DJIA 10154.43 ▲ 0.56% | Nasdaq 2198.23 ▲ 0.88% | Stoxx Eur 600 246.18 ▼ 0.78% | FTSE 100 5148.28 ▼ 0.20% | DAX 6009.11 ▼ 0.52% | CAC 40 3486.33 ▼ 0.40% | Euro 1.2969 ▲ 0.13% | Pound 1.5215 ▼ 0.85%

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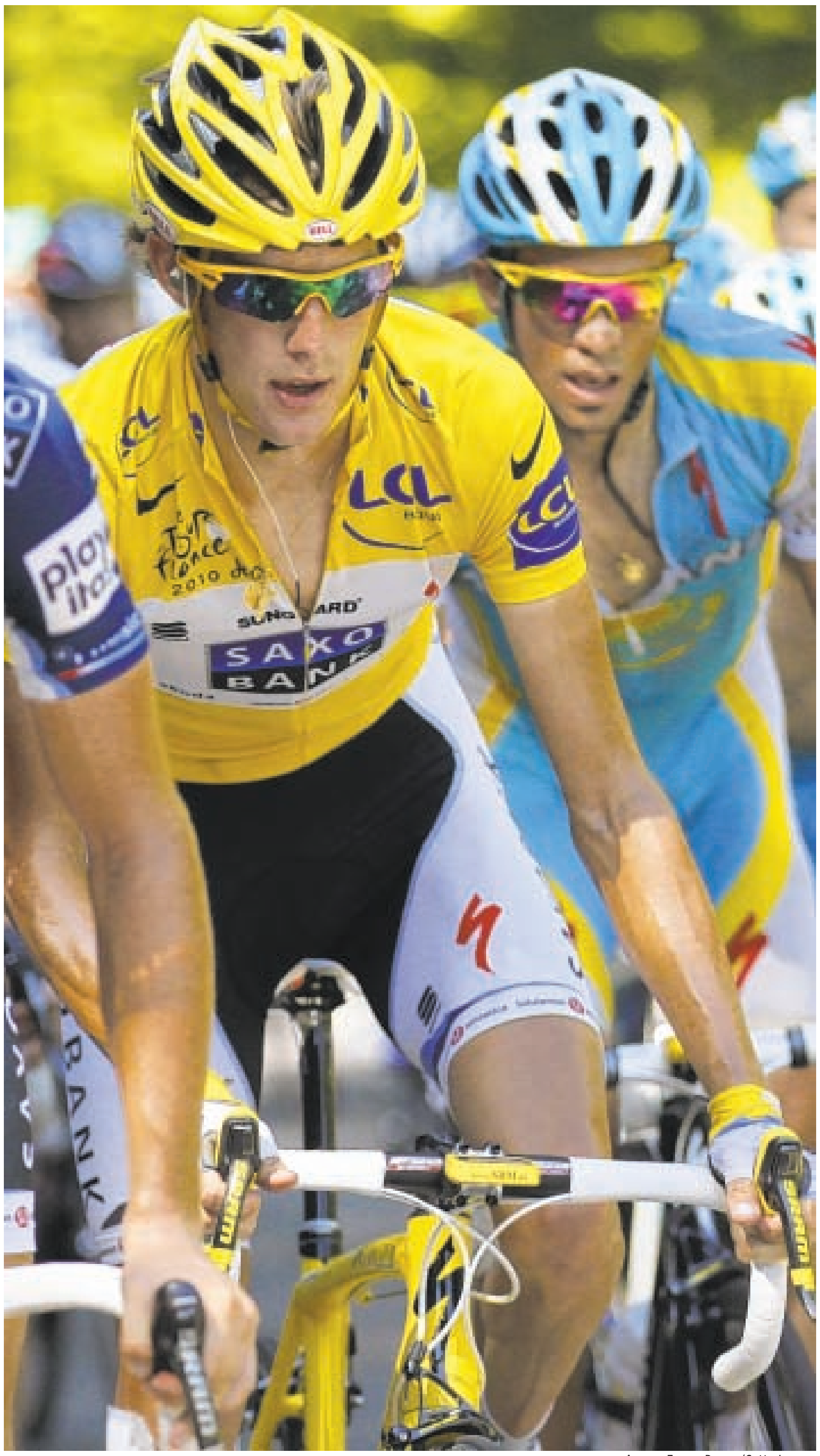
Tour controversy as Contador cashes in



Agence France-Presse/Getty Images

Alberto Contador of Spain challenges Andy Schleck, in the Tour de France leader's yellow jersey, in the 15th stage on Monday. After Schleck had chain problems, Contador took the race lead—breaking an unwritten rule that riders do not benefit from others' misfortunes. **Race report at WSJ.com/sport**

Gel reduces risk of AIDS for women

In a breakthrough that opens a new way to protect against HIV and other sexually transmitted diseases, researchers found that a gel applied by women before and after sex slashed the chance of acquiring the AIDS virus by 39% and the genital herpes virus by 51%.

*By **Mark Schoofs** in New York And **Peter Wonacott** in Vulindlela, South Africa*

It is the first time an HIV-prevention method controlled entirely by women, who bear the brunt of the epidemic in Africa, has been shown to work. About a third of women in the study said their partners didn't know they were using the clear, odorless gel.

"The winner in this is the woman who—for the first time since this scourge started—has a mechanism that helps her protect her body," said Mamphela Ramphele, a doctor and former anti-apartheid activist who now chairs the South African government's Technology and Innovation Agency, which helped fund the study and is investigating how South Africa can produce the gel.

The study was randomized, double-blind and placebo-controlled—the gold standard for clinical research—and the results were statistically significant. "It's a really well-done study," said Bruce Walker, director of the Ragon Institute of MGH, MIT and Harvard, which is dedicated to immunology and HIV vaccine research. The herpes virus, HSV2, renders women more susceptible to HIV, so blocking it could add to the gel's ability to prevent HIV.

"This is a potential game changer," said Dr. Walker, who was briefed on the results but wasn't involved in the study.

Still, because it is the first study to show the gel works, "I would like to see a confirmatory study," said one of the leaders of the trial, Salim Abdool Karim.

The gel, which the researchers estimate could prevent half a million infections over the next 10 years in South Africa, contained the antiretroviral drug tenofovir, provided free by California-based **Gilead Sciences** Inc.,

Please turn to page 11

Investors want tests to truly stress banks

As regulators prepare to release stress-test results for 91 big European banks on Friday, European politicians and finance officials are sounding surprisingly upbeat.

The mood among investors is decidedly different, with many convinced that undisclosed problems are lurking on some European bank balance sheets. Considering that the U.S. forced 10 of the country's 19 biggest banks to raise more capital after its own stress tests last year, a "soft" result Friday could undercut confidence in the tests.

One bank that has flunked is Germany's **Hypo Real Estate** AG, according to a person familiar with the matter. But that bank, now 100% state-owned, is already undergoing a restructuring of its asset portfolio and is preparing to transfer €210 billion ($271.47 billion) of toxic assets to a "bad bank" backed by the state-owned rescue vehicle Soffin.

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Hard to get a line on Ashton's empire

[Agenda]

By Bill Jamieson

"When I want to speak to Europe," Henry Kissinger once famously jibed, "who do I call?" This decades-old taunt looked to be solved last year with the appointment of British Labour peer Baroness Ashton to head the European Union's new External Action Service (EEAS). But whether Mr. Kissinger's successor Hillary Clinton will be put through to Lady Ashton anytime soon is moot.

Lady Ashton is building a massive new empire. In the face of deep internal rivalries within the EU—and many of the EU's 27 heads of state who would much prefer Mrs. Clinton to call them directly—she is arranging the final interviews for a prestigious administrative machine of 7,000 civil servants, a pyramid of high-ranking officials, 31 senior ambassadors and their deputies, a further 80 ambassadors for second-tier postings and a Brussels headquarters that will house around 500 senior officials and their assistants.

All told, there will be a network of 136 EU embassies round the world, speaking on behalf of the EU's present 27 foreign ministers on conflicts such as Gaza and Iran. Yet leading EU countries such as Germany, France, Italy and the U.K. will still insist on separate representation on global institutions such as the International Monetary Fund, the Group of Eight leading industrial countries and the Group of 20.

The hiring spree at EEAS and the administrative tooling up and kitting out required for this global diplomatic leviathan could not be taking place at a worse time.

It has sparked an outburst of indignation and anger as EU governments have had to embark on tough austerity programs, cutting public-sector workforces, wages and pension benefits while the institutions of the EU appear quite untouched and impervious to the fiscal pain across the Continent.

European Pressphoto Agency

Baroness Ashton visits South Ossetia, the breakaway Georgian state, last week.

Indeed, the EU as an institution, or more accurately a burgeoning collective of institutions, remains aloof, and on a course of relentless, unstoppable expansion over which member governments, never mind the voters and taxpayers at the bottom of the pile, seem powerless.

> 'These costs throw money out of the window to pay for Catherine Ashton's toy.'
>
> —Marta Andreasen, MEP

Many EEAS staff will receive, in addition to their salaries, low-tax arrangements, generous pensions and travel allowances and help with school fees and education expenses for children.

The EEAS will control a budget of around €7 billion ($9 billion), which includes the EU's aid and development budgets and the costs of peacekeeping operations in places such as Kosovo.

The organization has requested an additional €9.5 million for staff salaries. But this is an interim sum and the overall cost overrun for the establishment of EEAS has been put considerably higher.

Marta Andreasen, a former chief accountant of the European Commission and now a U.K. member of the European Parliament who serves on the budget committee, says the establishment of EEAS is likely to cost at least an extra €55 million. "While we are dealing with an economic crisis in Europe," she declared, "they are asking for budget increases—it is ridiculous."

"The whole of the EU should be more sensitive to the economic pain that people are going through at the moment. These costs are just throwing money out of the window to pay for Catherine Ashton's toy."

