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Portugal's decade of austerity rewarded by a ratings slapdown

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THE WALL STREET JOURNAL.

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Internal debate heats up at Fed

By Jon Hilsenrath

Federal Reserve officials are at odds as they debate what actions the central bank might take if the U.S. economy falters or if today's inflation, already low, turns into deflation.

Fed policy makers still expect the economy to keep growing, but an updated forecast to be released Wednesday afternoon with the minutes of the Fed's late-June policy meeting, is likely to show that they have nudged down their projections for the second half of the year—as have many private forecasters.

Bank officials disagree on the risk of deflation. Some see it as a threat; others play it down as unlikely. For now, the Fed—and particularly its chairman, Ben Bernanke, who has the ultimate say—appears to be in wait-and-see mode as long as the recovery is intact. His colleagues also are divided on how the Fed should act to spur economic growth if the recovery stumbles. Many believe the options aren't very appealing.

Some policy makers, including Fed governor Kevin Warsh and Jeffrey Lacker, president of the Federal Reserve Bank of Richmond, Va., are reluctant to revive Fed purchases of U.S. government bonds or mortgage-backed securities, the most forceful action the bank could take.

Fed staff estimate that the purchase of $1.25 trillion in bonds in 2009 and early 2010 pushed down long-term interest rates by roughly half a percentage point. But some inside the bank don't believe the impact was that large and think a new round of purchases might have even less effect as markets are now on a more solid footing. Renewing the purchases would also mean the Fed has a bigger portfolio to shrink, when the time for that comes, and could backfire if it pushed expectations for future inflation sharply higher.

"We're a long way away from needing to think about starting up asset purchases," Mr. Lacker said in an interview. "The recovery will take time. We just have to be patient and manage it carefully. I don't think this is a time to shift gears again."

Other policy makers—among them Boston Fed President Eric Rosengren, New York Fed President Bill Dudley and, to a lesser extent, Atlanta Fed President Dennis Lockhart—see reviving the purchases as an option that needs to be kept alive, particularly if deflation becomes reality.

"Given the amount of substantial excess capacity that we have in the economy, there is some risk of further disinflation," Mr. Rosengren said in an interview late last week. "[T]he risk of deflation has gone up and is more of a risk than I would like to see at this point."

Inflation, excluding the volatile food and energy sectors, is running around 1%, below the Fed's informal objective of 1.5% to 2%.

The Fed's June meeting was a pivoting point for the central bank. During the first four months of the year, officials mostly discussed how best to unwind the extraordinary support the Fed gave the

Please turn to page 7

First ladies bring Africa to the Élysée Palace

Agence France-Presse/Getty Images

French first lady Carla Bruni-Sarkozy, center, joins the wives of 10 African leaders at the Élysée Palace in Paris, Tuesday. They are guests at France's national celebrations.

Afghan recruit kills 3 British troops

By Alan Cullison

KABUL—An Afghan army recruit killed three British soldiers and wounded four more at an outpost in Helmand province Tuesday, officials said, sowing fresh concerns about the reliability of Western-backed Afghan security forces.

An Afghan policeman shot to death five of his British trainers in Helmand eight months ago, as the British soldiers were drinking tea at an outpost. The U.S. lost two of its soldiers in Wardak province last year when their Afghan interpreter opened fire on them.

Afghan and coalition officials denounced the attack and insisted such events are comparatively rare in the joint operations that Afghan and coalition forces carry out within the country daily.

President Hamid Karzai quickly issued a letter offering his condolences to the British government. British Defense Secretary Liam Fox called the attack "a despicable and cowardly act." He added that coalition forces "are working shoulder to shoulder with Afghans and will continue to do so undeterred."

Officials say such attacks point out the complications of rapidly expanding the Afghan army and police, so that the North Atlantic Treaty Organization can draw down its forces in the country.

Afghan army and police commanders say their recruits, who now number 230,000, are underpaid and outgunned, but that by hurrying new recruits into their ranks it is hard to determine who is loyal.

Afghan officials said that at about 2 a.m. the Afghan soldier fired a rocket-propelled grenade into the command center of the outpost in Baba Jee, near the Helmand provincial capital of Lashkar Gah. The blast killed three soldiers from Britain's 1st Battalion Royal Gurkha Rifles, and wounded four, said a spokesman for the Afghan Ministry of Defense. The soldier then escaped.

The deaths in November of the five British soldiers prompted a bout of questioning from the British public and media about their country's role in Afghanistan.

On Tuesday, the government came out in force to defend its strategy. "This is not typical of what the Afghan National Army is now doing, and we mustn't let this change our strategy of building up that army, building up the Afghan police, making sure they can take care of their own security and then we can bring our troops home," said Prime Minister David Cameron.

—Alistair MacDonald contributed to this article.

Crash data clear Toyota electronics

An analysis of data recorders from **Toyota Motor** Corp. vehicles suggest that some drivers who said their cars surged out of control were flooring the accelerator when they meant to hit the brakes.

The findings by the U.S. National Highway Traffic Safety Administration support Toyota's position that sudden-acceleration reports involving its vehicles weren't caused by electronic glitches in computer-controlled throttle systems, as some safety advocates and plaintiffs' attorneys have alleged.

But the findings don't exonerate Toyota from two known issues blamed for sudden acceleration in its vehicles: sticky accelerator pedals and floor mats that can trap accelerator pedals to the floor.

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Free-marketeers should not despair

[Agenda]

By Iain Martin

The triumph of free-market capitalism and liberal democracy—that didn't last very long, did it? After the Cold War they were declared to have won a combined victory that would secure their dominance down the centuries. The end of history—or the end of an ideological struggle about what is the best form of governing arrangement —was proclaimed in an essay published by the political philosopher Francis Fukuyama in 1989. It was then followed by a book bearing a similar title. The argument entered the mainstream: muscular American-led Western capitalism underpinned by strong notions of freedom and democracy was the future.

And now, just two decades later? Free-marketeers appear to be in retreat and on the rise is the phenomenon known as "state capitalism." China, Russia, Saudi Arabia and a host of other smaller imitators are making the running while economic liberals suffer a collective crisis of confidence triggered by the financial crisis and its fallout.

Those countries practicing state capitalism are not democracies, or if they have some form of voting it is not democracy as known in the West. Their state-owned enterprises hoover up natural resources and with the vast profits governments construct state investment vehicles, or sovereign-wealth funds, that invest in global markets. They are, to varying degrees, hybrids—with just enough freedom allowed to enable a private sector to function, and flourish in China's case, but with strict limits that ensure the government gets what it wants.

And what these governments want most of all is to perpetuate and strengthen their own hold on power. This subject is at the heart of a fascinating book by Ian Bremmer, published this summer. In "The End of the Free Market—Who Wins the War Between States and Corporations?" Mr. Bremmer tracks this trend and closes with some suggestions about what free-marketeers might do about it. He recommends not closing the door on free trade, foreign investment or immigration. And obviously keep focused on China, which he argues is so much more likely to have to move in a more free-market direction than the U.S. is to copy elements of its model.

Reuters

Francis Fukuyama asks who wins the war between states and corporations.

In state capitalism, the dice are generally loaded against anarchic free-thinkers and innovators.

However, the omens for free-marketeers are not hugely promising. The financial crisis has made it difficult to get a hearing. The idea that untrammeled competition and wild speculation in the private sector with roots in the U.S. caused the crisis that started in 2007 and has still not fully played out, is firmly fixed in the popular imagination. Western politicians, who had loved the endless cheap-money policies they authorized when times were good, were keen to take as little blame as possible when the boom they had helped inflate went bust. So, they blamed banks and reckless free-marketeering alone.

And in their policy responses, Western governments resorted to such vast bail-outs of the financial sector and other industries that they almost nullified the case for proper free markets. The result, in significant swaths of banking in nations such as the U.K., has been the re-emergence of a kind of corporatism, in which those in charge of these business must worry as much about pleasing the government as they must try to please their customers.

Why should state capitalists listen when they are told, by the governments who did the opposite in a crisis, to maintain open markets and improve competition?

As Mr. Bremmer puts it: "If Washington must spend hundreds of billions to bail out American-style capitalism and if a majority of Americans tell pollsters they favor a substantial government-led overhaul of the country's health-care system and its energy policy, how can U.S. officials argue with a straight face that foreign governments should intervene less in their domestic economies?"

It is a good question. Still, free-marketeers should not despair entirely. They still have the best arguments.

What drives genuine innovation, and growth of the kind seen in recent decades with computerization, is competition that begins in the marketplace of ideas. The enlightenment concept that "my idea is better than your idea, and now I'm going to prove it in a process of rational exploration and development," is what enabled entrepreneurs such as Steve Jobs and Bill Gates to start on their own in garages and small offices with nothing but smart ideas.

