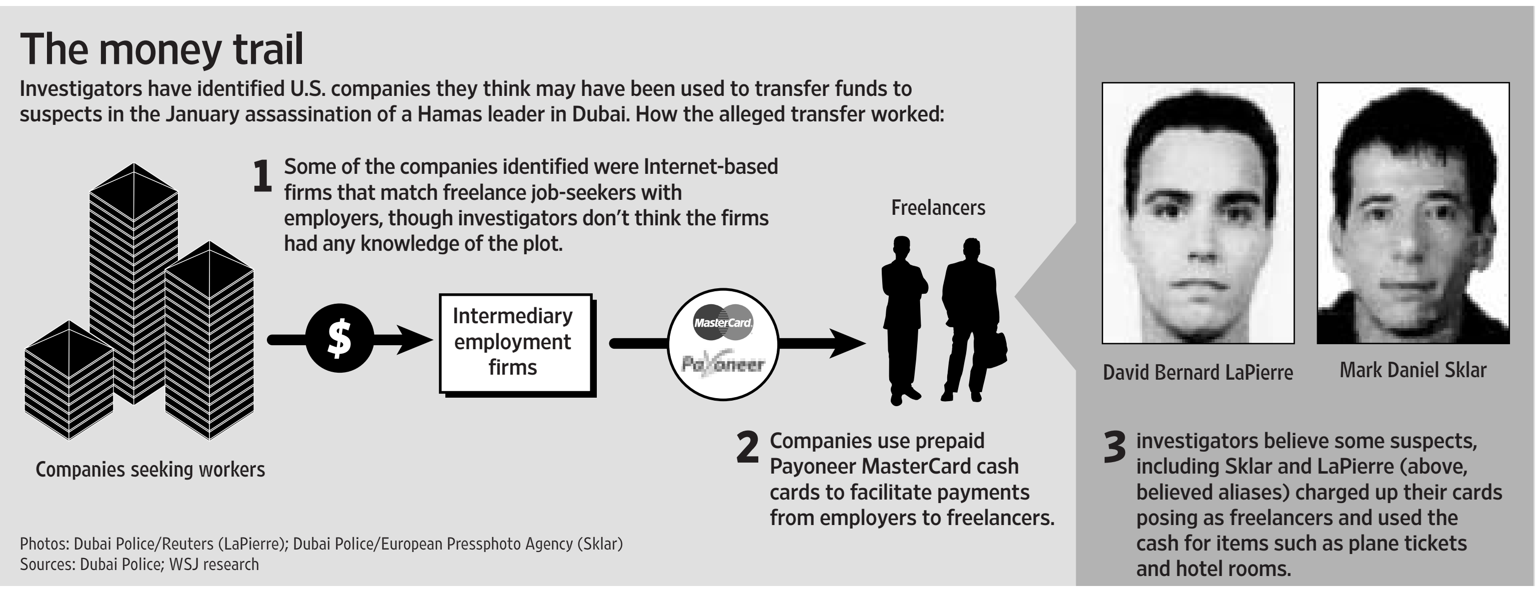
Representatives for the IMF and European Commission declined to comment.

If there is no new deal with the IMF and EU, Hungary's so-called standby loan agreement will expire in October. Without it, the government will have no financial safety net as it starts repaying the bailout loans next year in addition to its other obligations.

Hungary hasn't drawn any funds from the bailout loan since last year, and has been able to raise money on its own in the capital markets this year. But analysts say its ability to do so has been bolstered by the IMF and EU, whose presence reassured investors that the government was pursuing prudent policies.

Without them, the government will face a heightened degree of scrutiny. "If we don't have the IMF, we will have to make good economic policy to survive," says Gyorgy Barcza, an economist at KBC Bank in Budapest. "We will have to finance ourselves in the market. So our performance will be measured every day."

In an auction Thursday, Hungary sold 57.5 billion forints, or about $263.2 million, in Treasury bonds, amid strong demand. But signs of wariness remain. Since Mr. Orbán's Fidesz Party won the national elections in April, foreign investors' holdings of Hungarian government debt have dropped by 7.7%.



Photos: Dubai Police/Reuters (LaPierre); Dubai Police/European Pressphoto Agency (Sklar)
Sources: Dubai Police; WSJ research

Hamas probe leads to U.S. firms

American investigators, cooperating in a probe of the January assassination of a top Palestinian leader in Dubai, have identified a handful of U.S.-based companies believed to have been used to transfer money to suspects in the case, a finding that brings international authorities closer to identifying who funded the operation.

By ***Chip Cummins*** *in Dubai and* ***Evan Perez*** *in Washington*

The findings show American authorities playing a bigger role in the investigation than previously revealed. The case is especially delicate for the U.S., because Dubai police have said their prime suspect in the case is Mossad, the intelligence service of Israel, a key U.S. ally.

International investigators see money transfers made through the U.S. companies as key clues in a globe-spanning manhunt aimed at identifying more than two dozen suspects in the case, according to officials familiar with the matter.

The U.S. companies identified by investigators include Internet-based businesses that match freelance job-seekers with employers and process payments between the two sides. Authorities have identified financial transfers from several of these intermediary businesses into prepaid, cash-card accounts used by suspects in the Dubai killing, according to international investigators.

U.S. authorities say they don't believe the intermediary companies had any way of knowing the money would be used in the plot, according to a U.S. official familiar with the investigation.

Instead, U.S. investigators believe, suspects might have posed as freelancers in order to get money in a way that obscured their funding source, and used the money for operational expenses, such as buying plane tickets.

The next step in the investigation would be to determine who the employers were in the transactions.

Representatives of several companies identified in the probe said they hadn't been contacted by U.S. authorities and weren't aware of any investigation.

White House officials have declined to comment on how extensively the U.S. has been cooperating on the case with Dubai and the United Arab Emirates—a moderate, Western-leaning powerhouse in the Mideast.

Earlier this year, Dubai police identified 13 U.S.-issued, cash-card accounts they said suspects used in the operation. All the suspects linked to the cards used fraudulent passports, according to Dubai police. That means their names and details wouldn't have been on any international warning lists and wouldn't have otherwise raised alarm bells for the companies.