Daniel Gueguen, a French lobbyist and longstanding observer of the EU, says: "They are building a huge machine with embassies round the world. But what are Europe's policies on Israel or Iran? We don't know. It's vague. Catherine Ashton looks very weak and to me the whole thing is a disaster."

But the EEAS controversy is only one highlight of an overall EU budget that shows every sign of being out of control. A battle is looming this autumn over the proposed overall EU budget for 2011, which is expected to show a rise of almost 6% on this year's €113 billion.

Next year the administrative costs for all EU institutions is scheduled to rise by 4.4%, with the admin bill running to €3.7 billion. Cost increases averaging 4.8% are budgeted for other institutions. Just setting up the European Systemic Risk Board and three economic supervisory bodies overseeing the banking, insurance and securities sectors adds a further €15 million.

And the cost of the EU Parliament's "traveling circus" shuffling between Strasbourg and Brussels while its secretariat is in Luxembourg next year is set to total €240 million more than would be incurred by sticking with a single location.

Arguably most embarrassing of all for the EU at a time when member governments are slashing pay and benefits of their civil servants are the continuing increases in pensions and other perks for EU administrative staff.

The pensions bill next year is forecast to rise by 6.9% while the cost of European Schools, which provide high-quality free education to children of EU civil servant, is set to grow by 12.5% to €174 million.

The juxtaposition of fiscal austerity at government level and apparent continuing largess at EU "head office" is causing unease even in Brussels.

A senior European Commission official said at the weekend: "People will look at us and say, 'How is it they are immune, they keep growing when we are having to cut back?' The No. 1 issue should be to stop the mushrooming of the institutions. We don't need new institutions."

However, the EEAS is seen as the necessary and inevitable next step on the way to the EU having a global persona and footprint. That it has coincided with the onset of austerity programs will ensure an even hotter baptism of fire for Baroness Ashton than the envy she has already stirred.

And who ultimately takes that call from Washington is little more clear cut, given the miasma of telephone extensions now being wired into the EU's new leviathan.

Mr. Jamieson is executive editor of the Scotsman.

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'The Hungary news is a reminder that this ain't over yet. Greece has a big mountain to climb.'

Katie Martin on the IMF's decision to walk away from Hungary's loan talks

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Question of the day

Vote and discuss: Do you agree with the IMF's decision to walk away from talks with Hungary?

Vote online today at **wsj.com/polls**

Previous results

Q: How would you grade the financial-regulation overhaul?

A 3%
B 6%
C 6%
D/F 85%

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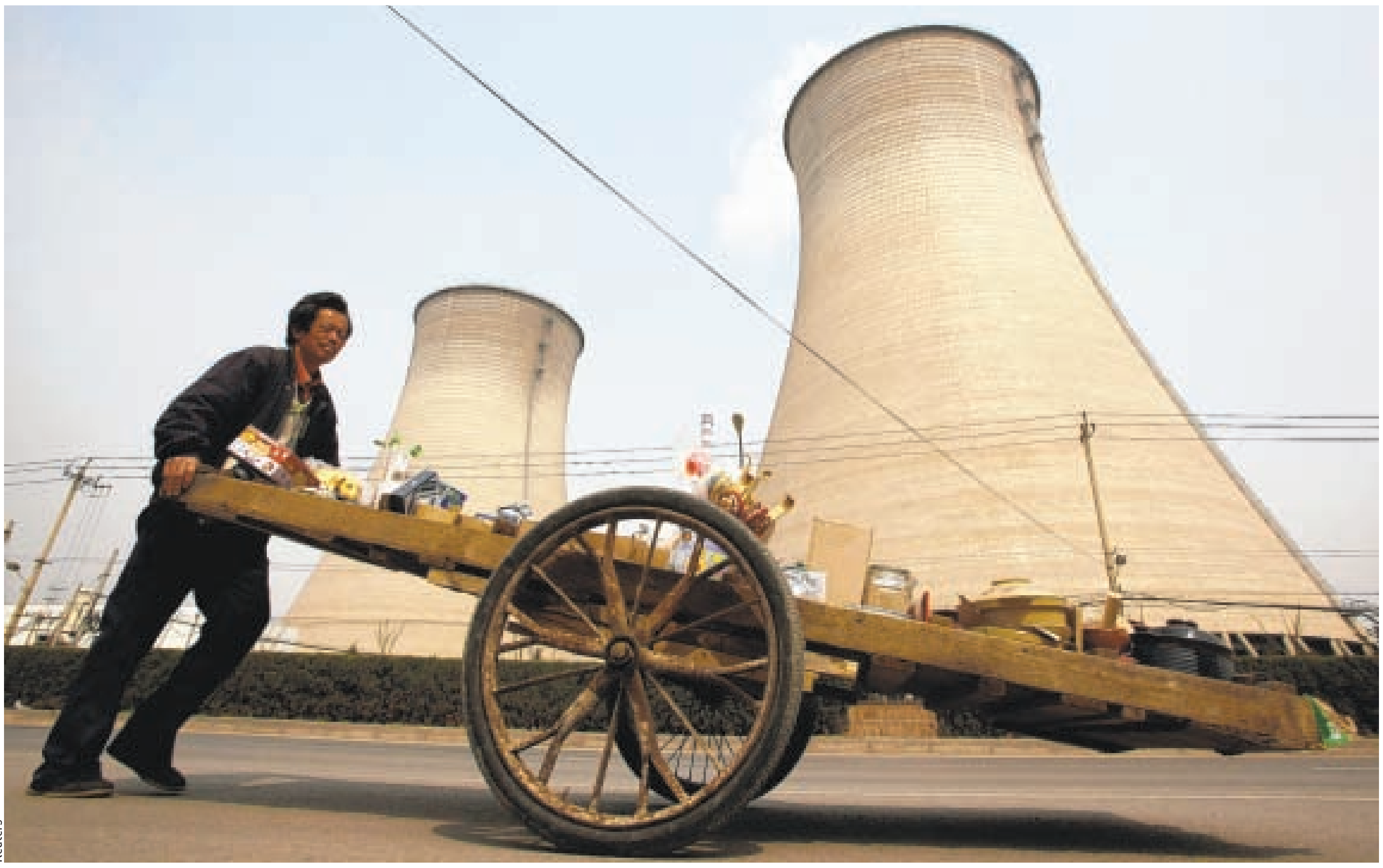
NEWS

China passes U.S. as top energy user

Surge reflects years of rapid expansion, while U.S. has taken harder recession hit



Reuters

A street vendor passes coal-burning power plant in Beijing in April. China's energy consumption has clocked annual double-digit growth for many years.

By Spencer Swartz And Shai Oster

China has passed the U.S. to become the world's biggest energy consumer, according to new data from the International Energy Agency.

The milestone reflects China's decade-long burst of economic growth and its rapidly expanding future needs as an industrial powerhouse. The Paris-based agency said China devoured 2,252 million tons of oil equivalent last year, or about 4% more than the U.S., which burned through 2,170 million tons of oil equivalent. The oil-equivalent metric represents all forms of energy consumed, including crude oil, nuclear, coal, natural gas and renewables such as hydropower.

The figures reflect, in part, how the global recession hit the U.S. more severely than China and hurt U.S. industrial activity and energy use. Still, China's total energy consumption has clocked annual double-digit growth rates for many years, driven by the country's big industrial base. Highlighting how quickly its energy demand has increased, China's total energy consumption was just half the size of the U.S. 10 years ago.

"The fact that China overtook the U.S. as the world's largest energy consumer symbolizes the start of a new age in the history of energy," IEA chief economist Fatih Birol said in an interview.

The U.S. had been the biggest overall energy consumer since the early 1900s, he said.

China's economic rise has required enormous amounts of energy–especially because much of the past decade's growth was fueled not by consumer demand, as in the U.S, but from energy-intense heavy industry and infrastructure building.

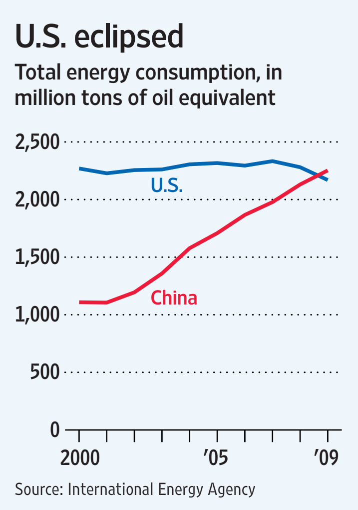
That growth has transformed global energy markets and sustained higher prices for everything from oil to uranium and other natural resources that China has been consuming. Its increasing reliance on imports has lifted energy prices and underpinned a resource boom in Africa, the Middle East and Australia.

Now, China's rapidly expanding need for energy promises to have major geopolitical implications as it hunts for ways to satisfy its needs. Already, China's rising imports have changed global geopolitics. Chinese oil and coal companies were among the first to look overseas in their quest for energy supplies, pitching the Chinese flag in places like Sudan, which Western companies had largely abandoned under international pressure.

The most ambitious effort to secure overseas energy supplies was the failed 2005 attempt by **Cnooc** Ltd. to take over California-based **Unocal** Corp. in an $18 billion bid trumped by politics and rival **Chevron** Corp. But Chinese companies have successfully expanded overseas, buying assets in Central Asia, Africa, South America and Canada, and even small stakes in the Gulf of Mexico. While their overall overseas footprint is small compared with big international oil companies, they are growing fast.

China's voracious energy demand also helps explain why the country—which gets most of its electricity from coal, the dirtiest of fossil-fuel resources--passed the U.S. in 2007 as the world's largest emitter of carbon-dioxide emissions and other greenhouse gases.

The U.S. is still by far the biggest energy consumer per capita, with the average American burning five times as much energy annually as the average Chinese citizen, said Mr. Birol, who has been in his current role for six years. The U.S. also is the biggest oil consumer by a wide margin, going through on average roughly 19 million barrels a day—with China a distant second at about 9.2 million barrels a day. But many oil analysts believe U.S. crude demand has peaked, or is unlikely to grow very much in coming years.