In a state-capitalist set-up could they really have done the same? The government in such states naturally favors the large enterprises it controls because it uses them to dispense patronage. In state capitalism, the dice are generally loaded against anarchic free-thinkers and innovators. In contrast, intertwined with western capitalism is political, religious and intellectual freedom. This is not a coincidence: the latter created the conditions for the former to flourish.

The difficulty, and Mr. Bremmer refers to it, is who will make such arguments for free markets when they have been discredited by a combination of cheap-money fixated politicians and a financial sector that was in love with its own excesses?

European governments don't seem keen to do it, with their populations addicted to the welfarism, early retirement and expensive government intervention that crowds out growth-inducing enterprise. Much of business seems to suffer from a post-recessionary shyness too. A few think tanks are dusting these ideas down, but it will take more than that. These themes will need popular expression.

That will require a recalibration of capitalism—with lessons from the financial crisis learned—and the emergence of leaders in the U.S. and Europe prepared to make the case night and day, until they change the terms of debate, that free markets adequately regulated are the best place to look for widespread prosperity. Mr. Bremmer's book is a good starting point.

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'Investors will realize this isn't good for the economy and therefore isn't good for shares.'

Alen Mattich on the impact of overly easy European bank stress test criteria

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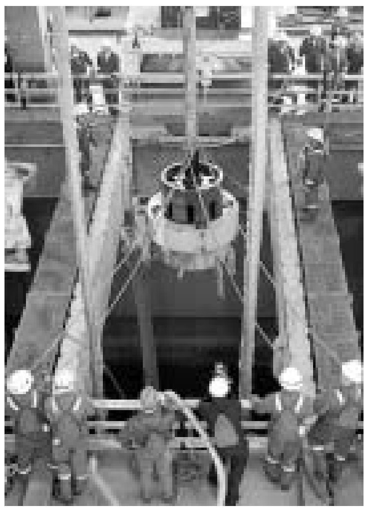

Follow the latest as BP continues to halt the oil spewing from its errant well at **europe.wsj.com**

Question of the day

Q: How will the Consumer Reports critical review of the iPhone 4 affect your purchasing decision?

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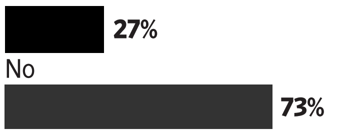

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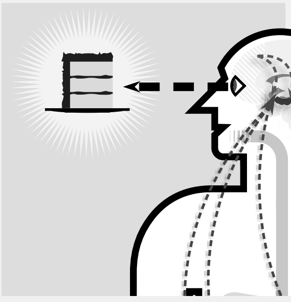

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NEWS

Italy nabs hundreds in mob sweep

By Gilles Castonguay

MILAN—Italian police captured the alleged boss of the 'Ndrangheta, along with more than 300 other suspects, in the biggest operation against the dangerous criminal organization in 15 years.

About 3,000 police officers conducted dawn raids in southern and northern Italy on Tuesday, seizing arms, explosives and some 60 million euros worth of property and other assets. The suspects, including Pino Neri, alleged head of the group's operations in the northern Lombardy region where Milan is located, face charges of arms and drug trafficking, murder and extortion, among other crimes.

Over the past decade, the 'Ndrangheta has managed to overtake the Sicilian Mafia and other criminal organizations as Italy's most deadly and financially powerful, generating billions of euros in revenue from drug trafficking. It is seen by investigators as tougher to fight because its members swear an oath of silence. Even its victims refuse to acknowledge its existence.

In recent years, the 'Ndrangheta has expanded, establishing bases in countries as far away as Canada and Australia. An agglomeration of cells, it has been difficult for authorities to decapitate.

Italian Prime Minister Silvio Berlusconi hailed the success of the move against the criminal organization, whose influence is felt in the political and economic life of the country. "We will continue the battle without rest to eradicate the weed," he said in a statement.

Interior Minister Roberto Maroni also was triumphant, saying in a statement that the operation "struck at the heart" of the 'Ndrangheta, based in the southern region of Calabria.

The sweep was the latest success for the Italian police, who in recent years have captured the bosses of the Mafia in Sicily and of the Camorra in Naples. The highlight of Tuesday's operation was the capture of Domenico Oppedisano, allegedly elected boss of the 'Ndrangheta by the organization's clans while attending a wedding in August 2009.

European Pressphoto Agency

Police capture alleged crime boss Domenico Oppedisano in Italy on Tuesday.

Mr. Oppedisano, said to be in his 80s, gave himself up without resistance when police raided his home at 4 a.m. in Rosarno, an agricultural town near the Tyrrhenian coast of Calabria, the head of a regional police force said.

At a news conference in Milan, Piero Grasso, the public prosecutor who oversees the fight against organized crime, said the recent investigation shows how the organization was more vertical in structure than previously suspected.

Public Prosecutor Ilda Boccassini, however, was reluctant to quantify the disruption that the arrests and seizures would have on 'Ndrangheta's operations. "We'll have to see what happens in the future," she said.

The organization invested in small- and medium-size businesses in sectors such as real estate and construction. It also worked to infiltrate local government in northern Italy. One of the suspects arrested was a public-health director in the town of Pavia, south of Milan, according to a news release.

Ms. Boccassini said at least 500 members of the organization worked in Milan and the surrounding area. "And there is bound to be more of them." Some of them had links to the free masons, she added.

One video showed a gathering of top 'Ndgrangheta bosses in Milan and voting, by a show of hands, to elect a boss to run the mob's operations in the northern city, the financial heart of the country.

Meetings were often held during special ceremonies such as baptisms and weddings. One was held at a center in Lombardy named after Giovanni Falcone and Paolo Borsellino, two famous public prosecutors killed by the Mafia in the 1990s.

—Davide Scigliuzzo in Milan and Margherita Stancati in Rome contributed to this article.

EUROPE NEWS

For Portugal, austerity's nothing new

BY BRIAN BLACKSTONE

BRAGA, Portugal—Indebted European countries from Greece and Italy to Spain have in recent weeks set off down a common path toward fiscal recovery, promising to slash spending and raise taxes.

One sobering scenario of what they may be up against comes from Europe's southwestern edge: Portugal, which embarked a decade ago on a similar journey of austerity, higher taxes and intermittent spending cuts, is still cutting—and still struggling.

On Tuesday, Moody's Investors Service cut Portugal's sovereign debt rating by two notches, to A1, citing the country's sluggish growth prospects and concerns that economic reforms in areas like labor markets won't bear fruit.

Moody's "remains concerned about the economy's medium-term growth potential," said Anthony Thomas, senior analyst at the rating agency, adding that Portugal's government debt, as a percentage of gross domestic product, has risen rapidly in the past two years.

The experience of Portugal—an early beneficiary of the euro zone's economic benefits and one of the earliest to experience the problems of being tied to a common currency—offers what some economists call a blueprint for what could be a long road to recovery for Spain, Greece and others.

"You have to be prepared that you are in for stagnant times," says Antonio de Sousa, who was Portugal's central banker in the late 1990s when the euro was created.

European Central Bank officials are optimistic that austerity is the right economic recipe for countries struggling to cope with the bursting of debt-fueled bubbles and a loss of competitiveness versus their larger peers to the north, like Germany. That contrasts with the prescription advocated by the U.S., of attempting to stimulate the economy with government spending.

"Fiscal consolidation and growth are not mutually exclusive," ECB President Jean-Claude Trichet said last week. "Prudent fiscal management provides the basis for balanced and sustainable growth."

Two decades ago, Portugal was regarded as an economic success. The country in the early and mid-1990s took steps to liberalize its economy, including an ambitious program of privatizing state companies, that led to rising wages and an investment-led boom.

Agence France-Presse/Getty Images

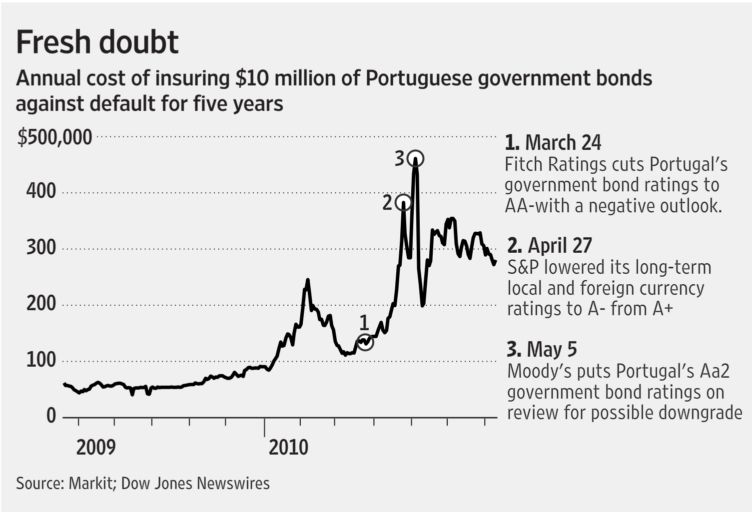
A worker marches against recent austerity measures during a union-organized protest last week in Lisbon.

