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THE WALL STREET JOURNAL.

VOL. XXVIII NO. 121

EUROPE

Friday - Sunday, July 23 - 25, 2010

DOW JONES A NEWS CORPORATION COMPANY

europe.WSJ.com

EU banks face results Friday of stress tests

By Dave Kansas and David Enrich

LONDON—After weeks of anticipation, European bank stress-test results are due out late Friday after the region's stock markets close, a closely watched bid to quell concern about the stability of European banks after a spring of fiscal and financial problems.

Most banks are expected to pass the tests—which may or may not be a good sign, depending on whether the exercise is deemed to be tough enough.

Industry and government officials in Greece, Spain and Germany have hinted this week that major banks in their countries will come through the tests without trouble. That optimism, especially given challenges facing a number of banks in each of the three countries, has raised questions about the rigor of the tests.

Thus far only one bank, Hypo Real Estate in Germany,

is known to have failed the tests, but since it has already been taken over by the government, its capital levels aren't an issue. The tests will cover 91 banks in 20 European Union countries.

Critics say they fear a repeat of the widely-panned stress tests that regulators conducted last October. At that time, European regulators offered vague assurances that the region's banks were sufficiently capitalized. The fiscal and banking crisis that emerged just a few months later seemed to undercut that view.

The current round of European tests, announced in mid-June, is being compared with the U.S. tests done in early 2009. Those tests, which found that 10 of the 19 big banks needed to raise an additional \$75 billion in capital, are now seen as a turning point in the U.S. financial crisis.

At the time of implementation, the U.S. tests were

widely criticized in a manner similar to the way in which the European tests are being panned. For instance, critics in the U.S. attacked some of the macroeconomic assumptions as overly optimistic, a complaint that has been lodged in Europe.

Under the EU test scenario, the EU economy shrinks by about 2% this year and 1.25% in 2011, compared with current expectations of modestly positive growth in both years. Michala Marcussen, head of global economics at Société Générale in Paris, said the EU metrics are broadly comparable to those the U.S. imposed upon its banks last year.

Ultimately, the U.S. tests helped calm fears about banks' solvency, partly because their outcome seemed credible. The exercise also worked because the roughly two-month testing process served as a sort of prolonged "bank holiday," giving investors

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A big hand for Schleck



Getty Images

Andy Schleck of Luxembourg raises his fist as he wins Thursday's Tour de France 17th stage ahead of Spain's Alberto Contador, left, who hopes to still be wearing the leader's yellow jersey on the podium when the race finishes in Paris Sunday. Related article on Page 28, race report on WSJ.com/sport

Plane makers strain to set ash standards

By Andy Pasztor

LONDON—Three months after volcanic ash temporarily closed nearly 80% of European airspace, aircraft and engine makers don't appear any closer to agreement on new standards spelling out when it is safe to fly through such plumes.

On Thursday, industry groups representing the largest aerospace companies on both sides of the Atlantic called for further studies but reiterated the potential dangers of flying through even low-level concentrations of ash. Without reliable, onboard ash-detection systems, the group of chief executives urged pilots to focus on

"avoidance of visible ash."

Stung by widespread flight cancellations and revenue losses exceeding \$1.7 billion earlier this year, European airlines have been pressing for development of global standards specifying safe ash levels. But that has proved to be a daunting task, partly because each eruption produces different size particles with unique chemical compositions.

The effort to create industry-wide standards has created debates and disagreements among safety experts, industry officials and national regulators. The U.S. Federal Aviation Administration, for example, argues that when

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The Quirk



Goodbye, girdle: curvy stars spark a raid on padded panties. Page 29

World Watch

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Editorial & Opinion

David Cameron's opportunity in Europe. Page 13

Scotland rebuffs U.S. Senate on Lockerbie hearing request

By Paul Sonne and Alistair MacDonald

LONDON — Scotland's government has rebuffed a request by a U.S. Senate committee to send two Scottish officials to testify at a hearing next week that will explore the country's release last summer of the convicted Lockerbie bomber amid allegations that oil company BP PLC may have influenced the decision.

Neither Justice Secretary Kenny MacAskill nor Scottish Prison Service health director Andrew Fraser will attend the hearing in person, a spokesman for the Scottish government said Thursday, noting that the Scottish government

had already provided comprehensive written information to the Senate.

The Senate has also invited BP Chief Executive Tony Hayward, BP Special Adviser Mark Allen and former U.K. Justice Secretary Jack Straw to testify. A spokesman for BP said Thursday that the company had received the invitations but had yet to respond. Mr. Straw couldn't be reached immediately for comment.

The Senate intends to explore Scotland's decision last summer to release former Libyan security agent Abdel Baset al-Megrahi. Scotland, the U.K. and BP have all said that the oil company played no part in the decision to release Mr. Megrahi.

However, the complex circumstances surrounding Mr. Megrahi's release have revived questions about BP's connection to the affair.

BP has said that in late 2007 it lobbied to speed up the passage of a Prisoner Transfer Agreement between the U.K. and Libya, which was ratified in 2009. Mr. Megrahi applied to be sent back to Libya under that agreement, but the Scottish government rejected his application.

Instead, it granted him a "compassionate release" on the grounds that he was suffering from terminal prostate cancer.

But more than 11 months after his release, Mr. Megrahi remains alive in Libya.

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PAGE TWO

A day of jitters over those stress tests

[Agenda]

BY BILL JAMIESON



Ahead of the release of the results of European bank stress tests scheduled for 4 p.m. Friday, the atmosphere in continental financial centers on Thursday could not have been, well, more stressful.

Reports circulated of some last-minute haggling among German banks over how much to reveal, while European officials appeared to be at odds over whether to release stress test results earlier than planned.

French and German supervisors were said to be among those pushing to bring forward the release of the results while there have been divisions among the 27 EU member countries over how much information to divulge.

In a closely coordinated announcement, European banks' holdings of doubtful government debt are set to be disclosed in stress test results. Bank supervisors hope that the results of the tests will convince markets that the Continent's banking sector can withstand losses on government debt and that any support that banks need will be manageable.

The group presiding over the test is the Committee of European Banking Supervisors (CEBS). It has asked banks to provide all holdings of government bonds, although it has left publication up to banks and supervisors.

Despite the confusion, the haggling and the last-minute interventions, the hope among officials is that the health tests of the 91 banks involved will show that Europe's financial system is past the worst.

But the central dilemma remains: How much of a write-down of troubled sovereign-debt holdings can be considered prudential? And if European



'Billions for the banks—the debts for us—we say Thanks' reads a protesters' banner outside the Deutsche Bank annual meeting in Frankfurt in late May.

financial officials insist that no euro-zone country can go into default, the intellectual basis of the exercise looks unsound. In short, can the stress tests be cited as proof of solidity?

The 91 banks participating have been asked to estimate whether their Tier 1 capital will stay above 6% under two adverse scenarios. The first assumes a "double-dip" recession. The second assumes heavy losses on government bonds in addition to this.

Officials and bankers from several countries including Germany, France, Greece and Belgium have said their lenders should pass. But rather than reassuring investors, this has given rise to doubts as to whether the assessment is too lenient to reassure the markets.

Major listed banks are expected to win through. But doubts have arisen over smaller players such as Spanish cajas and German landesbanks. Most of these are unlisted and therefore not so exposed to regular investor scrutiny.

A research note on Spain from UBS on Thursday downgraded estimates for government-related corporates and stocks highly exposed to Spain.

Its base case is that Spain's banks are able to recapitalize and prevent default. But banks will be

unable to provide extensive credit and the credit crunch will continue "for some time." With huge exposures to the construction sector—twice that of Japan in the 1990s—"meaningful write-downs and recapitalizations appear to be necessary for banks and cajas."

The stress-test results could not come quickly enough for financial markets where worries about the health and solidity of the banking sector have driven down share prices since problems over the budget deficit and debt levels in Greece sparked worries that the entire common-currency zone could descend into a major crisis.

But hopes that the worst may be over for Europe's banks, together with figures showing a 3.8% month-on-month surge in euro-area industrial orders helped European stock markets, including bank shares, to rally Thursday.

The reports of last-minute haggling, worries about over-relaxation of the tests for some banks and concerns over the timing of Friday's release led some observers to contrast the febrile atmosphere in Europe with that of the more disciplined similar exercise in the U.S., which played a key role in stabilizing the country's banking sector.

Said Christophe Nijdam at equity research house AlphaValue:

"When the American stress test was released over a year ago it was done with military precision. ... It was a 'aye, aye sir.' Here in Europe, you have a huge cacophony, some leaks from each national regulator trying one way or another to protect its own bank and own reputation as regulator."