Dubai has accused Israel's Mossad intelligence agency in the killing of Mahmoud al-Mabhouh, a founding member of Hamas' military wing, which has carried out scores of attacks against Israel. Israeli officials say there is no evidence implicating the Jewish state.

After Dubai released details of dozens of forged or fraudulently obtained passports linked to the case, the U.K., Ireland and Australia expelled Israeli diplomats after accusing Israel of forging passports used by suspects.

Washington has for years sent officials to the U.A.E. to ask authorities there to investigate and shut down suspected terror-financing networks in the country. The Dubai investigation is the highest-profile case in which the roles appear reversed: The U.A.E. is now seeking help from Washington in following an alleged criminal money trail that leads back to the U.S.

The White House, however, has scrambled recently to patch up relations with Israel after months of strained ties over stalled Mideast peace efforts and other policy clashes. The White House declined to comment on the sensitivities of cooperating in the Dubai case.

The Mabhouh case has also put the prepaid cash card sector under the spotlight. Regulators and law-enforcement officials say they have worried in recent years such cards may be vulnerable to misuse for money-laundering or other criminal activity—the type of abuse that has worried U.S. counterterrorism officials, international investigators said.

The cards are used like debit cards, but are charged up ahead of time with cash electronically—for instance by an employer. They have become increasingly popular among companies that pay workers or other payees in far-flung locales, where cutting checks or wiring in money isn't convenient.

Some of the **MasterCard** Inc.-branded cards used by Dubai suspects were distributed by **Payoneer** Inc., a New York-based online payment company, and issued by **Metabank**, owned by **Meta Financial Group** Inc., Storm Lake, Iowa, said Dubai authorities. Dubai said suspects also used four other cards issued by European finance companies.

In a statement, Meta said the company had been "informed by authorities that the suspects apparently used stolen identities, including fake passports, to obtain employment/compensation from U.S. companies and acquire bank cards issued by Meta and other banks."

The cards in question were "loaded" by companies for "payroll, disbursements, and other compensation," Meta said. The bank said it launched its own review of the matter, and has found so far that it had followed all bank and regulatory requirements.

Meta and Payoneer, in public statements, have confirmed they have been in contact with U.S. authorities in the matter.

Representatives at several other companies identified by U.S. investigators said their firms hadn't been contacted by U.S. authorities and they weren't aware of any probe related to the cards.

U.S. investigators believe the companies weren't aware of how the money flowing through them was used.

Big investors brace for new hazard: deflation

Continued from first page
invest, hurting profits and crippling the economy and investments like stocks. It can be caused by a drop in the money supply and credit, falling spending and high unemployment.

Mr. Gross has been aggressively buying U.S. government debt in recent weeks. Treasurys now account for about 51% of the portfolio of his Pimco Total Return Fund, up from less than 33% at the end of March.

Mr. Tepper, who runs the $15 billion hedge-fund **Appaloosa Management** LP, has about 70% of his portfolio in bonds rated double-B and triple-B—the lowest end of the investment-grade spectrum and the upper tier of junk. That's up from 63% earlier this year, investors say.

Recent data are responsible for the worries. The U.S. consumer-price index rose 1.1% in June compared with a year earlier. Friday's report on second-quarter gross domestic product showed the underlying inflation rate—which excludes volatile moves in food and energy prices and is closely watched by the Fed—was 1.1%, the lowest reading since the first quarter of 2009.

Mr. Fournier's $4 billion hedge fund, **Pennant Capital**, says "political winds shifted" when European nations recently said at the Group of 20 summit they will focus on balancing their budgets rather than stimulating growth. The growing clout of the Tea Party movement in the U.S. also has colored his view that elected officials won't have the ability to spend.

"The U.S. economy has to grow north of 2% to avoid deflation, and we're right around there," he says.

Mr. Gross says deterioration in an index produced by the Economic Cycle Research Institute that attempts to predict future economic health, a drop in money supply and fiscal tightening in much of the world are reasons for a shift in view at Pimco.

"We said, 'hey, two-thirds of the world is moving to the zero line,'" of inflation, Mr. Gross says.

Pimco's team predicts "core" U.S. inflation, which excludes volatile energy and food prices, might drop a tad below 0% over the next few years, and it could rise as high as 2% if growth improves.

One problem: It's hard to find attractive investments if deflation arises.

Commodities and other sectors are favorites amid rising prices, but there's less experience with extended deflation, which hasn't been seen since the Great Depression. Some say utilities and companies with stable cash flows are the best bets, along with government bonds.

Should kids born in U.S. be automatic citizens?

[Washington Wire]

By Naftali Bendavid

Sen. Jon Kyl said he wanted to look into whether the U.S.-born children of illegal immigrants should automatically become U.S. citizens, as they do now.

Mr. Kyl, an Arizona Republican, said he has discussed with Sen. Lindsey Graham (R., S.C.) the possibility of holding hearings on the topic, a highly controversial one.

The 14th Amendment to the U.S. Constitution says, in part, "All persons born or naturalized in the United States and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside."

But Mr. Kyl noted there were exceptions to the policy, such as the U.S.-born children of foreign diplomats stationed in this country.

"The question is, if both parents are here illegally, should there be a reward for that?" Mr. Kyl said on CBS's "Face The Nation" on Sunday.

An Arizona senator is pushing to examine whether children born to illegal immigrants should get the 'reward' of citizenship, in the wake of a controversial law.

The question arose during a discussion of a new Arizona law requiring police officers to determine the immigration status of people with whom they come into contact, if the officer has a "reasonable suspicion" that the individuals are in the country illegally. U.S. judge Susan Bolton recently struck down the heart of the law—police checks of immigration status—after the Obama administration argued that it is up to the federal government, not individual states, to set immigration policy.

Mr. Kyl, who supports the Arizona law, said the judge's ruling was "very sweeping." He said Congress should make clear that it expects federal immigration laws to be enforced, and to provide enough resources for that to happen.

"We are a nation of laws and we should be enforcing the law," he said.