Corporate chiefs step up criticism of Beijing

By Jason Dean

A series of recent comments by some of the world's top executives questioning China's treatment of international companies reflects an anxiety that is altering the relationship between foreign business and Beijing.

The latest example came when two of Germany's leading industrialists—Jürgen Hambrecht, chairman of chemical giant **BASF** SE and Peter Löscher, chief executive of conglomerate **Siemens** AG—raised complaints about a range of Chinese policies toward foreign business during a public meeting with Chinese Premier Wen Jiabao and visiting German Chancellor Angela Merkel. That followed complaints in recent months from other top executives of **General Electric** Co., **Microsoft** Corp. and **Google** Inc.

Foreign businesses are increasingly emboldened, executives and analysts say, by a sense that the Chinese market has become too important to stay silent over policies they feel jeopardize their future.

"In the past, people would have preferred to do this either privately ... or through a chamber of commerce or bilaterally in government negotiations," said Christian Murck, a veteran China-based executive who is president of the American Chamber of Commerce in China. But now, he says, "there's a greater degree of uncertainty about future Chinese policies and future treatment of foreign companies."

The concerns center on policies that foreign executives feel put them at a disadvantage against increasingly potent Chinese competitors, or compel them to transfer valuable technology to China, or otherwise limit their access to what is now the world's biggest market for everything from trains to cars to cellphones.

"Some of these issues have been longstanding. But the fact is that China is so crucial to the growth of companies that more light is being thrown on them," said Duncan Clark, head of Beijing-based consultancy BDA China and chairman of the British Chamber of Commerce in China. "The stakes are higher than ever." GE CEO Jeffrey Immelt, at a dinner in Rome last month, complained that it is getting harder for foreign companies to do business in China.

Reuters

BASF's Jürgen Hambrecht

Microsoft CEO Steve Ballmer, in remarks at the All Things Digital technology conference in June, said China's weak intellectual-property protection regime will be problematic for the technology industry going forward. As for Chinese censorship, he said that Microsoft has a few thousand people in China, and "we have to do something to comply with law," adding, "We are staying and trying to be part of a reformation process."

Google effectively dismantled its mainland Chinese search service in March after its top executives rebuked Beijing's censorship practices and charged that China was the source of a series of cyberattacks against Google and other foreign companies.

At Saturday's meeting between German and Chinese executives and officials, Mr. Hambrecht complained about companies facing the "forced disclosure of know-how" in order to do business in China. "That does not exactly correspond to our views of a partnership," he said, according to a report by Germany's Deutsche Presse-Agentur, whose reporter was at the meeting.

Mr. Löscher said German companies expect to be treated equally in the Chinese market, that technology transfer should be strictly voluntary, and that protection of intellectual-property rights should be strengthened, according to a Siemens spokesman. He also called for fewer restrictions on foreign investment in the auto and financial sectors.

China insists such concerns are unfounded. Mr. Wen, speaking at Saturday's meeting with German executives and officials, said China remains committed to opening its economy and noted that inflows of foreign investment continue to grow. "Currently, there is an allegation that China's investment environment is worsening. I think it is untrue," the state-run Xinhua news agency quoted Mr. Wen as saying in response to Mr. Hambrecht's remarks.

Mr. Hambrecht and others have raised such concerns before with Chinese officials, and people present said the discussion Saturday was cordial, not confrontational. But the comments were noteworthy because they were so open, made in the presence of German reporters.

Spokesmen for Siemens and BASF say Mr. Hambrecht and Mr. Löscher were speaking broadly on behalf of German business.

—Aaron Back, Shai Oster, James T. Areddy and Loretta Chao contributed to this article.

EUROPE NEWS

Hungary resists plan for cuts

BY GORDON FAIRCLOUGH AND MARGIT FEHER

BUDAPEST—Hungary's government said the International Monetary Fund and European Union are ignoring the economic risks of excessive austerity measures and that Budapest can't make deeper spending cuts now, despite a punishing reaction from markets after bailout-loan talks between the two sides broke off this weekend.

The Hungarian currency, the forint, on Monday fell to its lowest level against the euro in more than a year, and the cost of insuring Hungarian government bonds against default jumped sharply after the IMF and EU walked out of talks with Budapest on Saturday, saying the government wasn't doing enough to shrink its budget deficit.

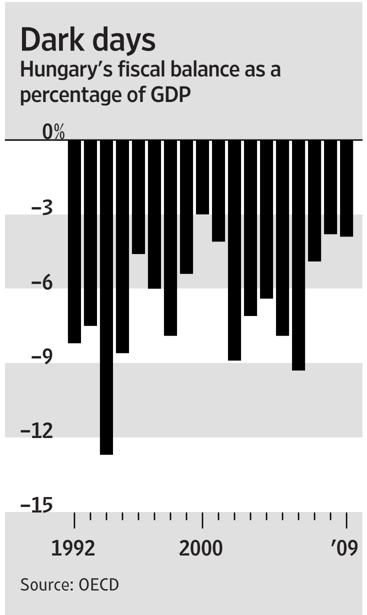
Anxious investors also pushed down the currencies of Hungary's neighbors Poland and the Czech Republic. In the wake of serious debt troubles in Greece, which have prompted Europe-wide efforts to shore up confidence, markets have focused on governments' commitment to strengthening their finances and reining in spending.

"The pressure is clearly going to remain on for some time," said Robert Beange, a senior emerging-markets strategist at Royal Bank of Canada in London. "The markets really want a deal" between the IMF, EU and Hungary.

The new populist government of Hungarian Prime Minister Viktor Orbán is trying to push back, arguing that further budget cuts risk stifling the country's nascent economic recovery. Hungary's gross domestic product is forecast to grow by about 0.6% this year, after contracting 6.2% in 2009.


Reuters

National Bank of Hungary Gov. Andras Simor at a news conference in Budapest after Monday's market selloffs.



"We've been through more than four years of austerity and that's why we have lost our competitiveness," Hungary's economy minister, György Matolcsy, said in a television interview Monday. "We told our partners that further austerity packages were out of the question."

Mr. Matolcsy also said the government planned to go ahead with a hefty new tax on financial institutions aimed at raising nearly $1 billion to boost government revenue this year, despite concern from the IMF and EU that the measure would constrain economic expansion. "The only alternative to the bank tax is austerity," Mr. Matolcsy said. And that "would damp growth more."

Meanwhile, Hungary's central bank on Monday left its key policy rate unchanged at a record low 5.25%, but said it is ready to raise interest rates if investors view the forint as excessively risky. Such a move would help strengthen the currency.

If the government fails to strike a deal with the IMF and EU, it won't be able to draw on the remaining funds in a €20 billion ($25.9 billion) rescue package obtained in 2008, when it was unable to raise money amid a global credit crunch. Hungary hasn't drawn any money from the standby loan so far in 2010, and doesn't need funds to finance itself for the rest of the year.

Still, the protection offered by the availability of the IMF and EU loan, as well as expectations that it would be extended into next year, has been an important source of reassurance for investors. Hungary's public debt is equivalent to about 80% of its GDP, the highest level in Central Europe. Its budget deficit this year is expected to be about 3.8% of GDP.

That is a relatively small gap, especially compared with other European countries, largely the result of the previous government's strenuous efforts to curb public spending. After signing the original IMF and EU deal, Budapest trimmed pensions, raised the retirement age, pared state subsidies and froze the wages of government employees.

The new government says that without the bank tax and some additional cuts in government spending, the budget shortfall for 2010 would be closer to 5% of GDP.

Mr. Orban's Fidesz Party swept to power after a landslide victory in April voting. The party campaigned with a populist message that austerity measures had been overdone. Fidesz politicians called instead for tax cuts and other measures they said would spark economic growth. In the wake of his electoral victory, Mr. Orban said he would seek to negotiate a better deal with the IMF.

Efforts to win support for some fiscal easing, however, were rebuffed by EU leaders, worried about the contagion effects of Greek's debt debacle. Markets pummeled Hungarian assets in June, after politicians hinted this year's budget deficit could be wider than expected, and suggested Hungary could follow in the footsteps of Greece.

The forint and Hungarian debt bounced back after the government said it would stick to the 3.8% of GDP deficit target for 2010 set under its agreement with the IMF. Analysts widely expected an agreement to be struck between Budapest and the IMF and EU.

Now, however, there may be little progress until after local Hungarian elections set for early October. Fidesz is likely to benefit politically from standing up to the IMF, and would risk alienating voters by proposing any of the long-term cost-cutting measures that the IMF would like.

—Veronika Gulyas contributed to this article.

ECB slows government bond buys to a trickle

BY BRIAN BLACKSTONE

FRANKFURT—The European Central Bank nearly halted its purchases of public debt last week, buying only €300 million ($387.8 million) in government bonds, in the clearest signal yet that its program to support vulnerable euro-zone countries is in its final stages.

Last week's bond purchases by the ECB represented the smallest amount since the central bank started purchasing bonds issued by Greece, Portugal and others on Europe's troubled periphery on May 10. After buying more than €16 billion the first week, the amounts have steadily dwindled, falling below €1 billion two weeks ago. In total, the central bank has bought €60 billion in government debt since early May.

The decision to scale down debt purchases comes amid signs of reduced stress in European financial markets in recent weeks. The euro has rebounded from four-year lows against the U.S.dollar and is trading near $1.30. Evidence that highly indebted Greece is ahead of its ambitious deficit-reduction target for this year also has helped calm investors' nerves somewhat.

ECB officials increasingly see the euro zone's economic recovery as durable and have ruled out the possibility of a double-dip recession, despite their expectations of slower growth in the second half of 2010.

Still, some analysts question whether the ECB is pulling the plug on bond purchases too soon. Yields on 10-year Greek bonds remain above 10%, not much below where they were in early May, when the ECB began buying government debt.