Nick Beecroft, senior markets consultant at Saxo Bank, described the efforts to enforce discipline on Friday's announcement as "a carefully choreographed piece of theatre. It is a necessary condition for the feeling of market security. Whether it is a sufficient condition, we have to wait and see."

The crunch test for Europe's banks comes with their holdings of Greek-government debt. The banks have been told by regulators to allow for 23-24% falls in the price of this debt. However, market worries in recent months have centered on the prospect of a more severe default that could require a 50% write-down in the value of Greek bonds.

For Europe's political and financial elite this is a possibility that dare not speak its name. So some have questioned the validity of the whole exercise. The deeper the discussion goes into stochastic modelling and "outlier" events, the more intellectually fraught it becomes.

For the moment, few disagree with the assessment of the International Monetary Fund. Earlier this week it stressed that the European banking sector was one of the main risks to the euro-zone's recovery and recommended highly transparent stress tests.

"A well-functioning financial system will be crucial to strengthening the moderate and uneven recovery," the IMF said.

"To maximize confidence-building, the IMF report recommends full disclosure of the findings and effective follow up."

That would become clear at 4 p.m. Friday.

Bill Jamieson is Executive Editor of *The Scotsman*

What's News

■ **The euro-zone economy** gathered steam at midyear, defying expectations—at least for now—of a fading recovery, as robust growth in Germany offset weakness in Greece and other indebted parts of Southern Europe. 5

■ **The EU trade commissioner** said recent changes to China's procurement rules aren't enough to address complaints of discrimination against foreign vendors. 6

■ **Stocks finished** sharply higher in Europe and the U.S., with investors setting aside fears regarding Friday's bank stress-test results and embracing stronger-than-expected economic data. 24

■ **Bernanke reiterated** in congressional testimony that the Fed will take action if the U.S. economy deteriorates. 7

■ **Credit Suisse reported** a small rise in profit, and its chief executive said the bank is ready to cope with tighter regulations. 20

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Iain Martin on Politics

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'Cameron has made a point of including him, and Clegg has responded, until yesterday, with a confident start.'



Continuing coverage



Follow the latest as 91 European banks receive results of their stress test today at europe.wsj.com

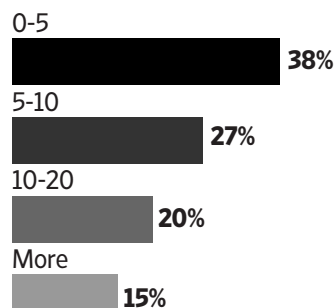
Question of the day

Vote and discuss: Will the U.S. overhaul prevent another financial crisis?

Vote online at wsj.com/polls

Previous results

Q: How many banks are likely to fail stress tests?



THE WALL STREET JOURNAL EUROPE
(ISSN 0921-99)
Commodity Quay, East Smithfield,
London, E1W 1AZ

SUBSCRIPTIONS, inquiries and address changes to:
Telephone: +44 (0) 20 3426 1234. Calling time from
8 a.m. to 5 p.m. GMT. E-mail: subs.wsje@dowjones.com.
Website: www.services.wsje.com

ADVERTISING SALES worldwide through Dow Jones
International. Frankfurt: 49 69 9714280;
London: 44 203 426 1111; Paris: 331 40 17 17 01.
Printed in Belgium by Concentra Media N.V. Printed in
Germany by Dogan Media Group / Hürriyet A.S. Branch
Germany. Printed in Switzerland by Zehnder Print AG WIL.
Printed in the United Kingdom by Newsfax International
Ltd., London. Printed in Italy by Telesampa Centro Italia
s.r.l. Printed in Spain by Bermont S.A. Printed in Ireland
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Dünya Basınevi.

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M-17936-2003.
Registered address: Boulevard Brand Whitlock, 87, 1200
Brussels, Belgium

NEWS

U.N. court clears Kosovo autonomy

By GORDON FAIRCLOUGH

The United Nations' highest court ruled Thursday that Kosovo's declaration of independence from Serbia is legal—a major victory for the fledgling Balkan state and one that could strengthen aspirations for more autonomy among ethnic minorities around the world, from Basques in Spain to Uighurs in China.

International law contains no “prohibition on declarations of independence,” said Hisashi Owada, president of the International Court of Justice, reading from the court's majority opinion in The Hague.

The judges' decision isn't legally binding. But it has significant political weight and could raise the likelihood that more countries will extend diplomatic recognition to Kosovo and increase the pressure on Serbia to reach some accommodation with what it considers a breakaway province.

“This potentially opens up a new phase,” said Richard Gowan, a politics and security specialist at the European Council on Foreign Relations. “Hopefully, both Kosovo and Serbia will recognize it's time for compromise.”

Serbia's initial reaction, however, wasn't conciliatory. After the ruling, Serb Foreign Minister Vuk Jeremic told reporters: “We will never recognize the unilateral declaration of Kosovo's independence.” He said Serbia would continue to oppose Kosovo's statehood at the U.N.



A 2008 photo shows Kosovars waving an Albanian flag, in red, and the flag of independent Kosovo, in Pristina.

So far, Serbia has received backing from Russia and China, permanent members of the U.N. Security Council. Russia, a longtime Serb ally, said Thursday that its stance wouldn't change because of the court decision. China, which is struggling to contain separatist movements at home, is likely to view the court's ruling as an unwelcome precedent.

Washington, one of the first capitals to recognize Kosovo's independence, on Thursday applauded the

decision. State Department spokesman P.J. Crowley said, “Now it's time for Europe to unite behind a common future.”

Twenty-two of the European Union's 27 members are among the 69 countries world-wide that recognize Kosovo, a deeply impoverished country of two million whose population is mainly ethnic Albanian.

Kosovo—which effectively separated from Serbia after a North Atlantic Treaty Organization bombing campaign against the Serbs in

1999—declared its statehood in 2008 after failed negotiations with the government in Belgrade.

“Kosovo's historic victory should not be felt as a loss in Belgrade,” said Kosovo's prime minister, Hashim Thaci. Kosovo's foreign minister called on Serbia to “come and talk to us.”

Kosovo's Albanians were jubilant after their courtroom win. “I am surprised. I didn't expect such a clear decision,” said Bajram Rexhepi, Kosovo's interior minister.



“Now there is an open road for recognition” by the international community, he said.

In Mitrovica, a town divided between an ethnic Serb north and an ethnic Albanian south, there were raucous celebrations in the Albanian areas. Across the river, in a Serb neighborhood, hundreds gathered to protest and listen to speeches, according to the EU police mission.

Many analysts said it will be politically difficult for the Serb leadership to acknowledge Kosovo's independence. And the court's ruling is likely to spark renewed policy debate in Belgrade. Many in the current government are eager to move forward with improving ties with the EU, with a goal of eventually joining the group. That provides some impetus for progress on Kosovo.

Freed Russian aims to go home

By GREGORY L. WHITE

MOSCOW—Igor Sutyagin, the physicist deported from Russia this month as part of the exchange for 10 Russian agents arrested in the U.S., broke his two-week silence, with a statement saying he misses his family and hopes to return to Russia at some point.

Mr. Sutyagin was the first of the 14 people involved to comment publicly since the July 9 swap, which evoked memories of similar Cold War exchanges. Days before the swap, he was plucked from a prison camp in Russia's north, taken to Moscow and pressured to sign a confession before being flown on charter flights to Vienna and then on to London.

In a statement issued through his lawyer, Mr. Sutyagin thanked his supporters and said he looked forward to seeing his family, who live outside Moscow. “I plan to finally return to Obninsk and fix the by now completely rickety porch of our little house ... beyond the Protva River,” he wrote. “A bit sooner, a bit later, I don't know yet, but it will certainly happen.”

People close to him said it could take months or longer, however.

“Desire alone isn't enough,” his mother told Russian news agencies. “He'll need to see what's happening here since for now, we have no faith in our government.”

Mr. Sutyagin, now 45 years old, had served 11 years of a 15-year sentence for espionage, but continues

to deny his guilt. An arms-control specialist, he was arrested in 1999 for allegedly passing secret information to a U.K. company investigators claimed was a front for the U.S. Central Intelligence Agency. Mr. Sutyagin insisted the information came from open sources. He has challenged his conviction in the European Court of Human Rights.

As part of the swap deal, Mr. Sutyagin and the other three men sent out of Russia received presidential pardons and retained their Russian citizenship. Russian officials have said they are free to return if they wish. But local media coverage of them has denounced them as traitors.

Two of the four had been serving sentences for espionage, while the other was a career KGB officer who was jailed for weapons and bribery charges. Mr. Sutyagin and one of the other men were sent to a hotel outside London as part of the swap; the other two went to the U.S.

They were exchanged for 10 Russian agents arrested in the U.S. in late June, helping neutralize a spy scandal that threatened to complicate efforts to improve U.S.-Russian relations. None of the Russian agents has made any public comment since arriving in Russia.