The senator rejected the notion that the Arizona law was anti-Hispanic and would hurt Republican electoral prospects in the future.

"There may be some—and I'm sure there are some—who try to take political advantage of any situation," Mr. Kyl said. "But if you live here in Arizona, you appreciate that we have a great tradition, especially with our neighbor to the south, Mexico."

U.S. NEWS

States delay workers' retirements

States are deciding it's time their workers retire later.

Lawmakers in at least 10 states have voted this year to require many new government employees to work longer before retiring with a full pension, or have increased penalties for early retirement. Similar proposals are pending in two states—California and Mississippi.

By *Jeannette Neumann, Michael Corkery* and *Marcus Walker*

The pace of change, which researchers call unprecedented in the U.S., comes as foreign governments from France to Morocco have either decided to increase or are contemplating a rise in the age at which private and public workers can receive state pensions.

A federal commission studying long-term U.S. fiscal issues is also entertaining the idea of changing the retirement age as a way to shore up Social Security, said a person familiar with the matter. A report is due to President Barack Obama in December.

In Europe, proposed changes to the retirement age are part of a broad effort to rein in the costs of a safety social net that has long been considered one of the world's most generous. Changes would affect workers broadly, not just public workers. Proposed austerity measures have provoked street protests.

The U.K. government said last week that it planned to do away with the fixed retirement age of 65 next year, saying people who wished to work longer should be allowed to do so.

In 2007, Germany raised the retirement age to 67 from 65, a change to be phased in by 2029. France's parliament is due to vote on a similar measure this fall, while Spain, Portugal and Ireland are all also considering such changes. Greece has passed legislation aimed at raising its average retirement age from around 61 to 63. As for Morocco, it's contemplating an increase in the retirement age for public and private sector workers to 62 from 60, according to its U.S. embassy.

Individual U.S. states, meanwhile, are already moving ahead as they respond to the widening gaps between the obligations made to workers and the money expected to be available to pay them, thanks to investment losses and recessionary budget pressures.

"It's a very positive change that the age for receiving full benefits is increasing," said Alicia Munnell, director of the Center for Retirement Research at Boston College, "Increasing the retirement age is the single most important thing [states] can do" to tame future pension costs because it reduces the number of years the state is paying a benefit.

Although rising lifespans long have been expected to pressure pension systems, the looming fiscal predicament has emboldened lawmakers to demand more years from employees. Also, as many states cut services, scrutiny has fallen on the compensation of public workers.

"The scales have tipped," said Tim Blair, the executive secretary of the State Employees' Retirement System of Illinois. In March, state lawmakers voted to increase the retirement age for most new hires to 67 from 60. "It had everything to do with the financial straits the state is in," Mr. Blair said.

In July, Missouri raised the retirement age for most new hires to 67 from 62. In June, California Gov. Arnold Schwarzenegger reached a tentative contract agreement with six public employee unions to bump up the retirement age by five years for new hires. The governor's office and six other unions remained in negotiations, with one of the sticking points an increase in retirement age.

In Utah, new fire and public safety employees as of July 1, 2011, must work 25 years, up from 20, before getting a full pension. Most other state employees must now work 35 years instead of 30 before receiving their pension.

The changes could fuel momentum to raise the age at which U.S. workers receive payments from Social Security, say industry experts. Recently, calls to increase the normal retirement age, now 67 for people born in 1960 or later, have come from both parties. In multiple speeches this year, Rep. Steny Hoyer, a Maryland Democrat and the House Majority Leader, said Congress might consider raising the age to reflect Americans' longer lifespans, as one option to bolster the program's long-term solvency. Rep. John Boehner, an Ohio Republican and the House Minority Leader, said in June that he would consider raising the retirement age for Social Security to 70 for younger workers.

Changes to the retirement age won't solve the most immediate financial problems that now ail many public-pension systems, mostly because adjustments generally affect new workers. They aren't expected to pay off for decades.

But the increases are part of a broader set of changes that together are reshaping government jobs. These positions long have been considered attractive partly because of the benefits, including a guaranteed pension. Now, cutbacks mean that increasing numbers of public sector employees will work longer with less benefits.

Detractors say that will affect the quality of government services. "We are hurting ourselves in terms of retaining good employees," said John Burnett, a Missouri lawmaker who opposed raising the retirement age in his state, which he said has some of the lowest-paid public employees in the nation. Proponents say an upside, in addition to fiscal savings, is that healthy, capable older workers will continue to bring skills and experience to bear.

In the U.S., the changes represent a small step toward bringing the retirement age for government workers, on average 60 years old, more in line with the private sector, around 63, said Ms. Munnell. While the retirement age of government workers has remained steady since the mid-1980s, private sector workers have been retiring later, largely as employers have shifted from guaranteed pensions to more-variable 401(k) plans, among other factors, she added.

The changes have faced some pushback. In Colorado, the teachers' union helped prevent an increase in the retirement age proposed for 2017. In Utah, fire and public safety workers lobbied successfully against a proposed 15-year increase in required years of service. Instead, the change adopted was an added five years.

"There's some point at which an old cop like me shouldn't be out chasing young criminals," said Michael Galieti, a 61-year-old police officer on the board of the 3,000-member Utah Peace Officers Association.

But generally, proposals have moved past resistance, partly because the changes apply to new hires. "People care most about things that affect them immediately," said Mr. Burnett of Missouri.

In Europe, proposed changes to the retirement age are part of a broad effort to rein in the costs of a safety social net that has long been considered one of the world's most generous. Changes would affect workers broadly, not just public workers. Proposed austerity measures have provoked street protests.

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As for Morocco, it's contemplating an increase in the retirement age for public and private sector workers to 62 from 60, according to its U.S. embassy.