Membership in the euro was expected to build on those gains by giving Portugal a stable currency, low interest rates and unfettered access to one of the world's largest trade zones. The country's booming economy left it in good shape to meet the common-currency zone annual budget deficit limit of no more than 3% of GDP.

But Portugal's boom contained the seeds of its own destruction. The rise in government tax revenue removed the urgency for unpopular spending cuts and economic liberalization. The government added workers, costs that would be hard to trim later.

Meanwhile, after Portugal adopted the euro in 1999, its dominant textiles industry wasn't able to use cheaper loans and a large common market to build a foundation for longer-term growth. Portugal's textiles were too expensive to compete with cheaper goods from China, but also lacked the high-fashion credentials of those from France or Italy.

Portugal's deficit soon exceeded the zone's limit. In 2002 it became the first member to be slapped with an excessive-deficit warning.



At a time when Spain, Ireland and Greece were sailing through the early years of the euro on housing bubbles and debt-fueled spending, Portugal began to retrench.

Lisbon went through modest austerity drives every few years beginning in the early 2000s. These included civil-service wage freezes and increases in value-added taxes that further weighed on the economy. Lisbon also pushed through pension changes, including greater penalties for early retirement.

Many economists say the cuts haven't gone far enough.

Government spending still accounts for more than half of Portugal's GDP. Portugal's budget deficit last year, at 9.4% of GDP, is lower than those of Greece, Ireland or Spain, but still more than three times as high as euro-zone rules permit.

At the same time, its economy has remained tepid: Portugal's growth rate, around 5% annually in the late 1990s, has averaged 0.8% since 2001, putting it near the bottom of the euro zone.

The country is showing signs of clawing its way out of a debt and recession spiral. Its GDP grew more than 4%, at an annualized rate, during the first quarter, thanks to gains in exports and domestic spending. Bank lending to business and households is growing.

The government is trying a more aggressive deficit-cutting plan than in the past, including higher value-added taxes and a high-wage surcharge aimed at bringing its deficit down to 7.3% this year.

But critics of Europe's approach say cutting spending and raising taxes won't be enough to save peripheral economies that lag the zone's economic engine, Germany, in innovation and productivity. They say these countries must undertake deep structural reforms in areas like labor markets and taxation.

Many business leaders in the industrial north say Portugal's future depends on the government's will to further liberalize the economy. The north is home to 80% of Portugal's approximately 7,000 textile-related companies, and has been hard hit by the industry's decline. Nationally, textile-related employment fell more than 25% from 2003 to 2009, to just over 160,000 workers.

"We face a very difficult moment and are probably going to face an even worse moment for the next decade," says Paulo Vaz, head of the textile association, known as ATP.

To adjust, some companies have focused on marketing, service and innovation, with an emphasis on exporting to fast-growing countries like Brazil, to which Portugal has cultural ties. While investments once flowed primarily from Portugal to Brazil, now it's going both ways.

But such changes will take many more years to fundamentally change Portugal's €163 billion ($205 billion) economy, and Lisbon's latest austerity drive could start to bite later this year, economists warn.

Portugal's central bank on Tuesday raised its growth forecast for 2010 but cut its 2011 forecast to 0.2% from 0.8%, citing deficit-reduction efforts and an ailing labor market.

"If Portugal is a blueprint, we have to look for several years of underperformance in Spain," says Ralph Solveen, economist at Commerzbank.

EU bailout fund moves closer to operating

BY NINA KOEPPEN AND WILLIAM HOROBIN

Plans moved ahead Tuesday to shore up confidence in the financial health of the euro zone's shaky governments and banks, as the head of a new bailout fund said it would be operational by the end of July and finance ministers agreed to publish the results of Europe-wide bank stress tests on July 23.

Klaus Regling, the head of the European Financial Stability Facility, a €440 billion ($553.56 billion) fund set up by the 16 euro-zone governments to bail out fellow governments facing financing troubles, said the improving financial-market climate meant the fund probably wouldn't be used. "At the moment, it is unlikely that any money will be needed. Markets are improving and the focus is shifting away from Europe," he said in an interview with The Wall Street Journal.

But he said cash from the fund, which will raise money in bond markets against the guarantees of other euro-zone governments, could be used by governments to provide capital for struggling banks.

"What a government does with the money is, in a way, up to the country. It will of course be discussed during the negotiations that precede any disbursement. If a country faces particular needs in the banking sector, it may well decide that a certain share of the money goes to the banking sector," he said. This had already happened in the case of Greece, he said.

Mr. Regling, who said the facility would be operational by the end of the month, estimated that it would take "three to four weeks" to deliver up finance after a government made a request for help. The German Debt Office, which issues German government bonds, would issue the bonds on behalf of the EFSF, he said. He expressed confidence that the facility would secure a top triple-A rating, even though its claims on government borrowers would rank alongside the rest of their sovereign bonds.

"It will have the same standing as any other sovereign claim on the country....That's really to protect the debtor country, because if there are too many preferred creditors, then private creditors would be reluctant to lend anything to the country concerned," he said.

Confidence grew Tuesday that the fund wouldn't be held up by objections from the new government in Slovakia, which will provide as much as €4.37 billion in guarantees for the facility. "I am confident that Slovakia will consent to the EFSF. Slovakia has a share of 1% in the capital of the EFSF and it is unthinkable that 1% can stop the other 99%," Mr. Regling said.

On a visit to Brussels, new Slovak Prime Minister Iveta Radicova hinted that Slovakia wouldn't block the fund, suggesting its hands had been tied by the previous government. Slovakia's signing of the EFSF "is a formal act whose commitment has been given by the previous government," she said, adding that decisions to activate the fund will require unanimity.

Turkey says it is still seeking Israeli apology over flotilla

Turkey on Tuesday welcomed Israel's finding that its military made tactical and intelligence-gathering errors when boarding a Turkish-owned aid ship bound for Gaza but said the admission wasn't enough to restore relations.

*By **Marc Champion** in Istanbul and **David Crawford** in Berlin*

Turkey is demanding that Israel apologize for the incident, in which Israeli commandos shot and killed nine aid activists aboard the ship May 31, threatening that it might otherwise sever ties. On Tuesday, Turkish Foreign Minister Ahmet Davutoglu called for action from Israel to match its words.

"Admitting to mistakes is very positive," Mr. Davutoglu told reporters at a news conference in Istanbul, commenting on Monday's findings in a report by the Israeli Defense Force. But he added: "In international waters, a civilian ship was attacked. This was not a mistake—it was an offense, a crime."

Meanwhile in Germany, the chairman of a banned Islamic charity that shares initials and roots with the IHH, the Turkish group that was at the heart of the Gaza incident, said the German government acted illegally in seizing its assets and shutting it down.

Germany's interior ministry shut down the Internationalen Humanitären Hilfsorganisation e.V, or IHH, on Monday. The order, reviewed by The Wall Street Journal, said the group had since 2006 sent about €7 million ($8.8 million) to six organizations controlled by the Palestinian group Hamas. The German IHH sent the money via couriers, avoiding bank transfers, according to a German intelligence official.

Mustafa Yoldas, the German IHH chairman, said the ban was "unjust" and "macabre." He said the order was preventing the German IHH from providing humanitarian aid to people living in the Gaza Strip, a region ruled by a Hamas-led government.

Israel and the U.S. have designated Hamas as a terrorist organization. In 2004 a German high court ruled that charities may not support violence or intolerance. In its ban order, the German interior ministry said charities may not differentiate between the civilian and military branches of a terrorist organization. Mr. Yoldas said he plans legal action seeking to lift the ban.

Huseyin Oruc, an executive board member of the IHH in Turkey said in an interview Tuesday that his group hadn't provided funds to any of the groups listed in the German ban order. He said the IHH was careful not to fund Hamas because it was a political party, and that the IHH doesn't fund political parties. Mr. Oruc also said there were no links between the German and Turkish aid groups.

Mr. Davutoglu repeated Ankara's demand for an international investigation of the Gaza incident, which Israel has refused. The report by the Israeli Defense Force, found that senior military officials made mistakes but that the commandos acted properly, shooting only in self-defense.

—Erkan Oz in Istanbul contributed to this article.

Spy probe unearths 12th suspect

BY EVAN PÉREZ

WASHINGTON—Authorities detained a 12th, previously undisclosed person implicated in the federal probe that busted a Cold War-style Russian spy ring, according to a U.S. official familiar with the matter.

The U.S. Federal Bureau of Investigation has been tracking the 23-year-old Russian man since the fall, when his name surfaced in a decade-long espionage investigation, the official said.