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ONLINE TODAY: To read Mr. Sutyagin's statement visit europe.WSJ.com.

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NEWS

Study aids Alzheimer's fight

BY GAUTAM NAIK

Scientists have found a way to dramatically reduce the erosion of memory and learning ability in a mouse model of Alzheimer's disease, potentially offering a new approach for tackling the illness in humans.

The Massachusetts Institute of Technology researchers achieved the result by tweaking a gene, SIRT1, in the mouse brain. The gene regulates the production of a class of proteins known as sirtuin one.

Mice with a model of Alzheimer's disease that were genetically engineered to produce more sirtuin one retained both memory and learning ability as they aged; the loss of both are hallmarks of Alzheimer's. Alzheimer's mice without the extra sirtuin one capability, and those genetically engineered to produce no sirtuin one at all, showed steep declines in learning ability and memory as they aged.

Sometimes described as the "longevity gene," SIRT1 has become the focus of intense research in recent years. Studies have shown that a highly calorie-restricted diet can turn on the gene and thereby in-

crease longevity in everything from yeast to mice. Similarly, a compound called resveratrol, found in red wine, may also switch on the gene.

The connection between SIRT1 and Alzheimer's is important because the illness has proved to be extremely hard to treat, even as its burden grows among the population. While lab-dish experiments have suggested a link between SIRT1 and Alzheimer's, the latest animal study establishes that link more definitively. It also suggests an alternative drug-based approach for the disease.

"This is the first demonstration that the SIRT1 pathway can mitigate Alzheimer's," said Leonard Guarente, a biologist at MIT and the lead author of the study, which appears in the journal *Cell*.

Dr. Guarente is a paid consultant for GlaxoSmithKline PLC, which he says is using his findings to experiment with drugs that activate SIRT1. He sits on the advisory board of Sirtris, a GlaxoSmithKline company that is conducting sirtuin research on the diseases of aging.

A spokeswoman for GlaxoSmithKline confirmed that the company was conducting early-stage research

based on Dr. Guarente's findings.

The research published in *Cell* was funded by an American Parkinson Disease Association fellowship and grants from the National Institutes of Health and the Paul F. Glenn Foundation, which backs research on the biology of aging.

Alzheimer's is a neurodegenerative disorder affecting up to one-third of people who reach the age of 80. Patients suffer from memory loss and impaired cognition, which are believed to be linked to amyloid plaques. These plaques form when certain proteins get broken up into smaller fragments known as amyloid peptides.

But the proteins can also be broken into harmless fragments. The MIT researchers demonstrated that sirtuin one breaks up the protein into such fragments, rather than the toxic ones associated with Alzheimer's disease.

In one group of mice, the biologists introduced a second SIRT1 gene. These animals had lower amounts of toxic peptides in their brains than the mice with just one SIRT1 gene.

When put through lab tests as

they aged, the first group of mice retained their memory and learning ability, while the other group showed a steep decline. Under a microscope, the brains of the first group also revealed less inflammation and fewer plaques.

Still another group of mice, engineered without any SIRT1 at all, showed an earlier and steeper decline in memory and learning than the "normal" mice.

"SIRT1 is protecting the mice against memory loss," Dr. Guarente concludes.

Translating these intriguing findings into humans won't be easy. Nobody knows whether mice are a good model for Alzheimer's disease. And any future drug that can boost SIRT1 levels will need to reach a patient's brain cells. That requires breaching the blood-brain barrier, not an easy hurdle to overcome but one that Dr. Guarente says Glaxo is working on.

The Alzheimer's Society, based in the U.K., said in a statement, "Much more research is now needed before we can find out if drugs that activate SIRT1 could be used to fight dementia."

Aerospace companies strain to set new ash rules

Continued from first page
ever volcanic clouds can be seen, they ought to be considered potentially as dangerous as violent thunderstorms—and avoided if at all possible.

Affecting both commercial and business aviation, the topic spurred widespread discussion this week throughout the Farnborough International Airshow near here. Preliminary information gathered by Honeywell International Inc., according to industry officials, suggests the eruption of Iceland's Eyjafjallajökull volcano in April may have posed a greater hazard to some engines than previously thought.

While the data are tentative and subject to change, these officials said, Honeywell's experts increasingly suspect that some of the ash plumes contained dense sulfuric clouds capable of causing significant problems for jet-turbine engines. Honeywell engineers have spent nearly two months studying a pair of turboprop engines that flew more than 30 hours through various concentrations of ash. After taking apart one of the engines that came from the Dornier 228 plane flown by British researchers, these officials said, Honeywell detected signs of internal corrosion and damage.

Honeywell's analysis is believed to be one of the most systematic and detailed efforts yet to try to understand what happens to engines that fly through volcanic plumes. Many industry officials have been waiting for the early results, and some were surprised by the company's decision against releasing anything during the show.

So far, Honeywell has declined to discuss what it found. Tim Mahoney, president of the company's aerospace unit, said in an interview during the show that one of the engines taken off the research plane and shipped to Honeywell's Arizona facilities operated normally.

The other engine, which was taken apart by engineers, is still undergoing detailed metallurgical and other testing.

"We're not ready to conclude anything yet," Mr. Mahoney said, because simply "dumping facts" out to the public can result in "too much conjecture." He said it is likely to be many weeks before an announcement.

Other companies have been less ambiguous in warning pilots.

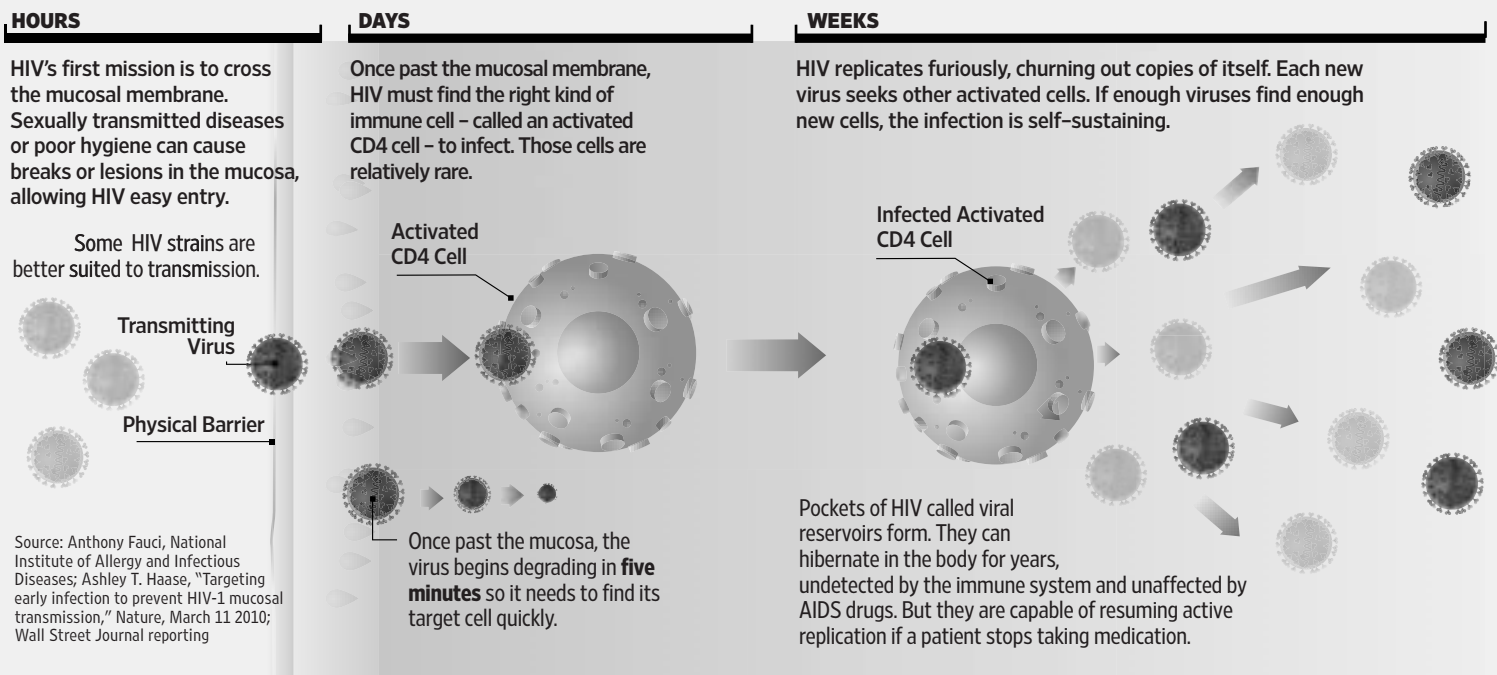
"So little is known about the phenomenon" that "we were very emphatic with our customers about avoiding any areas known to be contaminated with ash," said Andy Nureddin, vice president of services and support for Bombardier Inc.'s business-aircraft unit. The biggest unknown, he said, "is the variability of the makeup of ash clouds."