Golden years? | A snapshot of retirement trends in various countries

Note: Retirement data are for selected countries. *Age at which a person born in 1960 or later can receive full benefits; Sources: OECD; INSEE

No party yet

A sampling of states requiring or encouraging public workers to retire later:

- Arizona. Increased the retirement rule—worker's age plus years of service before retirement—to 85 from 80
- Colorado. Increased the retirement rule—worker's age plus years of service before retirement—to 88 from 85 as of 2011, and to 90 as of 2017
- Illinois. Increased retirement age to 67 from 60
- Michigan. Minimum retirement age of 60; before, workers needed 30 years of service at any age
- Minnesota. Increased penalty for early retirement for state patrol and correctional workers
- Missouri. Increased retirement age to 67 with 10 years of service up from age 62 with 5 years of service; some very-long-term workers may be able to retire earlier.

Bernanke's portfolio rebounded last year

BY LUCA DI LEO AND DARRELL HUGHES

Federal Reserve Chairman Ben Bernanke made up last year for losses suffered in his personal portfolio in 2008—thanks, in part, to the stock market recovery he helped bring about.

Mr. Bernanke's wealth rose last year, according to financial disclosure forms released Friday. As of the end of 2009, Mr. Bernanke's assets were valued between $1.2 million and $2.5 million, the same as in 2007. That compares with between $850,000 and $1.9 million in 2008, when stocks tanked.

Last year, the Standard & Poor's 500-stock index rose almost 25%, as the U.S. economy began to emerge from the worst recession in decades. In 2008, the S&P 500 fell almost 40%.

The disclosure forms, used by officials across the government, report asset valuations and income only in broad dollar ranges. Much of the increase in Mr. Bernanke's wealth came from a large-cap stock variable annuity he holds. Its value rose to between $500,000 and $1 million at the end of 2009, from $250,000 to $500,000 the previous year.

In his report, Fed Governor Kevin Warsh listed assets under his own name of between $802,000 and $1.8 million at the end of last year, up from $670,000 to $1.4 million in 2008. Mr. Warsh also reported hundreds of individual bonds and other securities held by his wife, Estee Lauder Cos. executive Jane Lauder, that were valued at least in the tens of millions of dollars.

Fed Governor Daniel Tarullo listed assets between $1.4 million and $3.5 million. Governor Elizabeth Duke showed assets of between $3.5 million and $8.2 million. The former community-bank executive disclosed individual stock holdings in roughly two dozen companies. Fed Vice Chairman Donald Kohn, who is scheduled to step down next month, will release his disclosure later.

Mr. Bernanke also earned between $200,000 and $2 million in textbook royalties. That's more than his 2009 salary of $196,700. Other governors earned a salary of $177,000 from the Fed.

Fed officials have some investment restrictions. They are restricted from directly holding stocks in banks or bank holding companies; owning mutual funds with a financial-sector focus; and buying or selling any security the week before the central bank's policy-setting meeting.

Raking in

Personal wealth disclosed by top U.S. central bankers

Ben Bernanke
2008: $850,000 - $1.9 million
2009: $1.2 million - $2.5 million

Kevin Warsh*
2008: $670,000 - $1.4 million
2009: $802,000 - $1.8 million

*excludes data from his wife's assets

Source: WSJ research

WORLD NEWS

Myanmar loosens grip on farmers

By A WSJ Staff Reporter

YANGON, Myanmar—Moves by Myanmar's military regime to loosen its grip on the impoverished nation's once-mighty rice industry in advance of an election this year have raised cautious hopes for the nation's economy.

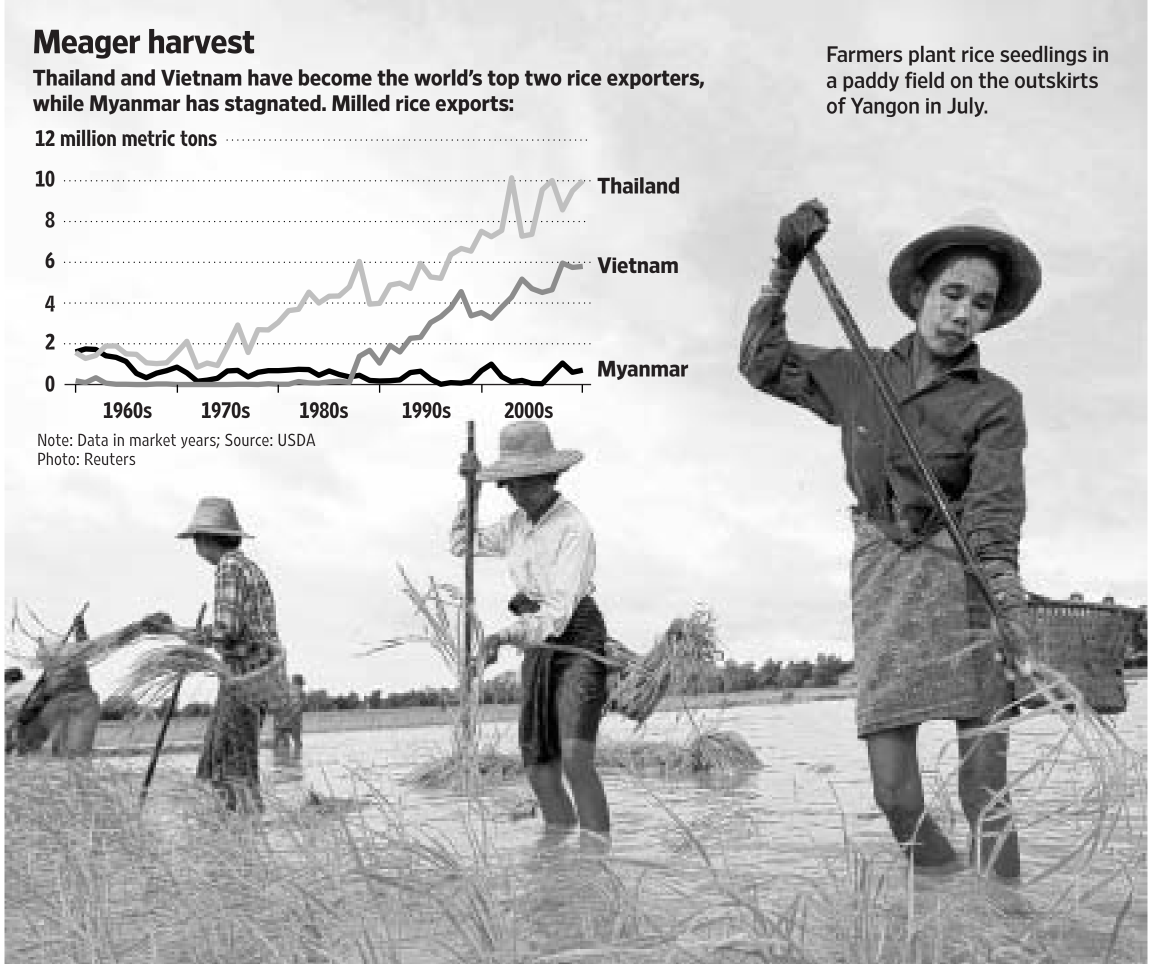
After years of tight control and a 2008 cyclone that devastated Myanmar's key rice-growing region, the regime last year granted private rice-export licenses for the first time in several years and allowed the formation of a private rice-industry association permitted to give loans to farmers and millers, local humanitarian groups say.