One worry, analysts maintain, is that if stress-test results from major European banks later this week rekindle worries about the region's banking system, then the ECB might be forced to lift the pace of its bond purchases again. That could, in turn, damage investors' confidence in the ECB's ability to stay in front of the crisis, particularly after a series of policy reversals earlier this year.

"We're still not in a normal situation, and I think the ECB is a little bit ahead of itself in heading for the exit," said Ken Wattret, chief euro-zone economist at BNP Paribas. "I wonder whether the ECB isn't getting a little carried away about the good news on the economy."

Officials have been publicly looking toward the exit since the ECB's last meeting July 8. ECB executive-board member Jürgen Stark, part of the German contingent within the central bank that expressed concerns about the debt-buying program in its early days, said recently that "if the situation [in financial markets] improves further, there is not a reason anymore to continue with this program."

In a Wall Street Journal interview last week, Bank of Luxembourg Gov. Yves Mersch suggested Athens' recent sale of six-month Treasury bills–its first debt sale since Greece accepted a €110 billion bailout from the European Union and International Monetary Fund in early May—was the type of "encouraging" signal that could lead the ECB to wind down purchases of Greek debt.

Moody's downgrades Irish credit rating

BY NEIL SHAH

Moody's Investors Service Inc. cut Ireland's debt rating, citing an expensive bank-rescue program and a flagging economy, but observers remain upbeat about Ireland's ability to put its government finances back in order.

Moody's lowered the rating on Ireland's government bonds by one notch to Aa2. Perhaps more importantly, Moody's upgraded the country's ratings outlook to "stable" from "negative." That move suggests Moody's doesn't expect to make more changes anytime soon.

The ratings cut briefly rattled investors, sending Ireland's stock market lower, but Irish bonds recovered some of their early losses. The nation's credit insurance costs rose and the euro, of which Ireland is a member, gained against the dollar.

Moody's move to reduce Ireland's rating brings it in line with Standard & Poor's, which cut Ireland to double-A in June 2009. The action follows last week's report from the International Monetary Fund that offered a cautious outlook on Ireland's economy while applauding the government's deficit-cutting efforts.

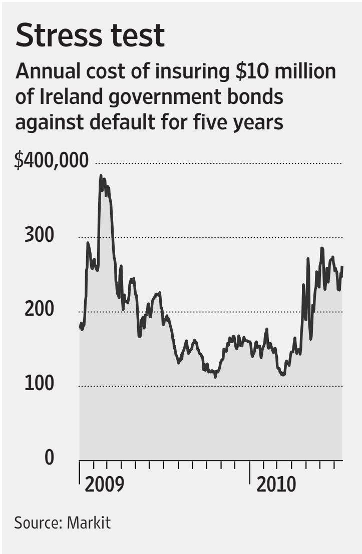
While Europe's fiscal crisis has abated in recent weeks, the Moody's downgrade is one of several recent reminders that the situation remains far from settled.

Over the weekend, talks among Hungary, the European Union and International Monetary Fund collapsed when the EU and IMF said Hungary needed to take bigger steps to reduce its deficit. And last week, Moody's cut Portugal's debt rating and S&P reaffirmed the U.K.'s triple-A rating, but said the country's outlook remained negative.

Ireland, like many peripheral euro-zone countries, had enjoyed a boom after joining the euro zone at its launch in 1999. But those same countries, especially Ireland, suffered enormously in the global financial crisis.

A key test for Ireland comes Tuesday, when the government returns to the bond market to sell as much as €1.5 billion ($1.94 billion) of new bonds to refinance its debts. However, many observers expect the sale to go smoothly, pointing out that Ireland has largely finished its re-funding obligations for the year.

—Paul Hannon contributed to this article.



EUROPE NEWS

Agence France-Presse/Getty Images

Bank of Greece Gov. George Provopoulos, left, and Greek finance chief George Papaconstantinou say they expect the nation's banks to pass the stress tests.

New doubts on stress tests

By David Enrich

LONDON—Greece's economy is in tatters and its financial system is under pressure. But its banks appear poised to glide through Europe's "stress tests."

A similar paradox is playing out across Europe. As regulators prepare to release stress-test results for 91 big European banks on Friday, European politicians and finance officials are sounding surprisingly upbeat.

The mood among investors is decidedly different, with many convinced that undisclosed problems are lurking on some European bank balance sheets. A "soft" result Friday could undercut the sense of confidence that European policy makers are seeking to instill.

If banks in countries like Greece fare well in the stress tests, "maybe that means they're not tough enough," said John Raymond, a banking analyst with CreditSights, an independent research firm. "I think the market is going to be disappointed."

One bank that has flunked is Germany's **Hypo Real Estate** AG, according to a person familiar with the matter. But that bank, now 100% state-owned after a series of recapitalizations by the German government, is already is preparing to transfer €210 billion ($271.47 billion) of toxic assets to a "bad bank" backed by state-owned rescue vehicle Soffin. It also has said it may need more than €2 billion more in capital from Soffin than the €8 billion it has already received.

Recent optimism about the stress tests' ability to soothe concerns about the European financial system has lifted shares of European banks and boosted the euro and pound against the dollar. At the same time, Moody's Investors Service's move to cut Ireland's credit rating and the collapse of Hungary's talks with the European Union and International Monetary Fund on a fiscal rescue package underscore how challenging the economic environment remains across Europe.

In Greece, the epicenter of Europe's debt crisis, the nation's banks have been struggling with rising loan defaults and the evaporation of liquidity as customers pull deposits and risk-averse investors refuse to buy Greek bank debt.

Despite that, Greek officials say they are confident about their banks' performances under the stress tests. (The banks aren't commenting.)

"I am certain the banks will pass those stress tests," Finance Minister George Papaconstantinou said in a speech Monday

Greek banks were among those that analysts and investors figured were most likely to need capital infusions under the stress tests. As a result, the Greek officials' remarks are fueling doubts about the credibility of the testing process.

Such concerns have been compounded by the tests' lack of transparency.

The tests are being conducted by financial regulators in 20 countries and are being coordinated by a small London-based group, the Committee of European Banking Supervisors, which has struggled to achieve a consensus among EU members over the tests' methodology. CEBS has revealed little about the tests' variables, and it is unclear how much will be disclosed when bank-by-bank test results are announced Friday.

The tests cover the largest banks comprising at least 50% of the total banking assets in each of the countries involved, which are the 16 members of the euro bloc as well as the U.K., Denmark, Poland and Sweden.

Based on recent public statements from European officials, most of the 91 banks appear likely to pass the tests.

Even in Spain, whose regional lenders, or *cajas*, have been swamped by a weakening economy, industry officials voiced confidence to Spanish newspapers this weekend that the country's troubled savings banks won't have problems under the stress tests. Of the 27 Spanish banks being tested, 18 are cajas.

Economists at the Royal Bank of Scotland Group last week simulated their own stress tests of Spanish banks, which found that the sector faced a roughly €50 billion ($64.6 billion) capital shortfall in the event of a downturn.

"We're concerned that there's going to be a much lower number" produced by the EU stress tests, possibly closer to €20 billion, said Nick Matthews, senior European economist at RBS. "That calls into question whether the stress tests have gone far enough."

EUROPE NEWS

Maurice Weiss/OSTKREUZ

Robert Dilssner, right, who like many Germans is fulfilling his conscription duties by volunteering instead of serving in the military, works with disabled people—here explaining how to load a dishwasher.

German hospitals lobby for the draft

By Patrick McGroarty

BERLIN—A proposal in Germany to abolish compulsory military service is drawing major opposition from unlikely quarters—the thousands of hospitals and other public-service providers where most young German men end up fulfilling their draft duties.

Germany is one of the last European countries with a draft, which many of its neighbors have abandoned since the end of the Cold War. But amid pressure to cut defense spending and modernize Germany's armed forces, Defense Minister Karl-Theodor zu Guttenberg has amplified a longstanding debate about military conscription by calling for it to be scrapped.

Mr. Guttenberg argues that conscripted troops are costly and of little use to the modern German military, or Bundeswehr, now focused on far-flung foreign missions to hot spots such as Afghanistan. The six-month stint that young German men are required to serve is too short for highly skilled military training, security analysts say. Conscripts also can't serve abroad, so many end up working in kitchens or at desk jobs.

Increasingly, though, conscription's main impact has little to do with military training at all. As attitudes toward mandatory service have changed over the decades, the draft's biggest beneficiaries have become Germany's hospitals, nursing homes and other social programs, where for the past 20 years more than half of draftees have opted to carry out nonmilitary service.

Abolishing the draft, they argue, would leave a hole in Germany's public services. More than 150,000 men out of 226,000 deemed fit to serve in 2009 filed as conscientious objectors, slating them for civilian-servant jobs. Unlike in countries such as the U.S., those who seek conscientious-objector status in Germany are always approved.

"It would definitely be a loss," said Peer Köpf, an expert on personnel and operations at the German Hospital Association.

Losing the steady flow of civilian servants would be the latest blow to Germany's health-care system, beleaguered by the spiraling cost of caring for an aging population. Earlier this month, Chancellor Angela Merkel's government announced further increases in premiums and cuts in medical spending to help plug an €11 billion ($14 billion) deficit in the country's public health-insurance system next year.

Hospitals, clinics and nursing homes have come to depend on the labor of such civilian servants, though the law dictates that they only do "supplementary" work that doesn't endanger traditional jobs.

Ria Schulze Bockhurst, head of human resources for two hospitals and several nursing homes around Münster in western Germany, said the organization's nearly 50 civilian servants perform basic nursing tasks and run errands, work that would otherwise need to be taken over by better-compensated employees.

Robert Dilssner, 22 years old, who is fulfilling his conscription duties at a work program for the disabled in Berlin, says eliminating the draft would hurt social programs in more ways than one. A number of his friends have pursued careers in health care or social services "that they never would have been exposed to if it hadn't been for their civil service," he said.