In coming weeks, international safety experts, including pilot and airline representatives, are slated to meet and discuss potential standards that would ease flight restrictions compared with current FAA rules and the industry recommendations released Thursday.

Airlines and some European regulators are leaning toward allowing limited flights even in areas where ash is visible.

Decisive moment | How HIV establishes infection

When a woman has intercourse, virus is deposited on a membrane called the mucosa. This is what happens next.



Experts urge earlier AIDS treatment

BY RON WINSLOW

VIENNA—Despite its notorious reputation, the virus that causes AIDS doesn't infect the human body easily, and the difficulties HIV has point to potential new prevention and treatment methods, according to a growing body of research.

The science, some of which was presented this week at the XVIII International AIDS Conference here, also supports an emerging argument for beginning AIDS treatment as soon as possible after infection, to thwart the virus's chronic and eventually devastating effect on the body's immune system.

Now, many people go months or years with HIV before beginning treatment with antiretroviral drugs.

"The earlier you treat, the more preserved is the immune function," said Anthony Fauci, director of the National Institute of Allergy and In-

fectious Diseases at the U.S. National Institutes of Health.

That argument raises a dilemma for scientists and public-health officials at a time when funding to combat AIDS globally has tightened. Early treatment could cost billions of dollars. Only about five million people are now receiving treatment out of an estimated 33.4 million infected with HIV globally.

"The scientific consensus continues to move toward earlier and earlier treatment," said Kevin Frost, chief executive of the Foundation for AIDS Research. "The political concern is how to pay for it."

Although HIV infects an estimated 2.7 million people a year, only a small fraction of encounters result in passing the disease from one person to another. In a study published in 2005, researchers found 1.2 new infections for every 1,000 episodes of intercourse between heterosexual

couples in Uganda in which one partner had HIV.

In one of the conference's keynote presentations, Dr. Fauci described the chain of events that occurs during the first minutes, hours and days after a woman is sexually exposed to HIV. According to that talk and information from other experts, after a woman has sex with an infected person, the virus is deposited on a membrane called the mucosa in the vagina. What follows over the next hours and days are efforts by the virus to establish itself in the body. During that time, the virus is susceptible to decay if it doesn't find the right target cells to infect, and to neutralization by the immune system.

If HIV succeeds, within seven to 10 days, pockets of HIV called viral reservoirs form in cells and can hibernate for years, undetected by the immune system, but capable of re-

suming active replication. Once such reservoirs form, Dr. Fauci said, "the horse is out of the barn."

The ability of the reservoirs to harbor HIV for decades is also a major hurdle in the effort to find a cure for AIDS, researchers say. That is why Dr. Fauci and other scientists say intervention against the early events of an infection is crucial.

For instance, condoms prevent the virus from landing on the mucosa. Male circumcision, a major focus of prevention efforts in sub-Saharan Africa, eliminates much mucosal tissue on the penis, Dr. Fauci said, closing off potential entry points to male infection. The reported success of an experimental microbicide gel likely results from its saturation of vaginal cells; even if HIV enters an activated cell, the drug will block viral replication.

—Mark Schoofs contributed to this article.

EUROPE NEWS

Upbeat data buoy euro-zone upturn

By BRIAN BLACKSTONE

FRANKFURT—The euro-zone economy gathered steam at midyear, defying expectations—at least for now—of a fading recovery.

Robust growth in Germany, which offset weakness in Greece and other indebted parts of Southern Europe, along with positive reports from companies and consumers, gives European officials ammunition in their effort to boost sentiment among investors and the International Monetary Fund about the region's prospects.

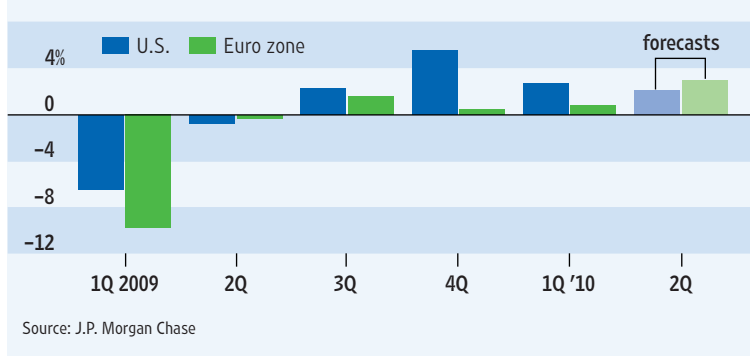
Still, the recovery faces considerable hurdles, economists warn. Countries in the region, especially Germany, remain heavily dependent on exports, which could falter if growth slows in the U.S. and China as expected. The euro's roughly 8% rise against the U.S. dollar in recent weeks, after it touched four-year lows, makes euro-zone products more expensive in global markets. Fiscal austerity throughout Europe later this year and in 2011 could cause domestic demand to stall.

But for now, Europe appears to be among the only major economic regions where growth estimates are being marked up.

"The euro zone does seem to have shaken off its worse concerns about the debt crisis," said Howard

Catching up

Annualized growth rates in the U.S. and euro zone



Archer, chief euro-zone economist at consultancy IHS Global Insight in London.

The euro-zone purchasing-managers index rose to 56.7 in July from 56, according to Markit, signaling robust growth as index numbers above 50 denote expansion. Germany's manufacturing PMI jumped nearly three points, to 61.2. France's service-sector PMI was also above 60.

Separately, the EU's statistics agency, Eurostat, said euro-zone industrial orders jumped 3.8% in May from April, pushing annual growth to a decade high. Economists had expected no change from April.

Consumer confidence in the euro zone rose sharply in July, according to the European Commission. The strong rise suggests consumers' fears of a sovereign-debt crisis are receding, Greg Fuzesi, euro-zone economist at J.P. Morgan Chase in London, wrote in a research note.

The euro climbed on the reports, though the gains were capped by uncertainty over the results of European banking stress tests due out Friday. Signs of a strengthening economy make it unlikely that European Central Bank officials will embark on fresh stimulus measures, analysts say. Still, the ECB is expected to keep its main lending rate at 1%

well into next year until the recovery is firmly established.

After expanding 0.8% at an annualized rate in the first quarter, the currency bloc likely grew 3% or more last quarter, economists say. Germany, which accounts for almost 30% of the region's gross domestic product, grew as much as 6% due to exports and higher investment, forecasters say. The July PMI figures, if sustained, point to euro-zone growth around 2.5% this quarter.

"There is good demand, and a lot of opportunities are developing for the second half of the year," says Stefan Kirschsieper, chief executive of toolmaker **Walter Kottmann** GmbH, a family-owned business in Wuppertal, Germany, that makes chisels for electric hammers used primarily in the building industry.

After laying off 20% of his work force during the recession, Mr. Kirschsieper says his business should return to its staffing level of 50 by September, thanks to improved business in Germany, France and the U.S., as well as fast-growing markets like Brazil and Mexico. In contrast, countries in Southern Europe hit hard by the debt crisis, including Greece, Portugal and Spain, "are very weak," he says.

Even Germany's famously frugal households are showing some improvement in their willingness to

spend, which could help the recovery to broaden beyond exports and related business investment. Retail sales jumped 3% in May from April, according to revised figures released this week.

"I can't see any danger for the next six months," says Klaus Förtisch, managing director of **Fendt-Caravan** GmbH, which supplies caravans and motor homes primarily in Germany, France and the Netherlands.

"We have good incoming orders from the dealer side, and we can see sales from dealers to customers," says Mr. Förtisch, whose company, based near Munich, had revenue last year of €120 million (\$154 million) and employs 570 people, a level it maintained through the recession.

The euro-zone reports will be welcome news for ECB officials who have ruled out a double-dip recession and have criticized recent IMF reports that have been skeptical about Europe's growth prospects.

However, Mr. Fuzesi expects the euro zone's momentum to fade later this year. After surpassing U.S. growth in the second quarter, the euro zone and U.S. should both grow at roughly 2% to 2.5% in the third quarter, he says. But by the fourth quarter, the euro zone should slow to 1% growth, well below the U.S.'s 3% pace, he says.

Thanks, but no thanks, Hungary tells IMF

By GORDON FAIRCLOUGH
AND VERONIKA GULYAS

BUDAPEST—Hungary's prime minister Thursday defied foreign critics of his fiscal policies, saying Budapest no longer needs help from the International Monetary Fund and won't seek to extend an emergency financing agreement it signed in 2008.

"We want to regain Hungary's lost economic sovereignty," said Prime Minister Viktor Orbán in a speech to parliament. Unless that happens, he said, "the country cannot rise, there can be no economic growth."