The government could reverse the changes at any time, as it did with similar changes in 2003. But its moves, following other signs of openness, provide a rare hint of moderation by the oppressive regime and, if sustained, could ultimately help ease global rice shortages.

The changes are notable because they cover a politically sensitive part of the economy. Past periods of unrest in Myanmar—in the late 1980s and in 2007—coincided with high rice prices, and the regime has typically limited exports to prevent domestic shortages and price spikes that could fuel discontent.

Those controls proved counterproductive. Without an export market to encourage investment, farmers spent little to boost production.

Some advocates say the loosening of export controls will have a positive effect if farmers get enough capital to invest in seeds and equipment. "If we could reach the near full required amount of farm credit alone we could easily increase production," says Tin Maung Thann, president of Myanmar Egress, a Yangon organization that works to promote economic and political change.



Farmers plant rice seedlings in a paddy field on the outskirts of Yangon in July.

The changes so far have been small, and while the state has raised the amount farmers can borrow, the loans aren't reaching everyone. Most farmers can obtain loans of about $10 per acre to buy seed and fertilizer from the state agricultural bank, around a tenth of what is needed. Farmers derisively call the government funds "tea money." Many turn to black-market lenders, despite high interest rates.

Per capita income in Myanmar is among the lowest in the world, at around $460 a year. Rice farmers today work much as they did centuries ago: Oxen pull wooden plows through paddies; millers rely on decades-old equipment that leaves rice grains broken and unsuitable for export to most markets.

The secretive regime, led by Gen. Than Shwe, didn't explain why it decided to license private exporters. Attempts to contact the government, which rarely speaks to foreign media, were unsuccessful.

U.S. clarifies Afghan airstrike directive

By Julian E. Barnes

As part of a review commissioned by Gen. David Petraeus, troops are now allowed to request airstrikes against insurgents who are using dilapidated buildings or other abandoned structures. Commanders conducting the review found that previously, under a misinterpretation of the rules, some soldiers thought they weren't allowed to fire on insurgents hiding in such places.

Gen. Petraeus, head of the allied force in Afghanistan, is examining the broader counterinsurgency strategy, looking for ways to improve its implementation and demonstrate results on a tight timeline. Key reviews of the strategy are to take place at the end of this year, and defense officials are keen to find ways to demonstrate their progress.

On Sunday, the Netherlands became the first North Atlantic Treaty Organization country to end its combat mission in Afghanistan, ending a four-year operation that was deeply unpopular at home. Two international service members were killed in fighting in the south of Afghanistan Sunday, according to the Associated Press, and a minibus carrying civilians struck a roadside bomb, killing six, also in the south.

The clarification on the use of force is part of a broader effort by Gen. Petraeus to review the tactical directive limiting airstrikes and artillery strikes that was issued by Gen. Stanley McChrystal, the previous head of the allied force.

Gen. Petraeus, who has spoken often about the negative effect civilian deaths have on a counterinsurgency effort, is expected to largely keep in place the limits on the use of airstrikes. Military officials said Gen. Petraeus is only expected to tweak the final directive—and will emphasize his support for Gen. McChrystal's efforts to limit civilian casualties.

Senior officials at the International Security and Assistance Force, the umbrella organization for coalition forces in Afghanistan, cautioned that Gen. Petraeus hasn't finalized a new tactical directive on air and artillery strikes, which will apply to all ISAF troops. But other military officials said the most important change implemented by the command will be to get rid of misinterpretations that have grown up around the rules, such as the overly broad definition of what kinds of structures couldn't be targeted.

Gen. McChrystal's guidelines on the use of force in Afghanistan have been controversial. Most Defense Department officials say the rules have succeeded in limiting civilian casualties and have helped improve the Afghan government and people's view of the allied military effort.

Military service members, by contrast, complain they are too restrictive and have at times put troops in danger. Some current and former military officials say the limits have stripped the U.S. of its greatest technological advantage over the Taliban.

Two senior military officials said Gen. Petraeus would largely keep intact Gen. McChrystal's previous guidance on the use of force, issued in July 2009. As part of the review, lower-level commanders have been examining their practices, ensuring they are in keeping with the intent of the original airstrike directive but not going beyond it, according to military officials.

In eastern Afghanistan, senior U.S. commanders determined, some soldiers were under the impression that they weren't allowed to fire on abandoned homes. The original directive, military officials said, was designed to stop troops striking residential compounds and structures where civilians might live.

To correct the practice, commanders have been told that a structure where civilians might live is defined as a building with four walls and a roof, and shouldn't be targeted. A structure with three walls and no roof, for example, could be targeted.

A senior defense official said Gen. Petraeus's review is aimed, in part, at examining "the bureaucratization" within the military of the directive on airstrikes.

Defense officials said the misinterpretation of the rule on structures is typical of the military, where junior commanders often add additional requirements to an original order. The officials compared it to a morning drill scheduled to start at 7 a.m. To ensure no one is late, each echelon below subtracts a half hour from the start time, only to have the soldiers show up at 5 a.m. and wait for two hours.