He said he had never considered doing military service, instead. "I saw [civilian service] as a chance to learn something valuable in helping other people, to experience a new perspective," said Mr. Dilssner, who will resume his engineering studies once he finishes his service at the end of August.

Already, health-care providers and civilian-servant employers are scrambling to adapt to a law that took effect on July 1 shortening the length of conscripted service time to six months from nine. After training and vacation time, Mr. Köpf said, civilian servants will end up on the job for just four months.

"Civilian servants frequently work with patients, and that definitely takes some getting used to," Mr. Köpf said. "With just six months, that won't really work anymore."

Aiming to cut roughly €1 billion a year from Germany's €31.1 billion military budget, Mr. Guttenberg wants to trim troop levels to 150,000 from 250,000, which would mean 40,000 fewer career and volunteer soldiers, who typically serve for at least two years, and seemingly no role for conscripts. Eliminating conscription, which costs include housing, feeding and training soldiers, could save at least €400 million a year, officials estimate.

Throughout the Cold War, compulsory military service was near universal in Europe. But Germany's draft, one of just five remaining among 28 countries in NATO, had its own particular purpose. The Allies initially banned Germany from cultivating a military force after World War II, but as tensions between the Soviet Union and the West grew, that policy shifted. The Bundeswehr was established in 1955, along with 18 months of mandatory military service for men.

Then the Soviet Union collapsed, and the main adversary of Western European armies vanished. Since the mid-1990s, Spain, Portugal, Italy, France, the Netherlands, Belgium and—as of this month—Sweden have scrapped conscription.

U.K. plans to overhaul tax rules

By Laurence Norman

LONDON—The U.K. Treasury is expected to promise a renewed fight to simplify the tax code on Tuesday, setting up an Office for Tax Simplification to reform Britain's mammoth 11,000-page tax rules, a person familiar with the matter said.

Chancellor of the Exchequer George Osborne is due to announce that former **PricewaterhouseCoopers LLP** tax partner John Whiting and ex-Treasury minister Michael Jack will head the new office.

The office will be asked to submit reports on at least two issues over the next 12 months—the first on tax relief and another on business taxation. The Treasury hopes to receive an interim report on overhauling tax-relief rules by the autumn.

As well as reporting on business taxes, the office will also be tasked with reforming the personal tax system. Mr. Osborne's Conservative party has said that under the previous Labour government, the tax system ended up discouraging people from taking jobs. In its coalition agreement after taking power in May, the new government promised to overhaul the tax system to make it "more competitive, simpler, greener and fairer."

Mr. Osborne has already announced a five-year program to lower the corporate tax rate to 24% from the current 28%, to be paid for by simplifying and reducing business-tax relief and avoidance.

The chancellor has also said he will look again at the rules dealing with foreign companies' profits to ensure the U.K. regime doesn't drive multinational companies abroad.

The person familiar with the matter said Mr. Whiting and Mr. Jack, who was a former Conservative Treasury minister in the 1990s, wouldn't be paid for their work.

EUROPE NEWS

Bank tied to Iranian nuclear effort

As the international sanctions noose tightens around Iran's nuclear program, Tehran is increasingly relying on a small, Iranian-owned bank in Germany to conduct business on behalf of the regime's blacklisted companies, Western officials say.

*By **Peter Fritsch** in Washington and **David Crawford** in Berlin*

The **European-Iranian Trade Bank** AG—known as EIH Bank for its German initials—has done over a billion dollars of business for Iranian companies associated with Iran's conventional military and ballistic missile procurement programs, including companies blacklisted by the U.S., the United Nations and the European Union, according to a person familiar with the matter.

Among those companies are units of Iran's Defense Industries Organization, the Aerospace Industries Organization and the Iranian Revolutionary Guard Corps, Western officials told The Wall Street Journal. Western governments allege those companies are involved in the development of Iran's nuclear and missile programs.

In 2009, Western officials say, EIH appears to have been involved in a broad sanctions-evasion scheme, conducting euro-denominated transactions on behalf of Iran's Bank Sepah, a bank under broad U.N., European and U.S. sanctions for facilitating Iran's weapons trade and proliferation activities.

Details of the transactions allegedly facilitated by EIH, including the kinds of goods traded and the identities of the sellers, couldn't be learned.

A spokesman for EIH, which is based in the German city of Hamburg, declined to comment. Bank Sepah didn't return calls seeking comment.

EIH is on a U.S. Treasury blacklist, and U.S. officials have raised concerns about the recent uptick in the bank's activities with Germany. President Barack Obama last month signed into law a bill that could bar foreign banks and companies from doing business in the U.S. if they do business with Iran.

A spokesman for Germany's banking oversight agency, BaFin, says the U.N. Security Council—not the U.S.—sets the standard by which Germany imposes sanctions on Iranian banks operating in Germany.

EIH "is not mentioned in the U.N. Security Council resolutions," and therefore may operate freely under German banking law, the BaFin spokesman said.

That could change in coming weeks. "Consultations are under way at the European level to decide whether other institutions should be designated with sanctions," said Tobias Pierlings, a spokesman for Germany's Economics Ministry. "The prerequisite for any designation is concrete evidence of participation by the person or entity in proliferation activities."

EU foreign ministers are set to meet July 26 to discuss new EU sanctions targeting Iranian trade. Those talks follow a European commitment last month to increase restrictions on Iran's financial transactions. The U.S. is pushing the EU to add EIH and others to its blacklist.

Critics of the global sanctions regime say the lack of harmonization among U.N., EU and U.S. sanctions allows Tehran to exploit the differences and continue to finance its nuclear ambitions. U.S. sanctions are by far the most far-reaching: Washington bans business with all of Iran's major state-owned banks. In the U.N., Russia and China have supported softer penalties.

Of the four Iranian banks registered in Germany, only EIH is free of any sanctions or controls, according to German officials. That's because EIH hasn't been sanctioned by the U.N., and Germany and other EU governments take their cue on sanctions from the U.N., not from the U.S.

EIH was founded by a group of Iranian merchants in Hamburg in 1971. It operates openly under the supervision of German bank regulators. Officials say it has become an important locus in Europe for facilitating Iranian trade in euros.

A pressure campaign led by the U.S. Treasury has caused many major European banks and businesses to restrict or abandon dealings with Iran. As some of those banks have pulled back, EIH has become more important in helping Iranian firms finance trade, Western officials say.

EIH's Iran business grew in the wake of **Deutsche Bank** AG's acquisition last year of **Sal. Oppenheim Group**, one official said. As part of that deal, Deutsche Bank acquired **BHF Bank** AG.

BHF was particularly active in banking for Iranian companies, according to people familiar with the matter. But Deutsche Bank—which

Bloomberg News

The Bank Sepah International in Frankfurt. EIH are its German initials.

does substantial business in the U.S.—has sought to unwind that business. EIH has stepped into the resulting void to aid Iranian transactions, Western officials say.

"Deutsche Bank has been a very good citizen on this," one official said.

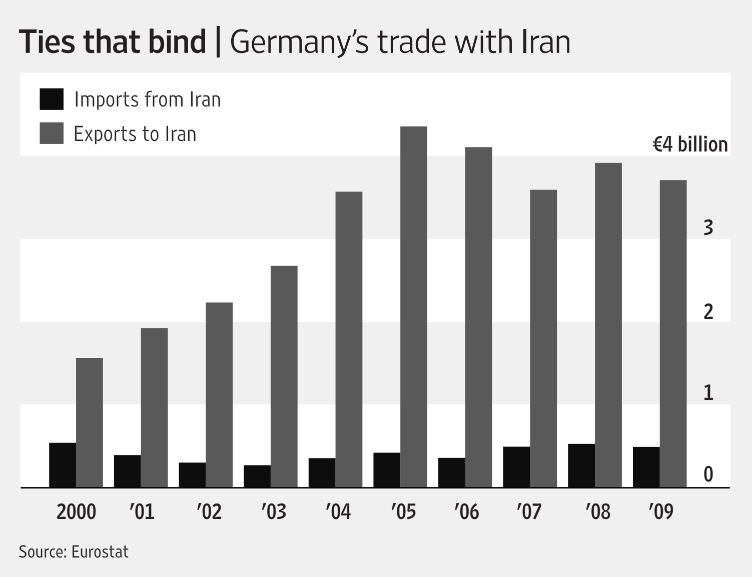
A Deutsche Bank spokesman said BHF's board has ruled out any new business with Iranian counterparties and will exit existing business arrangements with Iranian companies to the extent legally possible. He added that the bank is considering "all its options for BHF Bank including the option of selling BHF."

Still, Germany remains the Islamic republic's largest trading partner in Europe, a fact that is earning Berlin unwelcome scrutiny in the wake of efforts to deepen sanctions against Tehran. Though major firms such as **Siemens** AG have committed to wind down business ties to Iran, German trade between the countries totaled about $1.8 billion in the first four months of this year, up almost 20% over the like period in 2009.

A recent report by Avi Jorisch, a former U.S. Treasury analyst, found that five German banks still maintain accounts with Iranian entities under sanction by the U.N. It isn't clear, however, how active those accounts are.

Though EIH remains free of broad international sanctions, it is closely affiliated with companies blacklisted by the U.N.

The U.N. last month sanctioned Malaysia-based **First East Export Bank** PLC. That bank is controlled by EIH's parent, Bank Mellat—an Iranian bank that the U.N. last month said in a resolution has "facilitated hundreds of millions of dollars in transactions for Iranian nuclear, missile and defense entities."



In November, the U.S. Treasury unilaterally imposed sanctions on Bank Mellat and its CEO and chairman, Ali Divandari. Mr. Divandari is a member of EIH's supervisory board. He couldn't be reached for comment.