Mr. Orbán, a populist politician who pledged to take a firmer stance in negotiations with the IMF after he was elected in April, has grown increasingly tough in his public comments this week, after bailout-loan talks with the IMF and the European Union broke down over the weekend.

'We want to regain Hungary's lost economic sovereignty,' said Prime Minister Viktor Orbán.

Some of his most recent remarks appear to contradict comments by aides that Hungary remains committed to pursuing a deal with the IMF and the EU, both of which walked out of negotiations saying that Budapest wasn't doing enough to achieve lasting cuts in spending and shore up its finances.

The failure of the talks means that Hungary can't draw on the remaining funds in the €20 billion (\$25.54 billion) rescue package it received from the IMF, the EU and World Bank at the start of the glo-

bal financial crisis.

At a news conference earlier Thursday, Mr. Orbán thanked the IMF for its help in 2008, when the loans it offered saved Hungary from default after it was unable to raise funds in credit markets during the global financial crisis.

But he said Hungary doesn't intend to continue talks with the IMF on the current standby loan. He said Hungary will repay the loan by the end of 2012, something that could strain Budapest's finances. In the future, he said, the government will negotiate only with the EU.

As part of its membership in the EU, Hungary has agreed over time to meet certain targets for its government spending.

IMF spokeswoman Caroline Atkinson said at a news briefing in Washington Thursday that the IMF, for its part, remains "engaged with the Hungarian authorities and we are ready to resume specific negotiations and return there at any time."

Mr. Orbán's move to walk away from the safety net provided by the international loan agreement is a reversal of earlier statements by his government that it would seek a new standby deal with the IMF for next year, after the current agreement expires in October.

"It's a big blow to the credibility of this government," said Bartosz Pawlowski, a strategist at BNP Paribas in London. "The risk premium on Hungary has increased."

The Hungarian currency, the forint, strengthened, however, on Thursday. After plunging 3% against the euro Monday in response to news of the weekend breakdown of talks with the IMF and EU, the forint steadied and then began to regain lost ground.

On Monday, Hungary's central bank said it would buy forint to defend the value of the currency, using



Prime Minister Viktor Orbán, right, at a Budapest press conference Thursday with Croatian counterpart Jandranka Kosor.

development assistance from the European Union. It wasn't clear how much that was contributing to the rally.

Still, Mr. Pawlowski said that without IMF backing, investors could be wary of Hungarian debt and other forint-denominated assets. The markets have looked at the IMF deal as a form of insurance that government spending would remain in check. "Hungary is saying it doesn't want to consolidate its public finances any more. They feel they've done enough already," said Mr. Pawlowski. "That's not what you want to be saying at this point," with global investors intensely focused on government debt.

—Margit Feher
contributed to this article.

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EUROPE NEWS



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EU Trade Commissioner Karel De Gucht, right, and Chinese Vice Commerce Minister Gao Hucheng at the Shanghai World Expo's EU-Belgium pavilion on Thursday.

EU knocks China purchasing rules

BY ESTHER FUNG

SHANGHAI—European Union Trade Commissioner Karel De Gucht criticized China's procurement rules, saying recent changes to legislation favoring indigenous innovation aren't enough to address complaints of discrimination against foreign vendors.

On a visit to Shanghai on Thursday, Mr. De Gucht also hit on another source of growing tension between China and its trading partners, fears about the country's restrictions on exports of certain minerals.

Speaking at an event at the Shanghai World Expo, Mr. De Gucht said China needs to improve investment opportunities for foreign companies, as European businesses are raising "serious questions" about China's procurement policies. Many companies have expressed concern that recently drafted policies will discriminate against foreign companies in favor of domestic suppliers with "indigenous innovation."

Mr. De Gucht's comments follow unusually vocal complaints about

Chinese policies from leading Western executives in recent months. On Saturday, two of Germany's leading industrialists—Jürgen Hambrecht, chairman of chemical giant **BASF SE**, and Peter Löscher, chief executive of conglomerate **Siemens AG**—complained about policies toward foreign business during a public meeting with Chinese Premier Wen Jiabao and visiting German Chancellor Angela Merkel.

Mr. De Gucht said China's growing presence in Europe is reflected in its recent purchase of €420 million (\$536 million) of government bonds issued by Greece and Spain. Despite those countries' recent debt concerns, Mr. De Gucht said it was a good investment for China and there is little risk of the bonds losing their value.

Mr. De Gucht said European businesses are increasingly worried about the lack of protection for intellectual property in China. He said that recent changes to the indigenous-innovation legislation aren't enough to address complaints of alleged Chinese discrimination against foreign vendors.

"The core of our economy is intellectual property. That's why it's important that we get adequate protection," he said. "There's so much discussion about [China's] indigenous innovation policy, because it forces European companies to register as a Chinese company to get access to private procurement markets."

China Vice Minister of Commerce Gao Hucheng, speaking at the same event, said it is Chinese government policy to encourage trade openness and oppose protectionism.

At a separate briefing in Shanghai, Mr. De Gucht said the EU is confident the World Trade Organization will decide in its favor after ton a complaint alleging that China has placed export restrictions on some commodities. The EU, the U.S. and Mexico lodged a complaint at the WTO alleging that China restricts exports of nine key raw materials, including coke, bauxite, fluorspar and magnesium.

The materials are vital to the production of steel, aluminum and certain chemicals. China produces 60% of the world's coke, and is a

major producer of the other raw materials.

"We're confident this is a case that we'll win before the WTO because it's clearly against WTO rules," he said.

China said earlier this week it submitted a new proposal for membership in the WTO's agreement on government procurement, or GPA, which sets terms for preventing discrimination against foreign vendors in government purchasing deals.

The proposal is a revision of one China submitted several years ago, but some experts who have seen it say it still appears unlikely to satisfy the demands of many trading partners.

Speaking at the Shanghai Expo event Thursday, World Trade Organization Director-General Pascal Lamy said China's new GPA proposal is an improvement on the old one, and said that China overall is abiding by its WTO obligations on broadening trade and opening up its market.

"But it doesn't [mean] that sometimes there's no friction," he said.

Five of six Greek banks are set to pass stress tests

BY ALKMAN GRANITSAS

ATHENS—Greece's leading private lenders are expected to pass Europe's banking stress tests, but questions remain over whether one of two state-controlled banks being tested may be forced to seek new capital under a worst-case scenario.

In the past several days, both Greece's central-bank governor and the country's finance minister have said the Greek banks would pass, helping prompt a brief 2.5% rally in Greek bank stocks earlier this week.

"The Greek banks now have before them the famous stress tests," Finance Minister George Papaconstantinou said in a speech on Monday. "I am certain the banks will pass those stress tests unscathed."

Of the six banks being tested, Greece's four leading private lenders—**National Bank of Greece SA**, **EFG Eurobank Ergasias SA**, **Alpha Bank AS** and **Piraeus Bank SA**—are considered well-capitalized.

Those four boast Tier 1 capital ratios ranging from 9.1% in the case of Piraeus, to 11.5% for Alpha Bank—well above the 6% minimum that regulators will set as a threshold. Of the two state lenders being tested, **Hellenic Postbank** has a capital adequacy ratio of 17%; but state-controlled **ATEBank** has a Tier 1 capital ratio of just 7.7%.

Greece's weakening economy and rising bad loans have squeezed the banking sector. In the first quarter of 2010, ATEBank swung to a net loss of €37.4 million on a 69% increase in loan-loss provisions of €95.9 million. Since then, Piraeus Bank has made a combined €701 million offer for ATEBank and Hellenic Postbank.

Analysts say that the stress tests don't address the real challenge facing Greek banks: access to liquidity. Since late last year, Greek banks have become dependent on the European Central Bank while being effectively frozen out of Europe's interbank markets amid concerns about a Greek sovereign default.

According to the latest data from the Bank of Greece, ECB lending to Greek banks rose to €93.8 billion at the end of June, up from €89.4 billion at the end of May.

Banks brace for stress-test results

Continued from first page
 tors time to overcome their jitters. Financial markets sent mixed signals ahead of Friday's results. Euro-

pean bank shares shot higher Thursday, with the Stoxx 600 banking-sector index gaining more than 3% as investors bet on a repeat of the U.S. stress-test scenario.

At the same time, the cost of borrowing euros in the interbank lending market reached its highest level in 11 months with three-month Euribor at 0.884%. Such borrowing costs rise when banks are nervous about lending to one another.

The market dissonance is echoed by analysts who are producing starkly different estimates of the problems in the European banking system.

A simulated stress test run this week by analysts at Nomura estimated that the 91 European banks faced a collective capital shortfall of about €75 billion (\$96.19 billion). At least 16 banks—mainly hailing from Greece, Germany and Italy—failed

Nomura's test.