On July 27, Gen. Petraeus issued new counterinsurgency guidelines—rules laying down the military's current theory of how to fight the war in Afghanistan—that largely continue the practices laid out by Gen. McChrystal. The guidance tells troops to position their outposts near population centers in order to better protect the population, to be careful that money paid out for projects or contracts doesn't go to the insurgency, and to confront corrupt officials. In that document, Gen. Petraeus noted that if civilians are killed, the allied force will create more insurgents. "We can't win without fighting, but we also cannot kill or capture our way to victory," the document says.

At his confirmation hearing in June, Gen. Petraeus suggested that the problem with the directive stemmed from how lower-level commands implemented it. He said the military needed to ensure that subordinate leaders didn't make the guidance "more restrictive than necessary," especially when troops were in danger.

U.S. officials in Afghanistan argue that one of the most important results of Gen. McChrystal's bid to reduce civilian casualties is to boost the popularity of the allied military with Afghan President Hamid Karzai and with the wider population.

Kenya to vote on constitution that tackles touchy issues

By Sarah Childress

NAIROBI, Kenya—Kenyans will vote on a controversial new constitution in a referendum on Wednesday—the latest step in a series of efforts by Kenyan leaders to bring political change to their country to quell tribal tensions after ethnic violence left more than 1,300 people dead in early 2008.

The U.S., eager to bring stability to a regional powerhouse and a strong ally in its fight against terrorism, maintains a new constitution is central to that effort.

U.S. officials, including the Kenya ambassador, Michael Ranneberger, and Vice President Joseph Biden, who visited Nairobi in June, have spoken about the importance of the draft and the need for change.

"A new constitution, if it is adopted, will strengthen Kenya's democratic institutions," said Johnnie Carson, the U.S. assistant secretary of state for African affairs in a recent interview. "We believe this is an opportunity for fundamental change, but the decision for that change is in the hands of Kenyans."

The draft provides for a more decentralized democracy that checks the power of the president and establishes two houses of parliament. The current system of government allows for an imperial presidency, where the executive branch holds most of the power. Historically, whatever tribe has held executive power has become the primary beneficiary of any government largesse.

The document also tackles the controversial issues of abortion, Islamic courts, and land distribution. To date, land has been allocated on a tribal basis, and the poor have been denied access.

A study by the Nairobi office of **Synovate** Ltd., a global market-research company, said 58% of voters surveyed would approve the constitution, with 17% undecided.

The vote is expected to divide along tribal lines, as do most contentious issues in Kenya. Two main tribes, the Kikuyu and Luo, generally favor the constitution because their leaders are the country's president and the prime minister, who support the draft.

The Kalenjin group largely oppose the constitution because their main political leader, William Ruto, is against it.

The debate on the vote has been contentious—and sometimes violent. In June, two explosions ripped through an anticonstitution rally in a park outside downtown Nairobi, killing at least five people and wounding dozens more. Authorities haven't found the perpetrators.

Both the "yes" and "no" camps blamed each other for the blasts, heightening tensions between them.

Some Christian leaders also oppose the new constitution, criticizing its language on abortion and the Islamic courts. They say its provision allowing abortions where the mother's health is at risk is too permissive.

They also oppose the recognition of traditional Islamic courts that Kenya's Muslim minority use to resolve family and other civil matters.

The Muslim community—estimated at about 18% of the population—supports the draft.

WORLD NEWS

China's output growth cools down

BEIJING—China's manufacturing activity expanded at the slowest pace in 17 months in July, an official gauge showed Sunday, reflecting that tightening measures introduced earlier this year and growing uncertainty over global demand continued to weigh on the country's economic expansion.

China's official PMI, issued by the China Federation of Logistics and Purchasing and the National Bureau of Statistics, fell to 51.2 in July from 52.1 in June, the third straight month it has declined. The reading also was closer to the expansionary threshold of 50 than it had been in 17 months. A reading below 50 signals contraction.

Also, in a statement issued Sunday after a meeting to plan second-half economic policy, China's central bank said it would continue to implement the current "moderately loose" monetary policy while keeping a close eye on changes in the domestic and international situation, including the European debt crisis and monetary policies of major economies. China's economic policy will need to be "flexible" and "forward-looking," the central bank said.

Last week, the People's Bank of China had struck a confident note, saying that the country's current economic slowdown is beneficial for long-term sustainable growth, and that there is little risk of a "double-dip" recession.

Sunday's statement added to that view, signaling that the PBOC is unlikely to increase interest rates in the second half of the year, said Ting Lu, China economist of Bank of America Merrill Lynch.

Reuters

Workers make fuses at a dynamite-production line of a chemical plant in Huaibei, China, last month.

Economists said the decline in the widely watched purchasing managers' index also makes Beijing unlikely to take on any new aggressive tightening measures later this year as inflation pressures are expected to ease further.

"The Chinese economy is slowing down due mainly to the ongoing property-tightening measures, but the slowdown is clearly not as dire as some expected. We don't think the current situation warrants an all-out fight to rescue growth," said Mr. Lu.

With the outlook for developed economies increasingly murky, investors, executives and officials are closely watching indications of how China's economy will perform, because it has been the one consistent engine of growth in recent years.

China's economy is widely expected to surpass Japan's this year as the world's second-largest behind the U.S., based on market exchange rates. It came in slightly behind Japan last year.

In an interview published Friday, Yi Gang, a vice governor of People's Bank of China, mentioned briefly that "China actually is already the world's second-largest economy." But it wasn't clear what Mr. Yi based the statement on, and neither he nor the central bank elaborated.

China has long been larger than Japan based on purchasing-power-parity measures of their economies, but PPP isn't as widely used to rank economies as market exchange-rate comparisons. A decisive reading showing China surpassing Japan in annual gross domestic product isn't likely until early next year, although it's possible China's economy will be larger than Japan's during this year on a quarterly basis.

Despite the economic slowdown, the PBOC will keep continuity and stability of the monetary policy, and won't change the annual credit target of new yuan loans of 7.5 trillion yuan ($1.12 trillion) for 2010 while strictly implementing tight credit policies in buying property that were adopted earlier this year, according to a statement posted on the PBOC website.