Prosecutors in the Manhattan U.S. Attorney's Office last month charged 11 people with being agents of Russia's SVR foreign intelligence agency. Ten in U.S. custody entered plea deals on Thursday as part of a diplomatic agreement to swap them for four people held by Russia, most on charges of spying for Western intelligence agencies.

It is unclear what drew investigators' interest in the 12th man, but FBI agents began monitoring him shortly after he entered the U.S. in October 2009, the official said.

The man, whose name couldn't be learned, obtained a U.S. visa in August 2009, the official said.

However, investigators weren't able to gather enough evidence against him to bring charges and came to believe his case was different from that of the others who ended up being charged in the spy ring, the U.S. official said. It isn't clear whether he had the training of the others arrested.

Instead of being charged, the man was in federal custody Monday and was expected to be deported Tuesday, the U.S. official said. His location wasn't disclosed.

U.S. officials canceled the man's visa June 26. A day later, FBI agents rounded up 10 of the 11 members of the spy ring who were in the U.S. The 11th person jumped bail in Cyprus after he was arrested there.

The revelation comes on the heels of a historic prisoner swap carried out Friday on the tarmac of the Vienna airport. The U.S. turned over the 10 Russian undercover agents it had arrested, while Russia exchanged four prisoners it held. The swap marked a quick end to an embarrassing episode that threatened to set back improving U.S.-Russian ties.

The 10 long-term Russian agents arrested pleaded guilty last week to federal charges of conspiring to act as illegal foreign agents and agreed to be expelled from the country.

Since the Vienna swap, the 14 agents involved have remained out of public view in Russia, the U.S. and the U.K., where two of the prisoners held by Russia chose to go. All the agents are expected to undergo lengthy debriefing by intelligence officials before being allowed to move freely.

U.S. authorities said the minor children of the 10 arrested by the U.S. have been sent to Russia to join their parents.

Meanwhile, the U.K. government Tuesday revoked the British citizenship of Anna Chapman, one of the 10 agents in the swap. Ms. Chapman spent several years in the U.K. after marrying British-born Alex Chapman in 2002. After the pair split in 2005, Ms. Chapman continued to live and work in London before returning to Moscow and ultimately moving to New York.

As the spy saga unfolded, she received much publicity when photos of her, including some in which she was partially undressed, appeared in U.K. newspapers. After the swap, there was speculation she would try to return to the U.K.

The U.K.'s home secretary signed an order Tuesday to remove Ms. Chapman's British citizenship, effective immediately, according to the U.K. Home Office.

"The home secretary has the right to deprive dual nationals of their British citizenship and, once deprived, to exclude them from the U.K. where [the home secretary] considers that to do so would be conducive to the public good," a Home Office spokesman said.

The Manhattan U.S. Attorney's Office, which prosecuted the case of the spy ring, alleged that the agents were part of a program run by Russian intelligence.

—Cassell Bryan-Low contributed to this article.

Associated Press

This courtroom sketch shows the 10 Russian agents who pleaded guilty in U.S. federal court on Thursday.

Agence France-Presse/Getty Images

Vans carrying the deported Russian agents leave a Moscow airport Friday after the historic swap with the U.S.

Klaus swears in new Czech government

Associated Press

PRAGUE—Czech President Vaclav Klaus on Tuesday swore in the reform-minded government of Prime Minister Petr Necas, ending the country's longest period without a proper cabinet.

Following May's parliamentary elections, Mr. Necas's conservative Civic Democratic Party and two new parties—the conservative TOP 09 and the centrist Public Affairs—agreed to form a center-right coalition that would hold 118 seats in Parliament's 200-seat lower chamber.

The coalition wants to carry out fundamental overhauls, including revamping pension and health-care systems, reducing the deficit and the country's debt, and fighting corruption. The coalition has also proposed cuts in social benefits and tuition charges at universities.

"I want to assure you and the public that this will a hard-working government," Mr. Necas told Mr. Klaus. His coalition must seek a confidence vote in Parliament within 30 days.

The Czech Republic has been run by a caretaker government since a three-party coalition led by the Civic Democrats lost a confidence vote in March 2009 days before U.S. President Barack Obama's visit to Prague and in the middle of the Czech EU presidency.

The caretaker cabinet had no mandate to carry on fundamental reforms analysts say the country needs soon.

The Czech export-oriented economy contracted 4.2% last year due to the global economic downturn, and the European Union predicts Czech growth of 1.6% this year.

Karel Schwarzenberg, chairman of the TOP 09 party, becomes the foreign minister. He also held that post in the previous government of Prime Minister Mirek Topolanek.

His deputy chairman, Miloslav Kalousek takes over the finance ministry again.

Alexandr Vondra, a former deputy Czech prime minister and one-time ambassador to the U.S., is the defense minister.

France moves closer to burqa ban

By David Gauthier-Villars

PARIS—France's National Assembly nearly unanimously approved banning the burqa—a full-body robe worn by some Muslim women—with legislation that makes no mention of the head-to-toe veil.

France's bill, which passed Tuesday and is slated to be taken up by the Senate in September, makes no reference to Islam and doesn't single out the burqa. Rather, it forbids concealing the face in public—with numerous exceptions, including motorcycle riders, riot police, surgeons, metal welders and individuals wearing costumes.

The burqa, which is worn by about 2,000 women among France's 65 million people, is seen by many as an affront to French republican values. Religious expression in public life is frowned on as divisive. The burqa is "a sign of enslavement and debasement," according to President Nicolas Sarkozy.

However, the same republican values make outlawing the burqa tricky. Before Mr. Sarkozy's government submitted the bill to lawmakers, France's highest administrative court, the Conseil d'Etat, said an outright ban on burqas might not be compatible with the country's "international commitments on human rights." In a recent report, the Council of Europe, the European authority on human rights, advised member countries to refrain from burqa bans, saying they would crimp individual rights.

The 335-to-one vote on Tuesday came as several European countries are seeking ways to confine what they perceive as an expansion of radical Islam. Belgium and Spain are discussing measures to outlaw the burqa. A referendum last year in Switzerland banned the construction of minarets.

In France, the drive to prohibit burqas was launched in 2009 by André Gerin, a French Communist lawmaker and mayor of Vénissieux, near Lyon.

France already has rules separating state and religion, including a 2004 law banning head scarves, crosses, and other religious symbols or dress from public schools and government buildings.

Mr. Gerin says the full-body robe isn't a religious symbol but rather a tool used by extremists "to test our civilization." The lawmaker and other opponents of the burqa said a new law was necessary to "liberate" the women in France who wear the garment.

Some Muslim lobbying groups urged the French Parliament not to outlaw the burqa, saying such a prohibition would stigmatize France's Muslim community, which is the largest in Europe. These groups say they wish to create a French version of Islam that is compatible with the nation's secular values and dominant Catholic heritage.

A national debate the French government initiated last year on what it means to be French sparked irritation among Muslims "because we were portrayed as scapegoats," says Mohamed Bechari, president of the National Federation of France's Muslims, an advocacy group.

Reuters

Lawmakers in France's National Assembly voted to forbid concealing faces in public, not mentioning Islam.

Woerth will step down as party treasurer

By David Gauthier-Villars
And Christina Passariello

PARIS—French Labor Minister Eric Woerth said he will step down as treasurer of the ruling political party, amid conflict-of-interest allegations that have roiled President Nicolas Sarkozy and his government.

Mr. Woerth's planned resignation comes a day after Mr. Sarkozy advised his minister to give up his fund-raising post for the center-right UMP party.

Mr. Sarkozy said he wants Mr. Woerth to focus solely on overhauling France's debt-laden pension system, which the president has called a key mission. Mr. Woerth has said he has no plans to step down as labor minister.

As he left a cabinet meeting, Mr. Woerth said he "will look at the calendar" to determine a date to resign. A party spokeswoman said Mr. Woerth will step down as treasurer at the end of July.

The move is meant to ease concerns raised by the opposition Socialist Party that Mr. Woerth's ministerial and fund-raising duties are incompatible. Mr. Woerth became labor minister in March, after serving as budget minister since President Sarkozy took office in May 2007. Throughout, he also has been the chief fund raiser of the UMP.

Mr. Sarkozy is hoping to stem criticism of his labor minister until a planned government shuffle in October—after lawmakers vote on Mr. Woerth's pension plan. Mr. Sarkozy's party holds a majority of seats in parliament.

But Tuesday's announcement may not be enough to close a chapter that has affected French politics and public opinion.

"We will maintain pressure on the government," Socialist lawmaker Jean-Marc Ayrault told French television on Tuesday. "We won't let this case go away."

Earlier in Mr. Sarkozy's administration, Mr. Woerth drew criticism from political foes for serving as budget minister and UMP treasurer simultaneously.

As budget minister, he cracked down on tax dodgers, while as party treasurer, he was responsible for seeking political donations from France's biggest fortunes.