One possibility is that the stress tests will highlight weaknesses at banks that already have obvious avenues through which to improve their finances. In Spain, many regional savings banks, or *cajas*, recently agreed to enter into mergers that are designed to fortify their balance sheets. But that wasn't accounted for in the stress tests.

The task of coordinating the test procedures and results has fallen to the little-known Committee of European Banking Supervisors, based in London. Unlike in the U.S., where a single government administered the tests, CEBS has had to herd 20 different nations to the finish line, and that fractiousness has undercut transparency about the test methodology.

—Adam Bradbery and Geoffrey T. Smith contributed to this article.

Stressful day

Details on European banks' stress tests are released Friday. Here's a rundown of the schedule.

■ The Committee of European Banking Supervisors will publish an aggregated overview of the tests' results on 91 banks in 20 different countries, at 1600 GMT (5 p.m. BST, 6 p.m. CET, noon EDT)

■ National bank regulators and banks aim to publish breakdowns of the results within the next hour.

■ CEBS to release bank-by-bank data by 1630 GMT.

The stress-test results are likely to reveal:

■ The banks' potential losses over two years if the economy deteriorates and government bonds lose value

■ How the banks' capital cushions, which are key to absorbing losses, would hold up in a crisis

■ How much new money (if any) each bank would need to raise to prepare for the potential losses; each bank's holdings of government (or sovereign) debt from various EU countries

■ Follow live coverage and market reactions at WSJ.com.

Source: CEBS, WSJ research

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U.S. NEWS

U.S. will allow tax cuts to expire for wealthiest

By DEBORAH SOLOMON

WASHINGTON—Treasury Secretary Timothy Geithner said the Obama administration will allow tax cuts for the wealthiest Americans to expire on schedule despite calls from a small but increasingly vocal group of Democrats to delay any tax increases.

Mr. Geithner said the White House will allow taxes on top earners to increase on Jan. 1, 2011, as part of an effort to help bring down the mounting budget deficit. He said the White House still plans to extend tax cuts for middle- and lower-income Americans and expects to undertake a broader tax overhaul next year.

"We believe it is appropriate to let those tax cuts that go to the

most fortunate expire," Mr. Geithner said at a breakfast with reporters, hosted by the Christian Science Monitor.

His comments come as a number of Democrats, including North Dakota Sen. Kent Conrad and Nebraska Sen. Ben Nelson, have begun echoing calls by Republicans and some economists to extend the tax cuts for all earners, including the wealthiest. Many economists believe the recovery is too fragile to risk raising taxes anytime soon and that doing so could stall economic growth.

Mr. Geithner said there is "still some uncertainty about how strong the recovery is going to be," which may be impacting spending decisions by businesses and individuals. But he discounted that as a reason to extend the Bush-era tax cuts for



U.S. Treasury Secretary Timothy Geithner rejected concerns of business groups and many Republicans.

top earners, saying most private forecasts show moderate economic growth and increasing public confidence in the recovery.

He also rejected concerns voiced

by business groups and many Republicans that the administration's economic policies are creating uncertainty and holding back private investment. "Business always wants

their taxes lower and always wants to live with less regulation," he said, adding that U.S. firms are "doing very well...competing around the world."

Bernanke tells Congress Fed is at the ready

By TOM BARKLEY
AND VICTORIA MCGRANE

WASHINGTON—Federal Reserve Chairman Ben Bernanke reiterated in a second day of congressional testimony that he is prepared to take further action to support the economy if the outlook deteriorates but indicated the Fed's reluctance to do so, given limited options and questions about the effectiveness of any new measures.

"We are ready, and we will act if the economy does not continue to improve," Mr. Bernanke told the House Financial Services Committee in his second day of semiannual testimony to Congress.

Calling continuing weakness in the labor market "unsatisfactory," Mr. Bernanke said the Fed would consider new steps if job conditions don't improve as expected. "We are considering all options," he said.

With short-term interest rates already at record lows, he reiterated that unconventional options include providing more clarity on how long rates will remain low, lowering the interest rate the Fed pays on reserves that banks hold at the central bank, or resuming security purchases.

Such moves would be more effective if financial conditions deteriorate, said Mr. Bernanke. However, he said he expects the U.S. economy to resume a moderate recovery as tensions continue to ease in European debt markets.

House Democrats sought answers from Federal Reserve Chairman Ben Bernanke on what more can be done to support the economy and cut unemployment Thursday, while Republicans called the stimulus measures a failure.

"The question now is how will we pursue policies that will allow us to continue the progress that has recently clearly been made in the economy," said House Financial Services Committee Chairman Barney Frank (D, Mass.) in opening remarks during the semiannual hearing with the Fed chief.

Pointing to the European sover-



Ben Bernanke appeared before Congress for a second day Thursday.

eign debt crisis as most likely to blame for the recent softening in the recovery, he praised the Fed and Obama administration for taking action to help ease the turmoil abroad.

Rep. Mel Watt (D, N.C.) pressed Mr. Bernanke to detail what the Fed can do to combat today's "unacceptably high unemployment," as well as what Congress can do to aid the effort.

"Although there is some job growth, it is not nearly enough today," said Mr. Watt.

Highlighting the ideological di-

vide in Congress when it comes to the economy, the panel's top Republican, Rep. Spencer Bachus of Alabama emphasized the danger he sees in the country's massive federal deficits, declaring the country is in a "debt ditch." Democrats, by contrast focused on the what the Fed can do to bring down the high unemployment rate.

Long-time Fed critic Rep. Ron Paul (R, Tex.), called for a change in course since fiscal and monetary stimulus haven't brought down unemployment.

"The more we pump in, the more we bail out, the more unemployment goes up," said Mr. Paul.

Wading into one of the more hotly debated issues on the Hill, Mr. Bernanke said that if Congress decides to extend tax cuts adopted by the Bush administration, it has to find ways to offset the impact on the budget.

"If you extend the tax cuts, you have to find other ways to offset them," he said in response to a question from Rep. Bachus.

Mr. Bernanke said a "reasonable degree" of fiscal stimulus should be maintained in the short term, but that steps must be taken to reassure that the budget will be brought under control in the long run.

When Rep. Paul floated the idea of returning to a gold standard, Mr. Bernanke said that wouldn't be practical.

In answering questions on Wednesday, Mr. Bernanke outlined three options for supporting the economy, if necessary.

The Fed could verbally emphasize its commitment to keep short-term interest rates low for a long time. It could lower the interest rate it pays on reserves that banks store at the central bank, to encourage more lending. And it could reinvest proceeds from maturing or prepaid mortgage securities, instead of letting them run off the Fed's balance sheet, or make additional purchases.

"We have not fully done that review, and we need to think about possibilities," Mr. Bernanke said. "Clearly, each of these options has got drawbacks [and] potential costs."

In evaluating its public communications, the Fed is exploring how to underscore to markets and the public that it plans to keep interest rates low. Earlier this year, many investors were bracing for rate increases by late 2010. Recent worries about the economy pushed that into 2011.

In futures markets, traders now put a 30% chance on the Fed raising its key interest rate to 0.5% next April. That was down from a 38% chance in trading Tuesday and from

78% on July 1.

Mr. Bernanke emphasized that the labor market remains a key worry. The U.S. has lost 8.5 million jobs since the downturn started, and he said the pace of private payroll growth in the first half of 2010—100,000 a month, on average—is "insufficient to reduce the unemployment rate materially."

The Fed now sees the unemployment rate falling even more slowly than it previously expected, leaving it at a still-high 7% to 7.5% at the end of 2012.

Mr. Bernanke said the recent large federal budget deficits are appropriate, considering the weak economy. He said additional fiscal support from Washington could help, given weak private spending, but acknowledged concerns that markets might react adversely if the nation's deficit is not brought under control.

"The best approach, in my view, is to maintain some fiscal support for the economy in the near term, but to combine that with serious attention to addressing what are very significant fiscal issues for the United States in the medium term," Mr. Bernanke said. "I don't think it's either/or. I think you need to really do both. If the debt continues to accumulate and becomes unsustainable ... then the only way that can end is through a crisis or some other very bad outcome."

With almost half the unemployed out of work for more than six months, Mr. Bernanke noted the long-term risks of persistent joblessness.

"People who are unemployed for a long period of time often see their skills atrophy or see their skills become irrelevant," he said. "So not only for the sake of the unemployed and for the short-term strength of the economy, but also for our long-term viability and international competitiveness, I think we need to be very seriously concerned about the implications of long-term unemployment."

—Sudeep Reddy
contributed to this article.

U.S. NEWS

Obama's trips to tout stimulus rise

By LOUISE RADNOFSKY

President Barack Obama and top officials are stepping up the pace of their travel to promote the economic stimulus package to skeptical voters—particularly in states with close mid-term election contests in the fall.