Mellat has rejected the accusations. After the U.S. blacklisted Mellat's Malaysia unit in November, Iranian deputy economic minister Asghar Abolhasani told state news agency IRNA: "America has not provided specific and justifiable reasons for sanctioning Bank Mellat in Malaysia."

EIH's business has ticked steadily upwards. Since the end of 2007, the Iranian state has doubled its investment in EIH. In 2005, the bank reported having processed transactions valued at about €1.5 billion. In 2008, the last year complete results are available, the bank's 92 employees handled transactions valued at about €3.3 billion, according to its annual report. At the end of 2008, the bank reported almost €2.8 billion in assets.

Cameron to accent U.S. trade

By Alistair MacDonald And Laura Meckler

U.K. Prime Minister David Cameron will seek during his first official visit to the U.S. to play the role of a pragmatist more eager to drum up trade than indulge in the tributes to the nations' "special relationship" that tend to dominate such trips.

After landing Tuesday, Mr. Cameron will meet with President Barack Obama, Vice President Joe Biden and other senior U.S. officials in Washington, before flying to New York, to meet with United Nations Secretary-General Ban Ki-moon and New York Mayor Michael Bloomberg.

Most of the meetings will be devoted to building relationships, with an emphasis on issues such as the war in Afghanistan and trade between the two countries.

Throughout the trip, Mr. Cameron will highlight the latter issue. Britain's new coalition government, which he leads, has placed a major focus on pushing trade as a key part of foreign relations.

The U.S. is the U.K.'s biggest single national trading partner, responsible for 18% of British exports.

Bilateral trade valued at $170 billion a year flows between the two countries and the U.K. and U.S. are each other's biggest foreign investor.

Mr. Cameron points out that each day a million people in America go to work for British companies, and vice versa.

A senior Obama administration official said Monday that he doesn't expect the Oval Office conversation to touch much on trade. Rather, he said, expected topics include Iran, the Mideast peace process, the global economy and the war in Afghanistan.

More importantly, the official said, the meeting will be a chance for the two leaders to build their personal relationship.

"This is kind of a critical test in any respects," said Fiona Hill, director of the Center for U.S. and Europe at the Brookings Institution, a Washington think tank. "Is there still any oomph there in the British-U.S. relationship? ... Can they work out a

WPA Pool/Getty Images

British Prime Minister Cameron, right, listens to speakers in Liverpool Monday.

pragmatic, businesslike working relationship?"

The two leaders are likely to talk about the Scottish government's decision to free Lockerbie bomber Abdel Baset al-Megrahi from prison last year, White House Press Secretary Robert Gibbs said. Both sides have said they believe it was the wrong decision.

—Laurence Norman contributed to this article.

EUROPE NEWS

Wm. J. Hennessy Jr./CourtroomArt.com

Walter Kendall Myers, a privileged descendant of the inventor of the telephone who became a spy for Cuba, and his wife, Gwendolyn, stand at the lectern before Judge Reggie Walton during their sentencing hearing Friday in Washington.

Spy for Cuba gets life

By Evan Perez

A former State Department analyst, a privileged great-grandson of Alexander Graham Bell who became a spy for Cuba, defended his decades of work for Fidel Castro before being sentenced Friday to life in prison.

Walter Kendall Myers, 73 years old, and his wife, Gwendolyn, 72, admitted in court to spending nearly 30 years passing classified information to Cuba's intelligence agency.

He was sentenced after pleading guilty to espionage and wire fraud.

Mrs. Myers was sentenced to 81 months after pleading to conspiracy to gather and transmit national defense information. She is likely to serve 4½ years.

Prosecutor Gordon Harvey described the couple as "traitors." If they loved the Cuban people so much, Mr. Harvey said, why didn't Mr. Myers just donate his wealth to the underprivileged there? They admired the Castro revolution, but didn't defect because they only wanted to admire the revolution "from a safe distance," Mr. Harvey said.

The couple's story, coming on the heels of the Russian spy ring, reinforces the assertion of counter-intelligence investigators that foreign spy operations in the U.S. are continuing long after the end of the Cold War.

Code-named Agent 202 by Cuban intelligence, Mr. Myers and his wife, Agent 123, were recruited in the late 1970s amid Cold War tensions, the couple admitted.

He went to work for the State Department, gaining "top secret" security clearances to carry out espionage, Federal Bureau of Investigation counter-intelligence investigators alleged.

Mr. Myers is believed to have stolen classified data from his work as an official in the State Department's bureau of intelligence and research.

He had access to valuable information during the many flare-ups in U.S. relations with Cuba, from refugee crises to Cuba's hardships amid a tightened U.S. embargo under the Helms-Burton law.

The FBI declined to characterize the specific information he sold. But prosecutors noted in court filings that Cuban intelligence has been known to resell information to other countries, including Russia and China, as well as to such groups as the Irish Republican Army.

Before they were arrested in June 2009, the couple sent encrypted messages via shortwave radio and passed information in discreet shopping-cart handoffs at a Washington supermarket, and during trips to Trinidad, Brazil and elsewhere.

On Friday, Mr. Myers stood tall, managing to keep a slightly patrician air despite the blue prison-issued garb he wore, and read a 20-minute statement admitting their crimes.

'Fidel is wonderful, just wonderful,' Walter Kendall Myers gushed, according to the FBI. Mr. Myers, a former State Department aide, was recruited in the 1970s.

"We acted as we did for 30 years because of our ideals and beliefs," he said. They weren't motivated by "anti-Americanism," he said, but rather their objective was "to help the Cuban people defend their revolution."

Mr. Myers's voice broke twice—when he described his devotion to his wife and his friendships with African-American prisoners, whose oppressed life he said he came to know behind bars.

Mr. Myers quoted from Nelson Mandela as he vowed to help make a difference by tutoring fellow prisoners.

Mr. Myers grew up in wealth as an heir to Alexander Graham Bell and grandson of Gilbert Grosvenor, first editor of National Geographic magazine.

He went to private boarding schools and Brown University. He had two children from an early marriage. Mrs. Myers was born in Sioux City, Iowa, and raised four children in South Dakota before she married Mr. Myers.

U.S. District Judge Reggie Walton noted that Mr. Myers's background and contrasted it with his own family's American beginnings in slavery.

He said he was "perplexed" by Mr. Myers's claims of trying to help the Cuban people, given the regime's human-rights record. Judge Walton said that despite his ancestors' own experience in America, "America is not the devil that you may believe."

After their statement, the couple walked back to a table and smiled at their children seated in the front row of the courtroom. Family members wiped away tears.

The couple had essentially given up the spy game in 2007 with Mr. Myers's retirement from the State Department, fearing they were in danger of being discovered.

But an FBI undercover agent posed as the couple's new Cuban spy handler and met with them at various Washington hotels in 2009.

Mrs. Myers was suspicious of the purported handler, but went along to support Mr. Myers, who was thrilled at the thought of restarting his work for the Cubans.

During their meetings with the FBI undercover agent, the couple praised the Cuban revolution, according to FBI transcripts of secretly recorded conversations. They spoke of many medals awarded secretly to them by the Cuban government.

The highlight of their career, they said, was being secretly flown to Cuba in 1995 for a four-hour meeting with Fidel Castro himself.

"Fidel is wonderful, just wonderful," Mr. Myers gushed, according to the FBI transcript of the meeting with the undercover agent.

Mrs. Myers responded: "He's...the most...incredible statesman in...a hundred years, for goodness' sakes."

In Russia-U.S. warming lies a mutual opportunity

[Capital Journal]

By Gerald F. Seib

It's too early, and there have been too many disappointments in the past, to call it a Kumbaya moment. But American relations with Russia are in the midst of an interesting warming trend.

You don't have to take the word of somebody in Washington for that. A better source, perhaps, is Russian President Dmitry Medvedev.

In a little-noticed speech to Russian ambassadors last week, Mr. Medvedev said a recent visit he made to the U.S. showed the possibilities for "a positive agenda in our relations with the United States" and the "potential of our future cooperation."

He talked of a "paradigm shift" under way in Russian relations with the U.S. that could help the two nations reach common goals. And he spoke explicitly of Russia's need for "modernization alliances"—the kind that can update Russia's economy—with both Western Europe and the U.S.

Perhaps of more immediate importance, Mr. Medvedev bluntly called out Iran for moving toward a nuclear-weapons capability, made clear that the Kremlin views that advance dimly and said it reflects a "systemic" failure in the international effort to stop the spread of nuclear arms.

All told, the Russian leader described a relationship on the mend, just two years after Moscow's military incursion into Georgia sent it into a tailspin. (The world being what it is today, you can read an English-language version of the speech on the Kremlin's website at http://www.eng.kremlin.ru/transcripts/610.)

How seriously can one take the warm and fuzzy words? There's no denying continuing tensions over Georgia, as well as other areas of friction. Indeed, it's significant that Mr. Medvedev didn't do that. He acknowledged that he has limited faith in economic sanctions against Iran, and he nodded to continuing disagreements with the U.S. on missile-defense systems. "He didn't brush past disagreements," says one senior U.S. official, who considers that a sign of a maturing relationship.

Moreover, the last two decades illustrate the need to view signs of progress on the Russian front skeptically. The final leader of the Soviet Union, Mikhail Gorbachev, showed he could change history, but was unable to manage it. Former Russian President Boris Yeltsin seemed a true democrat at heart, but while the spirit was willing, the flesh was weak. Former President George W. Bush looked the previous Russian president, Vladimir Putin, in the eye and thought he saw a trustworthy partner, but that partner turned out to be as much autocrat as democrat.

And Mr. Putin is still around as prime minister, a post from which he is busy (perhaps with Mr. Medvedev's support) suppressing political opposition, cheering on a crackdown on Muslim activists in Chechnya and expanding the power of Russian intelligence services. American officials are divided on whether Mr. Putin shares President Medvedev's view of Russian relations with the West or whether it's simply impossible to know for sure.