The conflict-of-interest allegations resurfaced in the past month because of Mr. Woerth's ties to France's richest woman, Liliane Bettencourt, who is heiress to the **L'Oréal** cosmetics empire.

What has become known as "the Bettencourt affair" began as a family dispute. Three years ago, Ms. Bettencourt's only child, Françoise Bettencourt-Meyers, filed a complaint against a friend of her mother, saying he exploited Ms. Bettencourt's mental weakness to obtain lavish gifts.

The matter took a political turn when Ms. Bettencourt-Meyers, in legal filings, cited recordings of conversations between Ms. Bettencourt and her financial adviser. In the conversations—secretly recorded by a former butler of Ms. Bettencourt—her adviser, Patrice de Maistre, alludes to fiscal fraud and talks about making donations to Mr. Woerth and other UMP politicians.

Ms. Bettencourt has said her contributions to UMP were within legal limits. Mr. Woerth has said the UMP received only legal donations.

Mr. Sarkozy, in a television interview Monday, dismissed the allegations as "shameful" and expressed his support for Mr. Woerth.

European Pressphoto Agency

Nicolas Sarkozy, left, and Eric Woerth in April at the Finance Ministry.

U.K. says job losses in public sector will worsen

By Laurence Norman

LONDON—The Office for Budget Responsibility released numbers Tuesday suggesting last month's emergency budget would result in much greater public-sector job losses than originally reported.

The move came after days of controversy over whether the fiscal council, which is supposed to be politically neutral, had tarnished its independence by releasing a previous assessment of public-sector job losses that suggested the impact of the new government's austerity measures would be much smaller.

The new assessment of public-sector job losses is a blow for the government, which had leapt on the OBR's previous figures to suggest the impact of its austerity measures would be modest.

The development comes amid a backdrop of gloom about the British economy and the overall job picture. U.K. consumers became more pessimistic about the outlook for the economy and the job market ahead of the government's June 22 emergency budget, according to a monthly survey conducted by the Nationwide Building Society. The lender's overall measure of consumer confidence fell to 63 from 66 in May.

Nationwide found that 27% of the 1,000 consumers surveyed from May 24 to June 20 expected the economic situation to be better in six months' time than now, down from 30% in May, while 24% expect it to be worse, up from 22%.

Treasury chief George Osborne has said that by taking early action to pare the U.K.'s mammoth £155 billion ($233 billion) budget deficit, the new government would lift confidence and propel a private-sector recovery that would more than offset public-sector job losses. Mr. Osborne on Tuesday received backing for his plans from European Council finance ministers and the Organization for Economic Cooperation and Development.

On Tuesday, the OBR said Mr. Osborne's austerity measures would reduce public-sector payrolls by an additional 160,000 by the 2014-15 financial year compared with the plans the previous Labour government set out in its March budget. That compares with about 30,000 extra public-sector job losses that the OBR had pointed to in a release on June 30.

The OBR said Tuesday that there was a difference between the two sets of numbers because in its previous calculation, the office hadn't factored into its analysis of Labour's March budget's impact on public-sector jobs new assumptions about lower public-sector costs.

The OBR did say in its June 30 release it had made methodological changes in calculating the impact of the new government's austerity budget on public-sector jobs. But it didn't spell out how big a difference those changed assumptions would have on estimates of job losses.

OBR Chairman Alan Budd said he regretted the damage done to the OBR's reputation by the controversy and regretted not spelling out more clearly the impact of the changed assumptions.

—Paul Hannon contributed to this article.

BP hits turning point as it nears test of cap

BY GUY CHAZAN

BP PLC may finally be reaching a turning point in the Gulf of Mexico oil crisis, as it prepared to test a newly installed containment cap that could stop the flow of oil from its blown-out well for the first time since the Deepwater Horizon rig sank nearly three months ago.

BP shares rose 2.9% to 410.35 pence in London Tuesday, buoyed by rising optimism about the company's latest attempt to stanch the leak and relief that the finale of the Gulf oil disaster may be in sight. BP's stock has risen some 35% since hitting a 14-year low June 29.

Company engineers were due to begin pressure tests on the new custom-built cap late Tuesday, gradually closing its valves to shut down the flow of oil. If the results are encouraging, they may soon be able to cap the gusher that has been spewing as much as 60,000 barrels a day into the Gulf and has defied BP's best efforts to contain it.

But the company stressed the new system has never been deployed at such depths before and its success could not be ensured. Officials insist a relief well, which is still weeks away from completion, is still the only way to permanently plug the leak.

Success at halting the oil could ease some pressure on BP over its handling of a spill that has devastated fishing and tourism along the Gulf Coast and thrown the U.S. offshore drilling industry into chaos.

The company has so far spent $3.5 billion on the cleanup, and last month gave in to White House demands to set aside $20 billion in a special fund to compensate victims. The Obama administration handed the U.K. oil major a new bill of $99.7 million Tuesday.

BP was dealt a fresh blow Tuesday when Japan's Mitsui Oil Exploration Co. Ltd, one of the co-owners of the blown-out well, said it would be withholding payment for its share of costs related to the spill. The other co-owner, **Anadarko Petroleum** Corp., made a similar statement last week, after describing BP's behavior before the blowout as "reckless." BP said it was "disappointed" by the Mitsui move.

The most important part of the new sealing mechanism—a "capping stack"—was specially designed and fabricated from scratch at a facility in Berwick, La., owned by **Cameron International** Corp., and underwent rigorous testing on land before being deployed to the mile-deep well.

The stack, which weighs 75 tons, contains large hydraulic rams or valves like those used in blowout preventers—the piece of equipment that sits on top of a well and controls unexpected surges of oil or gas.

The pressure test is designed to check the integrity of the leaking well, with high-pressure readings indicating the wellbore is intact, despite the April 20 blowout which triggered the spill, and strong enough to be shut in indefinitely. Low pressure would suggest oil is leaking out the sides into the seabed, and could breach through the seafloor. In that case, BP will likely abandon the test and open up the well again.

"If the test confirms high pressure...the well can remain shut in and there'll be no leakage into the sea," said Kent Wells, BP's senior vice president of exploration and production. "We hope and pray that we see high pressures here."

Even if the pressure is low, however, BP will still be able to continue collecting the leaking oil and piping it up to a fleet of ships on the surface. BP should have the ability to capture up to 80,000 barrels per day of oil by the weekend, according to Coast Guard Adm. Thad Allen, who is leading the U.S. government's response to the spill.

If the cap doesn't capture all the oil, installing it was a necessary step to prepare for an expected busy hurricane season. The new cap can allow containment vessels to more quickly disconnect from the system and flee a storm.

While the company tests the well, it continued its collection efforts. As of Tuesday morning, a vessel called the Q4000 had collected 7,291 barrels of oil in the previous 24 hours, while the Helix Producer ship collected 1,011 barrels, a spokeswoman for the company said.

The Helix Producer ship has the ability to collect up to 25,000 barrels of oil a day.

—Susan Daker contributed to this article.

European Pressphoto Agency

Workers search for oil stains Tuesday on the beach in Pass Christian, Miss.

Federal Reserve officials are split over what to do if economy falters

Continued from first page

economy during the downturn. But in June they began considering what they might do if the economic outlook worsens. There are several developments giving them pause, including Europe's fiscal woes and increasing strains on U.S. state and local governments. Financial conditions have tightened since the beginning of the year, though recent stock-market gains are likely to hearten Fed officials.

"This is a time to be patient with policy and to see how the economy evolves," Mr. Lockhart said in a recent interview. "This little halting period that we're in now simply brings home the point that economies can go in two directions and we should be considering what we would do under various scenarios."

Private forecasters believe the Fed should sit tight, according to a new Wall Street Journal survey, in which only eight of 53 analysts said the Fed should do more now to spur growth.

The debate on further help for the economy will be in the spotlight for the next few days. On Thursday, a Senate committee will question President Barack Obama's nominees for the Fed board: Janet Yellen, president of the San Francisco Fed; Peter Diamond, a Massachusetts Institute of Technology economist; and Sarah Bloom Raskin, Maryland's bank regulator. Next week, Mr. Bernanke delivers the Fed's semi-annual update to Congress.

In public comments, Mr. Bernanke has played down the risk of a double-dip recession. But he has been keeping his options open. The Fed is better equipped to solve some economic problems than others. As Mr. Bernanke noted in a now-famous 2002 speech, the Fed has the power to fight deflation—or falling wages and prices—by printing money. But the bank's tools are less suited to reducing unemployment, which is influenced by factors ranging from fiscal policy to regulation to global demand.

In public comments, Fed chief Bernanke has played down the risk of a double-dip recession. But he has been keeping his options open.

Besides reviving its bond purchases, the Fed could take less aggressive action, but these steps also have drawbacks. The Fed currently isn't reinvesting the cash it receives when mortgage-backed securities mature or underlying loans are paid off. It could use the cash to buy new mortgage-backed securities, a signal of its intention to support growth. With mortgage rates already very low, however, it isn't likely this would have a big impact.