The White House has announced a total of 172 trips outside Washington, D.C., in which administration officials have discussed the stimulus package and its economic impact in the year and a half since the package was signed.

That includes 49 trips between June 1 and July 21, up from 31 in the same period last year.

The increased activity comes as Republicans are making an issue of the administration's spending on selling the stimulus, with House Republicans reviving an effort to block funding for signs saying a project was funded by the plan.

Under the banner of "Recovery Summer," the president has recently made visits to Holland, Mich., Kansas City, Mo., Las Vegas and Columbus, Ohio.

Vice President Joe Biden, cabinet secretaries and agency heads have headed other trips this summer, touring facilities which have received stimulus money, joining in ribbon-cutting and ground-breaking ceremonies, and making speeches.

The president and vice-president have also hosted fundraisers and rallies for local Democratic candidates before or after the official stimulus events.

In all, administration officials have made 70 stimulus-themed trips to six states which have competitive elections in November, and will be pivotal in the 2012 Presidential campaign: Ohio, Pennsylvania, Florida, Michigan, California and Missouri.

The events are generally ignored by the national press except when they involve the president, but receive significant attention from local media.

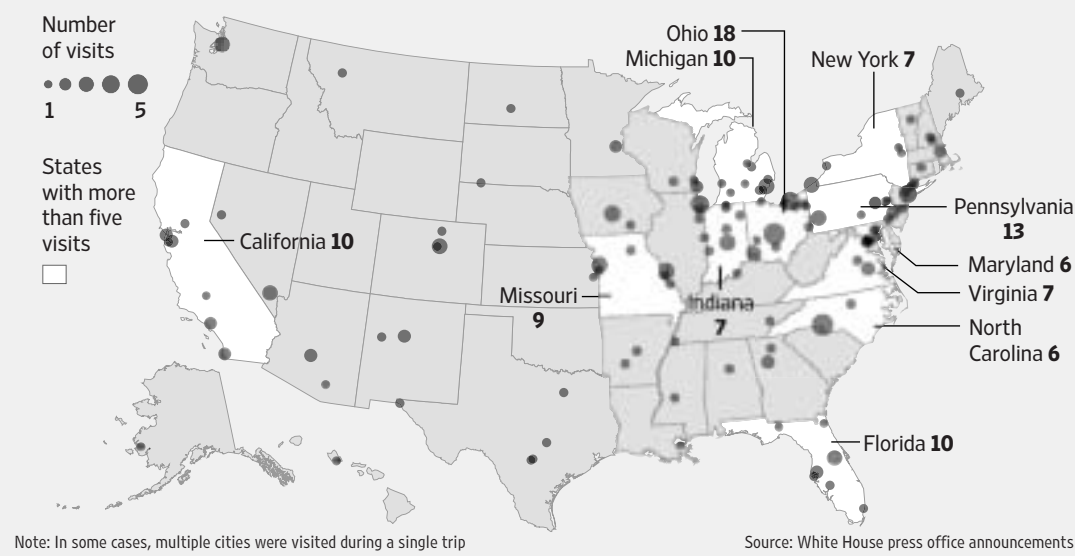
Ohio alone has had at least 18 visits from federal officials. Mr. Obama has gone there four times to



President Obama visits V & M Star, a maker of seamless pipe for the oil and gas industry, in Youngstown, Ohio, in May. The administration has concentrated stimulus-boosting trips in states with close mid-term elections.

Making the rounds

Where administration officials have visited in the 18 months since the stimulus plan was passed



talk about the stimulus—to Warren, Youngstown, Elyria and Columbus. Mr. Biden has traveled to the state twice.

In a two-day period during June last year, the labor secretary, interior secretary, commerce secretary,

Small Business Administration chief, Environmental Protection Agency administrator and White House auto industry recovery director held six stimulus-themed events in the state.

Ohio, Pennsylvania, Florida and California have highly competitive

elections for both Senate and governor this fall, and key House seats to defend. Obama administration officials have made four trips to the Allentown, Pa. district where Democrats see a chance to win a seat from a sitting Republican congress-

man.

Other popular destinations for stimulus events include Illinois, Indiana and Colorado, where Democrats are trying to hold on to Senate seats and, in Illinois and Colorado, the governor's mansion as well.

"Administration officials have visited over 40 states to survey Recovery Act progress since the program was passed more than a year ago and will continue to do so as long as Recovery dollars are being put to work," said Liz Oxhorn, the White House's spokeswoman on the stimulus plan.

The White House also says the visited states were among the most populous in the country. The administration has paid relatively few trips to Texas, however, or to other large southern states where the stimulus plan is particularly unpopular.

Presidential travel to promote domestic policies is not new. The president and vice-president are also allowed to travel on military aircraft to campaign rallies and fundraisers, though there are restrictions on other federal officials participating in overtly political events.

Partisan sparring over travel isn't new, either. In 2006, Democrats criticized President George W. Bush's and Vice President Dick Cheney's frequent travel in support of Republican candidates. Rep. Henry Waxman, then the top Democrat on the House Oversight Committee, ordered a report prepared on the issue.

That estimated the operating costs of Air Force One at \$56,518 an hour, based on a study by the non-partisan Government Accountability Office.

The hourly cost of operating a military aircraft for the vice-president was estimated at \$14,552. Top federal officials usually travel by commercial air-carrier.

Candidates' campaigns reimburse the White House for a portion of the travel costs when the president or vice-president fly for an official event and a political event.

White House apologizes to fired worker

By JONATHAN WEISMAN

WASHINGTON—Capping a bizarre sequence of events that has captivated politicians and pundits here, the White House apologized to a former Agriculture Department worker after she was fired over an allegedly racist speech first publicized by a conservative website.

The case of Shirley Sherrod, who had been the USDA's director for rural development in Georgia, highlighted the Obama administration's sensitivities to conservative political accusations in a heated political year. It also became the latest episode to show how a toxic political atmosphere and a rapid-fire media can quickly turn a minor event into a media conflagration—in this case consuming a previously unknown official deep in the government's bureaucracy.

Agriculture Secretary Tom Vilsack, who made the decision to fire Ms. Sherrod on Monday, offered "his personal and profound apologies" on Wednesday—and a new job.

The apology came after a review of an allegedly racist speech Ms.

Sherrod delivered last year showed it didn't reflect racial bias against whites but instead her view that poverty, not race, is at the root of rural problems.

"This is a good woman. She's been put through hell," Mr. Vilsack said of Ms. Sherrod.

The apology was echoed by White House spokesman Robert Gibbs, who said, "Ms. Sherrod is owed an apology. I will do so on behalf of this administration."

Mr. Gibbs went on to blame the media, factions on both sides of the political divide and "members of this administration" for overreacting to a short, selectively chosen snippet of Ms. Sherrod's March 2009 speech that was posted by conservative Internet activist Andrew Breitbart.

In the clip, Ms. Sherrod recounted a 1986 incident in which a white farmer had approached her for help saving his farm from foreclosure and she had handed him off to a white lawyer rather than giving his case her full attention.

In the full version of the speech, she said she saw the poor farmer,



Former U.S. Agriculture Department employee Shirley Sherrod received an apology from the White House after being fired for an allegedly racist remark—later found to be not racist.

Roger Spooner, mistreated by his lawyer, stepped in and worked doggedly to save the Spooner farm. Mr.

Spooner backed up that version of events and credited Ms. Sherrod with saving his farm.

Mr. Breitbart and some other conservative activists have argued that the Obama administration is insufficiently sensitive to bias against white people, citing the recent federal lawsuit challenging Arizona's new immigration law, among other instances.

After the NAACP last week accused elements of the tea-party movement of racism, Mr. Breitbart posted the snippet of the Sherrod speech on his website, biggovernment.com. It quickly made its way around the Web.

Mr. Vilsack said Wednesday he responded rashly after reading a transcript of the Breitbart clip.

For the past 18 months, the USDA has been consumed with settling tens of thousands of discrimination suits against it. He said he wanted to show it wouldn't tolerate discrimination in any form.

When Ms. Sherrod was fired Monday, the White House expressed support for the move. By Tuesday night, however, the Obama adminis-

tration was demanding that Mr. Vilsack reconsider the decision. By Wednesday, much of Washington was begging forgiveness.

"Race has become infused in American politics to a degree we hoped would not happen with Obama as president," said Abigail Thernstrom, a political conservative and vice chairman of the U.S. Civil Rights Commission.

The election of the first African American president in 2008 initially brought with it a surge of positive feelings about race relations. Immediately after, nearly half of white voters and three-quarters of black voters said they expected race relations to improve, according to the Pew Research Center for the People and the Press.