Bearing in mind all those caveats, the broadly cooperative relationship Mr. Medvedev described still is important in the short run for the foreign policy of President Barack Obama, who has made it a personal mission to build a constructive relationship with his Russian counterpart. Without some meeting of minds with Russia, and with China, dealing with the nuclear programs of Iran and North Korea will be immeasurably more difficult, and the odds of success even longer than they are now.

Without some meeting of minds with Russia, and with China, dealing with the nuclear programs of Iran and North Korea will be immeasurably more difficult.

The most significant part of Mr. Medvedev's speech is the broader rationale he offers for a new approach. He describes a foreign policy that needs to serve Russia's chief domestic goal of a "modernization" of its economy: "We believe that with the support of our government and in cooperation with foreign partners, Russian entrepreneurs, scientists, engineers will turn our economy into one of the driving forces of global development."

No coincidence, then, that when Mr. Medvedev visited the U.S. last month, he traveled not only to Washington but to Silicon Valley as well.

The Medvedev vision of a better relationship with the U.S. just passed one big test, when the two countries quickly and adroitly disposed of a spy scandal. More tests lie ahead.

Will Russia honor the spirit of sanctions against Iran, or, as some recent moves on sales of fuel and military equipment to Tehran suggest, undermine them? Indeed, Russia demanded loopholes in a United Nations sanctions resolution so that it could continue some military sales, and, in a recent interview with The Wall Street Journal, Mr. Medvedev complained that the U.S. is going beyond the letter of the sanctions resolution.

On the U.S. side, will the Senate ratify this year a new strategic-arms agreement Mr. Obama worked with Mr. Medvedev to conclude? Republicans are voicing some doubts, while administration aides seem optimistic about ratification. If the treaty languishes, it's doubtful that the Russian president will repeat the speech he delivered last week.

U.S. NEWS

Clinton unveils new aid for Pakistan

By Jay Solomon

ISLAMABAD—U.S. Secretary of State Hillary Clinton unveiled $500 million in new development projects for Pakistan on Monday, as the Obama administration seeks to use aid to build broader support in the South Asian nation for the war against al Qaeda and the Taliban.

Mrs. Clinton singled out mounting U.S. efforts to address Pakistan's chronic water and electricity shortages, including new dam projects and programs to refurbish electrical grids.

The secretary of state also said Washington would build new medical facilities in remote Pakistani regions, devote $100 million to aid small and midsize businesses, and create a $50 million innovation fund to develop new technologies.

"We share with Pakistan a vision of a future in which all people can live safe, healthy, and productive lives," Mrs. Clinton told a gathering of U.S. and Pakistani officials at Islamabad's Foreign Ministry. "These are the building blocks of strong, durable, and thriving societies."

Mrs. Clinton is in Islamabad for the second gathering of the Obama administration's comprehensive Strategic Dialogue with Pakistan. She was scheduled to proceed to a conference of foreign ministers in Afghanistan.

European Pressphoto Agency

Hillary Clinton, in Islamabad Monday, highlighted U.S. efforts to address Pakistan's chronic water and electricity shortages.

The engagement with Pakistan is focused on addressing the view among Pakistan's public that the U.S. is focused only on prosecuting war in the Muslim country,

Some Pakistanis charge the U.S. with historically abandoning its ally following military confrontations, such as the 1980s U.S.-backed insurgency against Soviet troops in neighboring Afghanistan.

The Obama administration and President Asif Ali Zardari have identified 13 areas where the U.S. and Pakistan can collaborate, including energy, water, judicial reform and education. The first gathering of the Strategic Dialogue was held in Washington.

Mrs. Clinton and her Pakistani counterpart, Foreign Minister Shah Mehmood Qureshi, acknowledged that skepticism inside Pakistan remains high toward the U.S. But both diplomats said they believed this perspective would change once development projects progressed.

"Perceptions will change ... once they see how their lives have changed," Mr. Qureshi said during a joint news conference with Mrs. Clinton.

In October, the U.S. Congress allocated $7.5 billion in development aid for Pakistan, which is scheduled to be spent in the next five years. This marked a tripling of nonmilitary U.S. assistance from the George W. Bush administration.

Republicans see path to control of Senate

By Naftali Bendavid

WASHINGTON—Democrats for the first time are acknowledging that Republicans could retake the Senate this November if everything falls into place for the GOP, less than two years after Democrats held a daunting 60-seat majority.

Leaders of both parties have believed for months that Republicans could win the House, where every lawmaker faces re-election. But a change of party control in the Senate, where only a third of the members are running and Republicans must capture 10 seats, seemed out of the question.

That's no longer the case. The emergence of competitive Republican candidates in Wisconsin, Washington and California—Democratic-leaning states where polls now show tight races—bring the number of seats that Republicans could seize from the Democrats to 11.

Democrats now control the Senate 59-41—after the death of Democratic Sen. Edward M. Kennedy, who was replaced by Republican Sen. Scott Brown—including two independents who usually vote with them. That means Republicans need 10 seats to take a 51-49 advantage.

Republicans would have to win virtually every competitive race to retake the Senate, without losing any seats of their own—clearly an uphill climb.

The trouble for Democrats is that many trends are against them. Surveys show that Republicans are more motivated than Democrats to go to the polls, and that voters are looking for new leadership in Congress.

"I think there is definitely a chance" of losing the Senate, said Democratic strategist Gary Nordlinger, a Washington-based media consultant. "I wouldn't call it a probability, but there is certainly a chance."

"Republicans still have to [win] all the competitive races in order to get to a majority, but at least there are enough seats on the table to pull it off," said Nathan Gonzales, political editor of the non-partisan Rothenberg Political Report.

Democratic politicians have been saddled with an economy that they'd hoped—and predicted—would be doing much better by now. And if Republicans retake one or both chambers of Congress, it would create a serious roadblock for President Barack Obama's agenda. But Republicans would also have greater responsibility for tackling stubborn problems such as the economy, energy and immigration.

As the races warmed up this spring and summer, Republicans raised more money than Democrats. In a dozen of the closest Senate contests reviewed by The Wall Street Journal, the GOP candidates as a group claimed 58% of contributions raised during the three-month period ending June 30. Democrats in those races, as a group, had a slim lead in total cash on hand.

Former Sen. Norm Coleman, a Minnesota Republican who lost his seat to onetime comedian Al Franken in 2008, is CEO of American Action Network, a conservative group that's spending about $750,000 to defeat three-term Sen. Patty Murray in Washington State. "Races like Wisconsin, California and Washington are clearly in play," Mr. Coleman said.

Many Democrats dismiss the notion that they're in danger of losing the Senate. "I believe that is wishful thinking," said Sen. Bob Menendez of New Jersey, who coordinates the Democrats' Senate campaigns. He added that the chances are minimal that Republicans would win so many of the seats in play while losing none of their own.

The math and the map show why Wisconsin, Washington and California are important.

Many Democratic strategists consider three seats all but lost—in North Dakota and Delaware, where popular Republicans are running for seats left open by Democratic departures, and in Arkansas, where Sen. Blanche Lincoln is trailing significantly in polls. Additionally, an Indiana seat, also open after a Democratic retirement, will be hard to retain.

Four other Democrat seats are tossups: in Pennsylvania, Illinois, Colorado and Nevada. If Republicans capture those eight seats, and win two of the three newly competitive races in Washington, Wisconsin and California, they would retake the Senate.

Politicians have long thought a change of control at the Senate, where only a third of members are running, seemed out of the question. That's no longer the case.

But Republicans also can't afford to lose any of their current seats. Democrats are mounting energetic campaigns in Missouri, Ohio, New Hampshire and Kentucky, where Republican senators are retiring. Then there's Florida, where Gov. Charlie Crist, after leaving the GOP to run as an independent, holds a lead. Senate Democrats believe he will align with them if he wins.

Democrats say that GOP primary voters boosted Democratic chances by selecting several tea party-inspired candidates who are proving to be too conservative or anti-government for the general electorate.

Wisconsin has emerged as a test of that claim. In the weeks before the Republican convention in late May, Ron Johnson, who hasn't held political office, began appearing at tea party rallies. Tall and silver-haired, he proved a commanding speaker.

Mr. Johnson provided copies of his speeches to local talk radio hosts, and conservative host Charlie Sykes read excerpts over the air. Mr. Johnson jumped into the race six days before the convention, pledging to spend millions on the campaign. "He literally came out of nowhere," said Brian Westrate, chairman of the Eau Claire County GOP.

Mr. Johnson built his successful company, which makes a specialty plastic for packaging, from the ground up, and it exports to various countries including China. But he also has made comments Democrats have seized on, such as asking in a March speech, "How is Social Security different from a giant Ponzi scheme?" Democrats are using that quote to suggest Mr. Johnson is radically anti-government. Mr. Johnson rejects the idea. "The problem is that Social Security funds have been spent," he said in an interview. "They're gone. I'm just describing the problem."

Wisconsin's Democratic Sen. Russ Feingold, meanwhile, says he's not taking the threat lightly. His campaign held 132 events the week of July 4 alone, and he has hosted town hall meetings in each of Wisconsin's 72 counties.

"I'm sure it will be close, but I'm used to that," Mr. Feingold said. "I will personally fight for every vote."

On many on high-profile, issues, Mr. Feingold has been able to separate himself from the Washington establishment that is now so unpopular. Last week, he was the sole Democratic senator to oppose the new bank regulation law, saying it was too weak.

They want to put me in the box of the classic Washington incumbent," Mr. Feingold said. "But people in Washington don't think I'm a classic Washington incumbent; they think I'm a pain in the neck. They're going after the wrong guy with those arguments."

Still, the candidates are essentially tied in early polls. Vicki Burke, who chairs the La Crosse County Democrats, said that "in talking to people who work in [Mr. Feingold's] campaign, they think, given the atmosphere, that this could be the first time where he could possibly lose a race."