The Fed, which has promised to keep short-term rates low for an "extended period," could strengthen that commitment in order to encourage investors to borrow and take risks. But several officials are uncomfortable with the language as it is, including Kansas City Fed President Thomas Hoenig, who has voted to remove it. Moreover, it's not clear the Fed could say much beyond what markets already anticipate. Financial markets and forecasters expect the Fed to keep its key short-term interest rate near zero well into 2011.

The Fed also could push short-term interest rates lower than the current target for the federal funds rate—the rate at which banks lend to each other overnight. That now sits a little below 0.2%. By eliminating the 0.25% that the Fed pays banks that leave money on deposit with the central bank, the Fed could push the fed funds rate to zero. But that could disrupt the money-market industry—a cause for hesitation among some Fed officials.

U.S. trade deficit jumps to widest level since '08

BY CONOR DOUGHERTY AND TOM BARKLEY

The U.S. trade deficit hit its widest level in a year and a half, as increased imports from China more than offset growth in exports, an imbalance that is weighing on the tepid economic recovery.

The U.S. trade deficit, the difference between exports and imports, increased 4.8% to $42.3 billion in May, the Commerce Department said Tuesday. That was the widest since November 2008. April's trade gap was revised upward from earlier estimates.

U.S. exports grew 2.4% to a 20-month high of $152.3 billion. Imports grew faster, expanding 2.9% to $194.5 billion. The U.S. trade deficit with China expanded to $22.3 billion in May, the widest level since October and 15% larger than the previous month. Imports expanded by $3.1 billion, far outpacing a $162 million gain in exports.

Oil imports declined in the month, but that was more than offset by increased shipments of cars, computers and apparel. U.S. producers exported more cars, industrial machines and household goods.

The wider-than-anticipated trade deficit for May prompted several economists to downgrade their estimates for second-quarter economic growth. Economists at **J.P. Morgan Chase** & Co. lowered their forecast to 2.5% from 3.2%. St. Louis forecasters **Macroeconomic Advisers** lowered theirs by 0.8 percentage point to 2.4%.

Still, import growth is a sign of stronger demand from U.S. consumers and companies. If that demand holds up, it could translate to better economic growth down the line. "The demand is there," said Ben Herzon, senior economist at Macroeconomic Advisers. "We just need to shift that demand to domestic producers."

Separately, the National Federation of Independent Business said its small business optimism index fell 3.2 points to a seasonally adjusted 89 in June. The index has gained ground since its recession low of 81 recorded in March 2009, but in the past several months has stalled around 90, still weak by historical standards.

Owners expect poorer business conditions and lackluster sales in the six months ahead.

Another report Tuesday, from the Labor Department, showed there are scant jobs for the nation's 15 million unemployed. The Job Openings and Labor Turnover survey showed 4.67 job openings for every unemployed person in May, up slightly from a month earlier. The May reading was much better than May 2009, when there were 5.84 unemployed for each job, but was still indicative of a very weak job market.

WORLD NEWS

Japan's women mark more firsts

Despite new work-force milestones, females employees still face a gap in gender equality

By Mariko Sanchanta

TOKYO—The past month has seen a flurry of female firsts in Japan. The Bank of Japan this week appointed its first female branch manager in its 128-year history. **Japan Airlines** Corp. announced its first female pilot captain. **East Japan Railway** now has female station masters in Tokyo for the first time.

Meanwhile, Renho, the mono-monickered member of Parliament, garnered a record 1.7 million votes in Sunday's upper-house elections. The telegenic 42-year-old former model was the only candidate in the country to receive more than a million votes, even as her Democratic Party of Japan was getting crushed elsewhere. Her re-election cements her standing as one of the most popular politicians in Japan.

These recent developments would indicate a wave of girl power is sweeping the country. But the reality lags behind the headlines. The advancement and promotion of women in the world's second-largest economy is debatable, and by some measures, has worsened in recent years.

In a survey that measured progress in bridging the gender gap in areas such as politics, education, economy and health, the World Economic Forum last year ranked Japan at 101 out of 134 countries. More than two-thirds of the countries covered in the report have posted gains in their scores since 2006. Japan has slipped in the rankings every year, sliding back from its 80th spot in 2006.

"Women's participation in the labor force is not so low, but it's an M-shaped curve that dips when women hit their thirties and have children," said Masaaki Kanno, chief economist at **JP Morgan** in Tokyo. "When they come back to work, they are not likely to be promoted and there is also a lack of child-care facilities in Japan, which makes it difficult."

In listed Japanese companies, women made up just 1.2% of senior executives last year, according to a survey by business publisher Toyo Keizai. In comparison, in the U.S., women held 13.5% of executive-officer positions in Fortune 500 companies in 2009, according to a survey by **Catalyst** Inc, a nonprofit organization that focuses on women in the workplace.

The reasons for the dearth of high-profile women are myriad and complex. Japan suffers from tepid economic growth, draconian immigration policies and a shrinking population. The country lacks infrastructure and support for women with children, including accessible child care. A series of laws have aimed to facilitate the advancement of women in the workplace—including the Equal Employment Opportunity Law passed in 1986 and the Child Care Leave Law in 1992—but critics say enforcement is weak. Also, women in this predominantly patriarchal society are traditionally meant to be demure and so have few female role models.

Gender gap

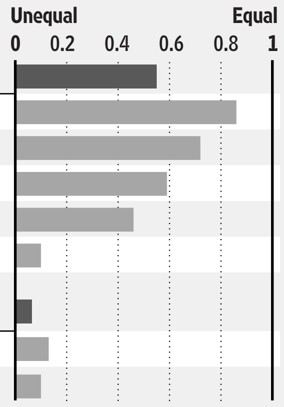
Japan fares poorly in gender equality out of total 134 countries

Overall ranking

Rank	Country	Score
1	Iceland	0.8276
2	Finland	0.8252
3	Norway	0.8227
4	Sweden	0.8139
5	New Zealand	0.788
9	Philippines	0.7579
100	Malaysia	0.6467
101	**Japan**	**0.6445**
104	Cambodia	0.641

In Japan

	Rank
Economic participation and opportunity	108
Professional and technical workers	77
Labor force participation	83
Wage equality for similar work	99
Estimated earned income	100
Legislators, senior officials, and managers	**109**
Political empowerment	110
Women in ministerial positions	85
Women in parliament	105



Source: World Econmic Forum Global Gender Gap Report 2009

"If I didn't have my parents around to look after my children, I don't think I could do this," says Mana Nakazora, the chief credit analyst at **BNP Paribas** in Tokyo. "I also think that women in their twenties are more conservative now than the previous generation, and they don't have role models. In China, women don't stay at home—it's regarded as perfectly normal to work."

Improvements in female participation in the work force have been slow in coming. The Bank of Japan trumpeted the appointment of Tokiko Shimizu, 45, as its first female branch manager. But the real news to some women was that it took more than a century.

"Compared with other central banks, the BoJ is more conservative," said a former BoJ employee, now working in Tokyo's finance sector, who asked she not be identified. "I left because my career at the BoJ wouldn't have been so promising. If one comes back after having children, it's very difficult to get back on the career track. The BoJ missed many opportunities to promote people."

A BoJ spokesperson said: "The Bank of Japan in recent years has implemented lenient policies for maternity and parental leave."

The private-sector record isn't rosy, either. Ari Fuji, 42, became the first female captain at any Japanese airline when she was made a captain this week for the JAL unit, JAL Express Co. In comparison, **AMR** Corp's American Airlines appointed its first female captain in 1986.

Shinohara, Temp Holdings, Iwata, Shiseido Co., Naoko Yamazaki, Reuters, Renho, Associated Press

Japanese work-force pioneers, from top left, Yoshiko Shinohara, president, Temp Holdings; Kimie Iwata, vice president, Shiseido; astronaut Naoko Yamazaki; Renho, DPJ reform minister

At **Sony** Corp., a leading multinational corporation, just 3.5% of its managers were women last year in Japan, according to the company. That compares with a ratio of 32.2% female managers at its operations in the U.S.

Still, the latest promotions suggest the drive to better utilize the female labor force is gaining some momentum, though the pace of change remains slow to glacial. **Shiseido** Co., Japan's leading cosmetics company, says it aims to achieve a 30% ratio of female leaders by the 2013 fiscal year, from a current ratio of 19%. It is one of the few Japanese companies to have a woman on its board of directors, and has an in-house child-care facility in its offices in Tokyo.

—Miho Inada contributed to this story.

Uganda says attackers had local help

By Will Connors and Nicholas Bariyo

KAMPALA, Uganda—A local Muslim extremist group may have assisted Somalia-based militants al Shabaab in carrying out Sunday's deadly bombings here, say security officials, in a sign the two unaffiliated organizations may be drawing closer together for attacks on shared targets.