The PMI data showed that China's new export orders grew last month from June but the growth slowed, while imports declined in July from June, signalling that exports and imports will continue to post lower annual growth in the coming months.

The new export-orders subindex in the PMI slipped to 51.2 in July from 51.7 in June and the imports subindex dropped to 49.3 from 50.4. China's customs is due to release July trade data Aug. 10.

Meanwhile, inflationary pressures likely continued to weaken last month as the input-prices subindex fell to 50.4 in July from 51.3 in June.

—Liu Li

Rising wages rattle China's small businesses

[The Outlook]

By Andrew Batson

ZHILI, China—The effects of China's rising wages and stronger currency are rippling through the close-knit group of textile and garment makers in this eastern town, and challenging the future of small-business success stories like it around the nation.

"We have to raise prices to cope with higher costs," says Fu Weimin, who runs one of the hundreds of small garment workshops in Zhili, where it seems nearly every business specializes in some part of the production of children's clothing. "Every year salaries go up."

Wages in China have been rising steadily for years, but pressure is now particularly strong as the rebound in the nation's economy runs up against the shrinking supply of younger workers caused by the one-child policy. Big foreign companies have felt the effects, with the local operations of **Toyota Motor** Corp. and **Honda Motor** Co. hit by strikes and **Hon Hai Precision Industry** Co., the world's biggest contract manufacturer of electronics, promising raises of at least 30%.

But the impact could be even more pronounced on China's more than 10 million small businesses, which account for 60% of the economy and 80% of jobs. Many small, light manufacturing businesses crowd together in highly specialized "clusters," particularly here in Zhejiang province on the eastern coast.

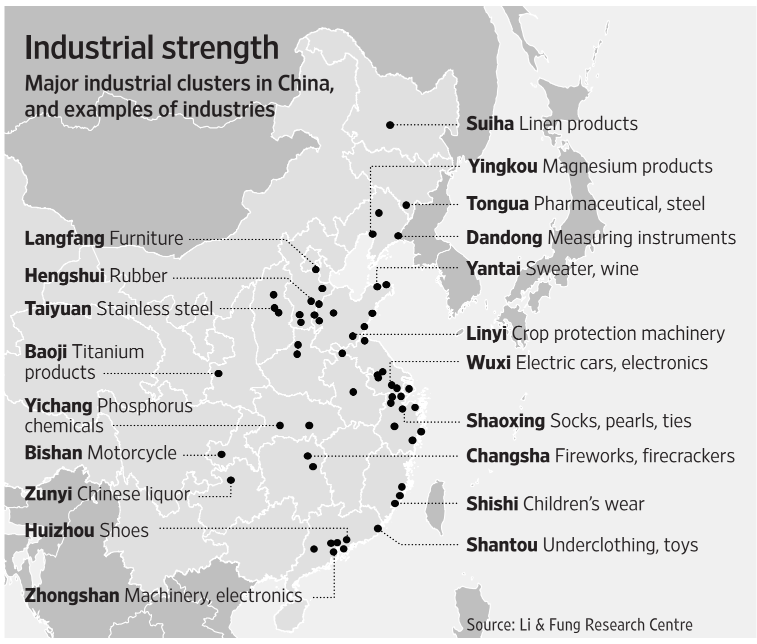
Huzhou, just down the road from Zhili, is noted for its bamboo products. The city of Wenzhou is famous for manufacturing a large share of the world's supply of cigarette lighters. What they all have in common is a reliance on the low-cost labor that is in increasingly short supply.

"The cluster-based model is labor-intensive. The real question is whether it can survive in the new environment of labor scarcity and higher labor costs," says Zhang Xiaobo, an economist at the International Food Policy Research Institute in Washington, who has researched the effect of clusters on rural development. "Right now is a critical transitional period. Some clusters will survive, some will collapse."

Since China relaxed its currency's peg to the dollar in mid-June, there is added uncertainty for those manufacturers who depend on export markets. The yuan is up by 0.75% against the dollar so far this year.

"If the currency appreciates 5% or 10% then we wouldn't be able to do this business anymore," as it would wipe out China's cost advantage, says Cindy Wu, sales manager of Da Wei Zipper Co. Such fears from businesses are a big reason China's government, despite outside pressure, is generally expected to limit the pace of its currency appreciation.

Banding together in tightly focused clusters has helped Chinese entrepreneurs overcome the hurdles to running a business in a state-dominated economy, says Mr. Zhang, the researcher. Start-up costs are lower, because each business can specialize in just one narrow segment. With production split up among many firms, each one can give credit to its customers and get credit from its suppliers, easing the burden of financing. And buyers like clusters because they can find everything they need in one place.



Zhili—the name could be translated as "Weavertown"—has focused on children's clothes since the late 1980s, when one local factory discovered they were more profitable than pillow covers. Imitators spread quickly, and as the town's reputation grew it attracted more clothing companies, creating a virtuous cycle. Today Zhili is a sprawl of low-slung buildings, a mix of family businesses in narrow alleys and larger factory complexes.

Li Qiang started out making children's clothes in his native Inner Mongolia, but moved to Zhili 11 years ago. Because traders all know Zhili, he can sell much more than he could back home. Plus, he says, the local government is helpful, and "people here are honest."

"What is holding us back now is finding enough workers," Mr. Li says. With rising raw material and labor costs eating into margins, he needs to increase his sales volume to keep up profits. But Mr. Li can't find enough skilled labor, even with wages that are already 40% higher than in other provinces. And it's hard to abandon Zhili's network and relocate to a cheaper province, particularly because it would require a big up-front investment.

To cope with the shortage of younger workers, many of Zhili's factories now recruit married couples in their 30s. Lin Yunjiang, general manager of Haodeli Garment Co., says almost all of his 240 workers are married couples. He has converted his employee housing from single-sex dormitories to individual apartments for couples.