In Washington State, Sen. Murray also faces a vigorous challenge. GOP leaders worked hard to persuade former state Sen. Dino Rossi to run. He faces a primary challenge from former professional football player Clint Didier, who's been endorsed by former Alaska governor Sarah Palin.

Mr. Rossi, who has run strong but unsuccessful statewide races twice before, is off to a fast fundraising start. He has brought in $1.4 million since entering the race a month ago, compared with the $1.6 million Ms. Murray raised over the past three months. Ms. Murray, who's been raising money for a longer time, has $6.8 million in her coffers overall.

Washington State Democrats say they are confident Ms. Murray will prevail, but some say it won't be easy. "I think she will have a tough race, but I certainly hope she wins," said Norm Osterman, treasurer of the Walla Walla County Democrats. "All Democrats are having a tougher time this fall."

In California, Democratic Sen. Barbara Boxer has a slight lead in most polls over Republican Carly Fiorina, former chief executive of **Hewlett-Packard** Co.

Ms. Boxer has $11.3 million in cash to $620,000 for Ms. Fiorina, but Ms. Fiorina has the ability to spend money from her own fortune.

The state has struggled with budget problems that its leaders seem incapable of fixing, souring Californians on incumbents.

In a recent Field Poll, 43% approved of the job Ms. Boxer is doing, among her lowest ratings ever. While she led Ms. Fiorina 47%-44% in the Field Poll, that was down from a 30-point lead in March 2009.

WORLD NEWS

Somali terror group expands reach

Investigators say al Shabaab recruited local man to coordinate Uganda bombings and got funding from al Qaeda

The terror group behind last weekend's deadly Uganda blasts recruited a local man to coordinate the attacks and received funds from al Qaeda, say investigators, as it extends its reach beyond lawless Somalia.

By ***Will Connors***
in Kampala, Uganda,
Siobhan Gorman
in Washington
and ***Sarah Childress***

Al Shabaab, the Somalia-based group that has claimed responsibility for July 11's triple suicide blasts that killed 76 people in Uganda's capital, Kampala, has in recent months built up Pakistan-style terror training camps. One top leader, Sheikh Muktar Robow, has helped to transform the group from a local insurgency into a global jihadist organization modeled on, and swearing allegiance to, al Qaeda.

That picture of the group, and its development under Mr. Robow, emerged from interviews with Ugandan, Kenyan and U.S. investigators; current and former U.S. intelligence officials; and Somalis, including a member of the militant group.

A U.S. intelligence official said information gleaned from militant communications shows links between al Shabaab and al Qaeda leaders in Pakistan and Yemen. U.S. officials also see evidence of overlap in training and membership and say their working assumption is that al Shabaab has several hundred core members, similar to the numbers in al Qaeda in Pakistan and in al Qaeda's Yemeni outpost.

Intelligence officials say they believe al Qaeda is using the Somali group as a symbiotic host body, allowing its operatives access to other African countries. "As much as we're looking at al Shabaab, they are riding on the back of a more experienced player," said Col. Herbert Mbonye, the director of counterterrorism for Uganda's military intelligence body.

That relationship has raised red flags at U.S. intelligence agencies. In the past 18 months, militant training camps have emerged in Somalia similar to those that developed in Pakistan's tribal areas, a U.S. intelligence official said. Intelligence officials are now following about two dozen individuals from the U.S. and other Western countries who may have been affiliated with al Shabaab, or gone through these camps.

"It's quite an alarming story," the U.S. intelligence official said.

Al Shabaab's relationship with al Qaeda relationship appears to have been cultivated in part by Mr. Robow, a top commander. Also known as Abu Mansur, he is among the U.S. government's most wanted terrorists.

Mr. Robow offered a warning of sorts ahead of Sunday's blasts, which hit a restaurant and a sports club where people had gathered to watch the final match of the World Cup. Speaking during a public address at Friday prayers earlier this month, Mr. Robow called for attacks against countries that had sent some 6,000 troops under African Union auspices to support the Somali government's offensive against al Shabaab. "We tell the Muslim youths and Mujahedeen, wherever they are in the Muslim world, to attack, explode and burn the embassies of Burundi and Uganda," Mr. Robow said, according to local media reports.

Reuters

An al Shabaab fighter brandishes her gun during a July 5 demonstration near Mogadishu against the African Union Mission in Somalia.

Mr. Robow grew up in southern Mogadishu as a devoted student of the Quran, according to public speeches he has made. He studied law at the University of Khartoum in Sudan, and then returned to Mogadishu to teach Arabic for several years. He is about 40, U.S. officials believe, based on a birth date on an Eritrean passport he used.

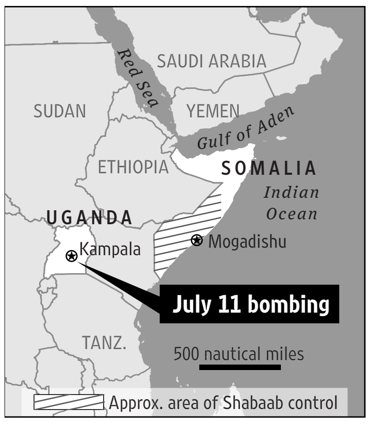
In 2000, Mr. Robow traveled to Afghanistan to train with the Taliban and al Qaeda, which used the strife-torn South Asian country to plot the Sept. 11 attacks in the U.S. In Afghanistan, Mr. Robow learned to fight, fire a sniper rifle and conceal roadside bombs, an al Shabaab official in Somalia said. He stayed less than a year, leaving before U.S.-led forces swept into Afghanistan.

Back in Somalia, Mr. Robow became a member of the Union of Islamic Courts, which aimed to establish strict Shariah law in the country, which had been largely lawless for a decade. The group came to power in 2006. Mr. Robow helped to establish an Islamist government and founded al Shabaab, a youth brigade that would serve as the union's armed wing.

The Islamist government soon collapsed. Al Shabaab endured. Mr. Robow, a skilled orator, became an al Shabaab spokesman and eventually deputy commander.

Al Shabaab, which controls vast territory in Somalia, has been engaged in a running battle with Somalia's transitional government. The group has pinned the government to a strip of the capital, Mogadishu, and largely prevented officials and parliament from meeting.

Beyond his ambition to overthrow Somalia's government, Mr. Robow has advocated linking the group's ambitions to global jihad. Through media interviews and in videos posted online, he sought to attract fighters in Afghanistan, Chechnya and Iraq, largely because foreign recruits could replenish al Shabaab's ranks and aid its finances. In a 2008 interview, he lamented that there "are not enough non-Somali brothers."



Source: AEI Critical Threats

The same year, the U.S. Treasury Department declared al Shabaab a terrorist group and named Mr. Robow its "spiritual leader." Mr. Robow later released a statement saying the group was "honored" to be included on the list but expressed disappointment al Shabaab wasn't ranked higher.

Senior U.S. administration officials said some foreign fighters who answered Mr. Robow's calls—some of whom have "close links" with al Qaeda—came with experience, funding and the agenda of establishing Somalia as a base from which to attack Western targets.

The foreigners also brought new tactics. Roadside bombs and suicide blasts, once unheard-of in Somalia, are now part of al Shabaab's armory. The group's commanders have banned dancing, mustaches and, most recently, watching World Cup games on television. Fighters punish offenders with floggings or public amputations.

On Wednesday, armed al Shabaab fighters drove through towns in southern Somalia, blaring a warning to residents through megaphones mounted on their vehicles, according to witnesses. "You must collaborate with [us] and allow your sons to fight the enemy of Allah," Abu Maryama, a senior al Shabaab official told crowds in the southwestern town of Baidoa. "If you pay no heed to this ... you will be considered as another enemy and face punishment."

Harsh retribution and indiscriminate deaths have sapped public support for the group, and created rifts within it. Mr. Robow has been caught between those who want to focus the insurgency in Somali—and retain a measure of popular support— and the global jihadists who don't care about local backing, according the al Shabaab colleague. Mr. Robow, a Somali who has long opposed foreign intervention in his country, may not be considered radical enough for the new agenda, according to a recent report by the International Crisis Group, a Brussels based think tank.In the Uganda attack, the group's two factions apparently found middle ground.

The blasts have presented U.S. officials with a quandary. They see a need to step up support and involvement in the region, but they haven't determined the best course. "Violence always breeds urgency," the U.S. intelligence official said. "The question is: What [to do]?"The U.S. has been tracking al Shabaab and al Qaeda in Somalia for years, officials say. The Central Intelligence Agency works with military special forces units to collect intelligence and pinpoint targets, a former senior intelligence official said. The U.S. also works closely with the Ethiopian and Kenyan governments on counterterrorism operations.

Those efforts have grown in recent years as U.S. officials discovered as many as 20 Americans from Minnesota making their way to Somalia, including one who was determined to have been among five suicide bombers in an October 2008 attack in northern Somalia.

The intelligence-gathering paid off last year when U.S. Special Forces killed Saleh Ali Saleh Nabhan, a top operative linked to both al Qaeda and al Shabaab who was believed to be linked to 1998 U.S. Embassy bombings in Kenya and Tanzania. But U.S. Special Forces units and intelligence officials have been grappling with a broader response to the terror threat from Somalia. Calling in airstrikes could fuel retaliatory measures against a weak Somali government. It could also stir up anti-U.S. sentiment that would advance the group's agenda, said the U.S. intelligence official.

On Thursday, an al Shabaab leader underscored that point, delivering a message on the radio in Mogadishu congratulating what he called the Martyr Saleh Nabhan Brigade for the Kampala attacks.

Intelligence agencies have warned about al Shabaab's growing ambition to attack other countries—particularly Ethiopia, Djibouti and Kenya—as well as the West, the U.S. intelligence official said.U.S. intelligence hadn't picked up many direct threats against Uganda, but there has been a general concern about attacks targeting countries that supply troops to A.U. forces.

—Nicholas Baryio in Kampala and Keith Johnson in Washington contributed to this article.