Ugandan police and military officials say they have evidence that the Allied Democratic Forces, or ADF, a Ugandan rebel group based near the mountainous border with the Democratic Republic of the Congo, was involved in the blasts, in which at least 76 people were killed.

But they haven't shared that evidence thus far, and the links made publicly appear speculative.

Al Shabaab claimed responsibility for the attacks. The Islamist group, which is trying to topple the Somali government, is calling for Ugandan and other African Union peacekeeping forces to withdraw from Somalia.

Police inspector Gen. Kale Kayihura said at a news conference on Tuesday that the ADF was likely involved in the attacks. He didn't elaborate.

Police said Tuesday that four foreign nationals had been arrested, but they declined to provide details.

A Ugandan military official said the army had evidence—provided by an ADF rebel arrested last month—that the Ugandan and Somali groups were working together. Al Shabaab "cannot come here and survive alone," said the official. "They need locals who believe in what they are doing to help them."

Some terrorism experts cast doubt on the role of the ADF in Sunday's bombings.

"It seems pretty implausible. I don't see any need for al Shabaab to use them to do what they can well do themselves," said Andrew McGregor, an authority on Somali and East African insurgencies and editor of the Jamestown Foundation's Global Terrorism Analysis.

The U.S. is working closely with local authorities to piece together evidence from the bombings.

There are three FBI investigators on the ground in Kampala and a team working on the case from Washington, according to a senior American diplomat in the region.

—Keith Johnson in Washington contributed to this article.

IEA expects slower growth in oil demand from China

By Spencer Swartz

LONDON—The International Energy Agency said it expects the pace of oil-demand growth to slow next year in China and most other parts of the world, indicating that crude prices are likely to trade at subdued levels well into next year.

In its first assessment of 2011 global oil trends, the Paris-based agency forecast world oil demand to grow by 1.3 million barrels a day, or 1.6%. That increase rate is below the 2.1% rise in global crude consumption expected this year, although it is in line with 1.7% growth seen on average annually from 2000 to 2007.

Despite a higher rate of global economic growth projected next year, the IEA said the dual impact of improving energy efficiency in industrialized nations and a gradual phasing out of economic stimulus in emerging markets like China—the fastest-growing oil consumer globally—would slow the pace of oil consumption.

It also said the Organization of Petroleum Exporting Countries would continue to have between 5.5 million and six million barrels a day of spare oil-production capacity far into 2011 to offset any unexpected supply disruptions. Most of that capacity is held by Saudi Arabia, the world's biggest oil exporter.

"Whisper it quietly, but we might, just might, be in for some market stability for a while longer," the IEA said. The agency, an energy adviser to mostly industrialized nations, said it expects oil prices to average \$79.40 a barrel in 2011. Front-month oil futures in New York traded about 20 cents lower in London at \$74.75 a barrel.

The IEA's latest forecast highlights a more benign view of the global oil market compared with a year ago when many industry observers were warning that a sharp drop in oil exploration spending would hurt future supply and drive crude prices sharply higher by 2010-11. Capital expenditures did drop by almost 20% last year, but are expected to rebound by about 10% in 2010.

What has also changed is a more relaxed view on oil consumption. Consumers are still bent on maximizing energy efficiency in places like the U.S., and oil traders have lingering doubts about the health of Europe's and America's economic recovery and the knock-on effect in emerging markets.

The IEA said it expects total Chinese oil demand to rise by just 4.8% next year to 9.56 million barrels a day compared with robust growth of 9.1% this year. China is the world's second-biggest oil consumer at a distant second to the U.S., which is forecast to burn 18.86 million barrels a day on average in 2011, down slightly from this year.

There are some potential problems ahead. Non-OPEC oil supply is forecast to grow by just 400,000 barrels a day in 2011, half the growth rate expected this year and far below recent historical averages, due to aging oil fields.

The IEA also cautioned that regulatory and legal uncertainties in U.S. offshore oil drilling, stemming from the Gulf of Mexico oil spill, could cut U.S. oil output by as much as 300,000 barrels a day by 2015.

Special Advertising Section

SERBIA

Recovery helped by new emphasis on exports

Educated work force, improving infrastructure and location at the crossroads of Europe boost economy

By Jonathan Gregson

Serbia, just as many smaller economies, was knocked off course by the global financial crisis but is now getting back on track and has huge growth potential.

As Vladimir Gligorov, staff economist at the Vienna Institute for International Economic Studies (WIIW), points out, Serbia achieved fast growth for three to four years until the crisis, which resulted in negative growth of 2.8% last year. But the tide is turning, he says. The Serbian economy started growing again in the first quarter and, according to the latest IMF forecast, GDP should expand 1.5% this year, rising to 3% in 2011.

"A key element in the recovery," according to Prof. Gligorov, "is the shift from growth driven by domestic consumption — as was the case up to 2008 — toward a more export-driven economy." He notes that precrisis exports accounted for only 20% of GDP, but "now there are signs of recovery, particularly in industrial production, and exports are currently growing around 18% [annually]."

Przemyslaw Wozniak, senior economist at the Warsaw-based Center for Economic and Social Research, also sees the current shift of the economy from domestic demand toward exports as being "the key driver of economic recovery." He points to recent important policy changes introduced by the government to get a grip on public spending.

According to Miroslav Prokopijevic, who is principal fellow of the Institute for European Studies in Belgrade, "key advantages are Serbia's geographic location and its well-educated work force." Sitting astride key road and rail routes linking Central and Western Europe with the southern Balkans, Turkey and the Middle East, Serbia has great potential as a transportation and logistics hub.

"Previously," says WIIW's Prof. Gligorov, "infrastructure was a problem, but now that is improving." Further investment is needed to modernize the rail network, where the European Bank for Redevelopment and the European Investment Bank are currently considering loans of €100 million and €150 million respectively to renew railroad track and purchase locomotives. Dr. Wozniak of the Center for Economic and Social Research also points to "major investments in road infrastructure, especially the upgrading of the Serbian section of Highway 10 running from Hungary to Macedonia and Greece."

"Growth sectors," according to Dr. Wozniak, "include telecoms, since rates of penetration of mobile services remain very low." The Norwegian mobile group Telenor purchased Mobi 063 in 2006 for €1.5 billion (the largest transaction to date in Serbia), and now there is huge foreign interest in the planned 40% privatization of Telekom Serbia, with Deutsche Telekom and Egypt's Orascom Telecom both expressing interest.

Other potential candidates for privatization, says Dr. Wozniak, are the railway company and the national airline. He also sees "investment potential in upgrading Serbia's airports, especially since the introduction of visa-free travel to the European Union."

The automotive sector is also on the move following Fiat's initial €700 million investment in 2008, alongside €200 million from the Serbian government, in the Krgujuvec factory in southern Serbia. Last year it produced 15,000 Punto cars, and there are

REUTERS/Ivan Milutinovic

> *"Growth sectors include telecoms, since rates of penetration of mobile services remain very low."*

plans to double production this year as more vehicles are exported to markets like Egypt and Morocco.

"Fiat's investment has had a major impact on Serbian industry," says Dr. Wozniak, "especially local parts and components manufacturers."

Similarly, Serbia's steel industry, which accounts for some 15% of total exports, is undergoing a revival. By far the largest foreign investor is U.S. Steel, which bought Smederevo's Sartid steel mill in 2003, and currently runs three production lines in Serbia employing some 6,000 workers. Production is now cranking up, with a second blast furnace restarted in June following overhaul and the plant operating at full capacity.

REUTERS/Ivan Milutinovic

Last year Fiat's Krgujuvec factory, in southern Serbia, produced 15,000 Punto cars and there are plans to double production this year.

At the same time, the Italian STG group, which specializes in making steel from waste iron, is about to open its €35 million Sirmium Steel foundry in Sremska Mitrovica, creating 200 jobs and having an annual capacity of 250,000 tons of steel beams.

Another major investor is the leading French building materials group Lafarge, whose purchase of the Beocin cement plant has been followed by further substantial investments to modernize the plant and significantly reduce its environmental impact. Lafarge has also developed the Beocin Business Park as a nonprofit initiative to attract other investors to the area, and earlier this year the Ontario-based metal components company Mars Metal moved in as the first tenant.

Prof. Prokopijevic of the Institute for European Studies says that new foreign direct investment into Serbia this year is expected to be around €1 billion, down slightly from last year's €1.2 billion, although a higher proportion of this will go into greenfield investment than buying into state-owned companies being privatized.

Competitive advantages in terms of costs are growing thanks to the free-floating Serbian dinar, which has declined 30% since the global crisis and recently breached 100 to the euro. According to Prof. Gligorov, this makes Serbia more competitive compared with its neighboring countries that are EU members and whose currencies are pegged to the euro.