Other entrepreneurs are trying to break out of the dependence on low-cost labor by investing more in capital equipment. "I figured out that a company's competitive advantage is in its technology," says Ye Ahua, who founded **Bestex Textile** Co. six years ago with his sons. He says he invested more than 20 million yuan in equipment for producing high-quality cotton cloth, when most local garment factories invest less than half a million. As a result, the factory needs only 70 workers.

For more entrepreneurs to follow in his footsteps they will need better access to financing than they have gotten from China's banking system, which favors big state-owned corporations. The government has promised to improve things, and says loans to small businesses are now growing faster than those to big ones.

INTERVIEW

Working to put companies of Europe in a better light

Chief of French employers' group Medef now wants to promote the interests of business across the EU

[Laurence Parisot]

By Carl Mortished

Laurence Parisot is a household name in France. In a recent poll by Sunday newspaper Journal du Dimanche, the boss of French employers' organization Medef featured alongside famous actresses as one of the country's most popular women.

Until recently, the job of running Medef was an attractive sinecure for a retired industrialist, but the diminutive Frenchwoman has broken the mold, using the Medef platform to make business politically sexy; no mean feat in France, where for decades it was a dirty word.

A friend and confidante of President Nicolas Sarkozy, whom she met at Sciences Po, the elite political-science school, Ms. Parisot has just been re-elected for a second five-year term at Medef. Now, she wants to go further and use Medef to promote the interests of business across Europe, and she is looking to the Confederation of British Industry in London, the BDI in Berlin and Confindustria, the Italian employers' lobby, to achieve that goal.

Ms. Parisot describes herself as a 'very strong feminist' and has promoted a new law, currently in France's Parliament, requiring that women make up 40% of the boards of leading companies.

"In September we will make some initiatives between employers' organizations between key European countries," she says.

Ms. Parisot acknowledges that bringing national business interests together will be difficult and will require compromise. Each country has its strengths and its challenges.

Britain's problem, she says, is its decision a decade ago to focus on financial services—a mono-industry, as she describes it—while France's Achilles' heel has been its slowness to bring about structural reforms.

"For Germany, the main problem is they are first in class and they are waiting for others to arrive at their level," she says.

Ms. Parisot wants EU governments to rally round European champions. For example, she says, "London is the City. As a French person I would prefer it to be Paris, but as a European, I really prefer that we keep the City in London than that some new regulations, such as Basel III, push all the financial people to Hong Kong or Singapore."

The Basel III reforms to banking regulation are a key concern for Ms. Parisot, who considers the tightened solvency rules a potential threat to the EU financial sector. The drive for tighter regulation is inspired in Washington, she says, even though the U.S. was slow to implement the Basel II rules.

"The danger comes from the U.S., and the impact on the cost of credit and volume of credit will be very significant. This is a very important competitiveness issue," she says.

Last week she co-wrote with CBI Director-General Richard Lambert and the boss of the BDI a joint letter to the British, French and German environment ministers, castigating them for their support for deeper cuts in carbon-dioxide emissions.

The letter came after Chris Huhne, the U.K. energy secretary, and his French and German counterparts, Jean-Louis Borloo and Norbert Röttgen, earlier in July called on the EU to raise its target for reducing greenhouse-gas emissions to 30% by 2020 from 20%.

"We were very upset," Ms. Parisot says. "We wrote a tough letter to these ministers. To reduce by 20% our CO2 by 2020 is a big step which costs a lot and which is quite harmful in competitiveness."

Ms. Parisot reckons Mr. Borloo's stance hasn't secured wide support within the French government, but Britain has set out its stall to be at the cutting edge of climate-change legislation. Ms. Parisot is worried climate change is one of many policy areas in which European business risks losing its competitive edge.

She also criticizes DG Competition, the EU's antitrust directorate, for being too focused on the internal market, thereby hindering European businesses keen to join forces in order to face global competitors.

"DG Competition is less harsh towards **Microsoft** when it seeks to establish itself in Europe than when two Europeans wish to grow together. I am in favor of competition but it must be on the right scale. The scale today is the planet, with powerful new forces being built in Brazil, India, Indonesia. We must raise the bar together."

Ms. Parisot wants European employers' organizations to find common ground for some projects, even in the area of industrial policy, a subject she describes as taboo in Britain. For example, she argues, Europe needs to coordinate its efforts in nuclear power.

"**Areva** and **Siemens** split. Siemens is looking towards Russia and Areva towards Japan. Isn't it crazy? We all know energy will be the most important thing for 20 years forward," she says.

Ms. Parisot insists she is not an interventionist, and she has a track record in France of being on the political right, an economic liberal, opposing subsidies and campaigning for economic reform. She is a businesswoman to the core, having inherited Parisot Group, her family's private furniture business. And with family backing, she bought 75% of Ifop, the French polling organization. In her first term at Medef she promoted key economic reforms, including raising France's state pension age by two years, and she recently forced the government to retreat on measures such as the imposition of a carbon tax and curbs on executive pay.

She also describes herself as a "very strong feminist" and has promoted a new law, currently in Parliament, requiring that women make up 40% of the boards of leading companies.

It is a reform that strikes a personal chord for Ms. Parisot. Aged 50 and unmarried, she says she has battled discrimination at every stage of her career, and she reckons the climate for French professional women has deteriorated over the past decade.

"I encountered misogyny every day, every morning. Sometimes you don't see it. Sometimes I didn't understand why I didn't get a contract," she says.

She believes Europe needs to harmonize. Even on taxes? Yes, she says, and that means bringing business leaders to the political table. In the past, progress in Europe depended on good relationships between the French president and the German chancellor. Today, she says it has become too complex for governments alone to form policy and do deals. There must be a compromise and business must be part of the deal.

"That is why I push my colleagues from CBI, from BDI and from Confindustria. If we think European competitiveness is an issue, we have part of the responsibility to move forward," she says, adding "If we continue [the way we are going], I am pretty sure we will be weaker and weaker. L'union fait la force. The potential if you put the U.K., France and Germany together. Can you imagine the potential that represents? If we don't react, China will swallow us. And India, too."

Carl Mortished is a writer based in London.

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Laurence Parisot is a household name in France