As Albert Jaeger, IMF mission chief for Serbia, noted in his May report, inflation has come down, foreign banks are maintaining or even increasing their exposure to Serbia, and the international reserve position remains healthy. "The ongoing rebalancing of the economy from domestic demand to export-driven growth is expected to underpin Serbia's shift to a more sustainable growth model," he added.

Kashmir issue to weigh on talks

By Tom Wright

LAHORE, Pakistan—India's top foreign-affairs officials will meet with their Pakistani counterparts in Islamabad this week to push forward talks on a wide range of issues between the two countries, but a brewing row over the disputed Himalayan territory of Kashmir looks set to cast a pall over the discussions.

Indian External Affairs Minister S.M. Krishna will hold talks Thursday with his Pakistani counterpart, Shah Mahmood Qureshi, the culmination of a series of meetings since February that have aimed to restore relations between the two nuclear-armed neighbors. India suspended an earlier peace initiative following the 2008 attacks on Mumbai by Pakistani gunmen that left more than 160 people dead.

But a resurgence of violence in the Indian-administered portion of Kashmir has created a backdrop of mutual recriminations that don't augur well for progress, analysts say. New Delhi has blamed the violence on Pakistan-based militants who it says also carried out the Mumbai attacks, which Pakistan disputes.

Indian Home Minister P. Chidambaram said this month he believed that Pakistan-banned militant group Lashkar-e-Taiba was behind violent mid-June separatist protests in Indian-controlled Kashmir, which is in Jammu and Kashmir state. Indian officials say more than a thousand well-trained militants are waiting in Pakistan-held Kashmir to infiltrate Indian territory.

India would consider the disturbances an internal matter "if Pakistan were to stop fueling the insurgency," said Ashok K. Mehta, a retired Indian army general and security analyst. He added that Pakistan must show it can stick to commitments it made before 2008 not to allow its territory to be used as a base for attacks on Indian soil.

Associated Press

Indian Prime Minister Manmohan Singh, center left, and Pakistan's Prime Minister Yusuf Raza Gilani at a summit in April. A resurgence of violence in the Indian-administered portion of Kashmir has created a backdrop of mutual recriminations.

Pakistan's foreign ministry has denied those claims and has raised concerns about human-rights abuses by Indian security forces against stone-wielding Kashmiri separatist protesters. At least 15 Kashmiris have died in the past month in encounters with security forces in the Indian-held portion of Kashmir, India's government acknowledges.

India says Pakistan has been involved in the rioting, an accusation that Pakistan denies. If New Delhi repeats its claims "at the official level it will adversely affect the prospects for the talks," says Hasan-Askari Rizvi, a professor of political sciences at the University of the Punjab in Pakistan.

India and Pakistan divided Kashmir after a war in 1947 and both claim the territory in its entirety. The resolution of the issue is seen as crucial to forging better relations between the nations.

India has said it wants Pakistan to crack down on groups like Lashkar-e-Taiba before the talks progress to other issues such as Kashmir, opening up cross-border trade and managing shared water resources. Pakistan has said it wants a broad basis for the talks, which began in 2004 but were suspended following the Mumbai attacks.

Both sides have been careful to dial down expectations for this week's meeting, which was agreed to by the prime ministers of Pakistan and India during a summit in Bhutan in April. India's External Affairs Ministry said in a statement that it hopes the meeting would pave "the way for a substantive dialogue on issues of mutual concern" in the future. Attempts to reach a spokesman for the ministry were unsuccessful.

A spokesman for Pakistan's foreign ministry declined to comment. A Pakistan government official in Islamabad said there was no official agenda for the talks as there had been before the Mumbai attacks, which shows the discussions are still at a tentative stage.

Tensions remained high in the territory on Tuesday, as Indian security forces imposed a partial curfew in the capital, Srinagar, after separatist leaders called for a mass protest march. India called out the army earlier this month to back up police in the state after violence escalated. There are more than half a million Indian security personnel in the state, which is home to 10 million people.

Iran groups pose threat to troops in Iraq

By Ben Lando

BAGHDAD—Iranian-supported militias targeting American bases now pose a more serious threat to U.S. forces than al Qaeda as they seek to exert influence over Iraq's uncertain political makeup, the top U.S. general in Iraq said Tuesday.

Army Gen. Ray Odierno also said the U.S. troop drawdown is on schedule.

The Iranian-backed groups continue to pose a threat to U.S. troops, Gen. Odierno said, adding that the danger of rocket-assisted mortar attacks against U.S. bases by the groups had increased in the past few weeks.

"There's a very consistent threat from Iranian surrogates operating in Iraq," Gen. Odierno said. U.S. forces have increased security at some of its bases in response.

These groups are also seeking to influence Iraqi politics, still mired in a months-long stalemate over the formation of a new government. Top political parties, including current Prime Minister Nouri al-Maliki's, have strong ties to Iran.

"This is another attempt by Iran and others to attempt to influence the U.S. role here," he said.

The Iranian-backed groups, which American commanders say have operated in Iraq since the 2003 U.S.-led invasion, pose a more subtle threat to the Iraqi state, Gen. Odierno said, which makes them less overtly worrisome than al Qaeda.

Associated Press

Gen. Ray Odierno says Iranian-supported groups are targeting U.S. bases.

U.S. and Iraqi forces have claimed significant advances in their fight against extremist groups this year, announcing the arrests and killings of several top operatives of the local al Qaeda affiliate.

But those victories haven't dented insurgents' ability to orchestrate large-scale attacks.

The Iraqi government has consistently blamed a series of deadly bombings across Iraq in recent months on al Qaeda in Iraq, or AQI, and like-minded groups.

The killing of two top AQI operatives earlier this year weakened the group's decision-making capacity and its ability to communicate with leadership figures in Afghanistan and Pakistan, Gen. Odierno said.

He also said the U.S. drawdown was progressing on schedule, with about 74,000 troops currently in the country. According to the Obama administration's drawdown timetable, U.S. forces will number just 50,000 by the end of August.

The drawdown comes as Iraqi politicians continue to wrangle over a new government months after inconclusive parliamentary elections in March.

It also comes after nearly a year of bloody, high-profile bombings across Iraq. Both developments have raised worry that attacks could climb, as U.S. forces continue to withdraw.

Gen. Odierno said the violence and political instability won't affect the U.S.'s timetable.

U.S. and Iraqi officials say that despite the recent attacks, overall violence is down sharply from the worst of Iraq's sectarian bloodshed a few years ago.

"Unless we think that the government is going to fail, which could create incredible instability, which would not allow us to move forward with the political process, we're going to move forward with the withdrawal," Gen. Odierno said.

"Our assessment is that the Iraqi security forces are capable of maintaining a level of stability necessary for Iraq to continue to move forward politically and economically," he added.

Scientist seeks return to Iran after surfacing in Washington

By Chip Cummins And Siobhan Gorman

A missing Iranian nuclear scientist who Tehran said was kidnapped last year by the U.S. resurfaced at an office of the Pakistan Embassy in Washington, and U.S. and Pakistani officials said he was seeking to return home.

Yet researcher Shahram Amiri's reappearance Monday evening at the embassy's Iranian interest section deepened the mystery surrounding his recent whereabouts.

Iran called for his safe return. U.S. Secretary of State Hillary Clinton told reporters he had traveled to the embassy on his own, and that he was free to leave the country.

Mr. Amiri was in good health when he arrived at the embassy, a Pakistani diplomatic official said Tuesday. Officials there will assemble the paperwork and plane tickets to send him home, the official said.

Iranian state news outlets reported early Tuesday that Mr. Amiri was dropped off by U.S. authorities, but the Pakistani official said there was no evidence of that.

The Iranian interest section is run by Iran under the legal protection of the Pakistani Embassy, and offers a channel for Washington to communicate with Tehran, which doesn't have formal diplomatic relations with the U.S.

Mr. Amiri disappeared during a trip to Saudi Arabia in June 2009. American officials denied Tehran's charge that he had been kidnapped by the U.S. This year, ABC News reported he had defected to the U.S.

In June, Iranian state media aired a video claiming to show Mr. Amiri alleging he was being held against his will in the U.S. after being captured by U.S. forces in Saudi Arabia. In a second video that surfaced on the Internet, someone claiming to be Mr. Amiri appeared to contradict that, saying he was in the U.S. of his own free will, but denying he had defected to the U.S. The authenticity of the videos was never confirmed.

It is also unclear what role—if any—Mr. Amiri may have played in Iran's nuclear program. A Pakistani official said he thought Mr. Amiri's intelligence value was modest. "Amiri is not a top scientist in Iran and thus not privy to highly sensitive information," the official said.

State Department spokesman P.J. Crowley said Mr. Amiri had been in the U.S. "for some time," but declined to say how long.

—Tom Wright, Zahid Hussain and Jay Solomon contributed to this article.

Agence France-Presse/Getty Images

Nuclear scientist Shahram Amiri