After Mr. Obama had spent a year in office, Pew found that 54% of blacks still believed the Obama presidency had improved race relations. Only 32% of whites said that, and 15% said it had made relations worse.

Ms. Sherrod, meanwhile, said she was considering Mr. Vilsack's offer of a new job.

U.S. NEWS



Agence France-Presse/Getty Images

Gen. David Petraeus, here at a police training center in Kandahar, Afghanistan, earlier this week, is expected to make several more moves to retool the counterinsurgency strategy.

Petraeus sharpens Afghan strategy

By JULIAN E. BARNES

WASHINGTON—Gen. David Petraeus plans to ramp up the U.S. military's troop-intensive strategy in Afghanistan, according to some senior military officials, who have concluded that setbacks in the war effort this year weren't the result of the strategy, but of flaws in how it has been implemented.

The officials said Gen. Petraeus, who took over as allied commander in Afghanistan this month and is conducting a review of the war, intends to draw on many of the same tactics he implemented to turn around the war in Iraq—and which his predecessor, Gen. Stanley McChrystal, introduced in Afghanistan.

But the officials said Gen. McChrystal put too much attention on hunting down Taliban leaders, at the expense of the U.S. counterinsurgency strategy, which focuses on protecting civilians and bolstering popular support for the government. Supporters of Gen. McChrystal dispute that assessment, dismissing any notion there were flaws in how he fought the war.

Gen. Petraeus's determination to intensify a strategy focused on driving a wedge between the Taliban and the Afghan people could be tricky to pull off, given the mount-

ing political pressure in the U.S. to show results in the nearly nine-year war, and to begin drawing down troops next year.

Gen. McChrystal was fired last month by President Barack Obama after the general and his staff made disparaging comments about senior civilian officials in a magazine article. When announcing the change in command, Mr. Obama praised Gen. McChrystal's work and said the appointment of Gen. Petraeus, who wrote the army manual on counterinsurgency, would guarantee that the strategy would continue uninterrupted.

Gen. Petraeus is expected to make several more moves to retool the strategy, according to people familiar with the situation. They are expected to include a greater focus on how Afghanistan's security forces are being trained and how to make the Afghan people feel safe, they said, without offering details.

Under Gen. Petraeus, the coming offensive in the southern city of Kandahar will remain the primary effort for international forces, military officials said. But he is also expected to highlight other operations that are showing success, particularly the campaign against the Haqqani terror network in eastern Afghanistan.

Some in the White House advocate a pared-down approach that requires fewer troops and greater emphasis on drone attacks on insurgent leaders. These officials would like to see an accelerated withdrawal of U.S. troops.

During the Iraq surge, Gen. Petraeus proved adept at parrying suggestions for a rapid withdrawal and won time to show his strategy could work. He is again under pressure to show quick progress. When the Obama administration committed earlier this year to a 30,000-troop surge to underpin the counterinsurgency strategy, it said it would review the effort in December—a tight timeline that included a July 2011 date for the beginning of troop withdrawals.

Gen. Petraeus may have less time. Officials say he is under pressure to demonstrate results ahead of a North Atlantic Treaty Organization conference in Portugal in November. Gen. Petraeus declined to comment.

Gen. Petraeus has notched some early successes, including Afghan President Hamid Karzai's endorsement of a plan to establish local village defense forces—an initiative he had long opposed, fearing such initiatives would create militias outside of his control.

Supporters of Gen. McChrystal point out that the groundwork for the initiative was laid by Gen. McChrystal.

Gen. Petraeus has called on some of the outside advisers who helped him develop the surge strategy in Iraq to make recommendations on a renewed campaign in Afghanistan, according to military officials. Those advisers include Stephen Biddle, a national-security expert at the Council on Foreign Relations; Frederick Kagan of the American Enterprise Institute in Washington; and Kimberly Kagan, who heads the Institute for the Study of War in Washington.

People close to Gen. Petraeus said he is unlikely to try to persuade the Obama administration to back off its promise to begin drawing down troops in July 2011. But they do expect him to privately push for troops to be removed slowly, along a timetable that keeps a large force in Afghanistan.

"I think Gen. Petraeus will talk again about putting more time on the Washington clock," said Peter Mansoor, who served as Gen. Petraeus's executive officer in Iraq and is now a professor at the Ohio State University. "I think we have more time than we think in Afghanistan."

An effective counterinsurgency

strategy can take years, and it remains unclear whether Gen. Petraeus' approach will work in Afghanistan, where volatile tribal politics, a lack of infrastructure and rudimentary local security forces pose significant challenges.

Under Gen. McChrystal, much of the public attention this year was on the operation in Marjah, the first major offensive of the surge, where officials promised they would deliver a "government-in-a-box." But months after American forces retook the center of Marjah, the U.S. has struggled to help the Afghan government deliver services because of problems with security and with the government's effectiveness.

Some government officials and military analysts view the emphasis placed on Marjah as a strategic mistake. Rather than demonstrating the reach of the Afghan government, it showed the limits, they say.

"Marjah is not critical terrain; it is not a key population center," said Jeffrey Dressler, an analyst at the Institute for the Study of War. "You had to clear Marjah out, but it was not the place to implement a district governance plan."

Supporters of Gen. McChrystal argue it is too early to judge the success of how he implemented the counterinsurgency strategy.

U.S. moves to stem Afghan financial woes

By MARIA ABI-HABIB

KABUL—U.S. and Afghan authorities are setting up a joint task force to monitor the billions of dollars in cash flow out of Afghanistan every year, officials said, as the U.S. announced debt relief for the war-ravaged country.

U.S. and Afghan officials say they believe at least some of the money leaving the country comes from corruption and opium trafficking. Afghanistan's Finance Ministry and

border police will contribute to the task force, working with officials from the U.S. Treasury Department and other agencies, said U.S. Ambassador Karl Eikenberry.

Parts of the plan have already been implemented, such as stepped-up monitoring of cash leaving Kabul's airport. The full effort should be in place in the coming months, Mr. Eikenberry said.

Afghan and U.S. officials estimate that as much as \$3.65 billion a year—equal to a tenth of Afghani-

stan's gross domestic product—is being loaded onto commercial flights in Kabul and flown out of the country. Much of the money is declared and legal to move and destined for Dubai. But "we don't have a clear understanding of the components of the cash leaving the country," he said.

The scope of the money flow, first reported last month by The Wall Street Journal, has prompted U.S. and Afghan officials to investigate whether aid and reconstruction

money is being diverted. Officials also say they believe some of the money is proceeds from the opium trade and Taliban cash from extortion and drug trafficking.

The effort to clamp down on the money flow is seen as vital to a war effort that is now focused on building the credibility of the Afghan government.

"We need to investigate whose money it is and whether it is legal," said Afghan Finance Minister Omar Zakhilwal.

The U.S., meanwhile, has forgiven \$108 million of Afghanistan's debt, Mr. Eikenberry said. The sum is the U.S. share of \$11 billion in Afghan foreign debt, or about 96% of the country's total, that nations have pledged to forgive.

Afghanistan qualified for debt relief after undertaking financial and regulatory overhauls.

The money saved is to be used for government services, such as education and health care, the Afghan finance minister said.

WORLD NEWS

Clinton presses Vietnam on rights

BY JAY SOLOMON

HANOI—U.S. Secretary of State Hillary Clinton publicly pressed Vietnam to further open its political system amid concerns about the Communist government's crack-down on democracy activists and the Internet.

Mrs. Clinton made her comments Thursday during a two-day visit to Hanoi aimed, in part, to herald the strengthening U.S.-Vietnam relationship 15 years after the two nations normalized ties. The American envoy said growing ties between Washington and Hanoi could serve as a model for reconciliation among former wartime foes.

Still, Mrs. Clinton emphasized that Vietnam's emergence as an Asian economic power depends on its willingness to open its political system. She said that Hanoi, even as Washington's friend, should expect to face pressure from the West on human rights.

"It is true that profound differences exist, particularly over the question of political freedoms," Mrs. Clinton told a lunch on Thursday honoring the restoration of U.S.-Vietnam relations. "The United States will continue to urge Vietnam to strengthen its commitment to human rights and give its people an even greater say over the direction of their own lives."

Vietnamese Foreign Minister Pham Gia Khiem, appearing with Mrs. Clinton at a press event earlier Thursday, praised Vietnam's shared



Secretary of State Clinton, speaking in Hanoi on Thursday, urged Vietnam to strengthen its commitment to human rights.

interests with the U.S. but pushed back on Washington's criticism of Hanoi's respect for civil liberties.

"Human rights have common values but ... it depends a lot on the cultural and historical background," Mr. Khiem told reporters at Hanoi's Foreign Ministry. "Human rights cannot be imposed from the outside."

Criticism of Vietnam's human-rights record has intensified recently as authorities have arrested several dissidents. Authorities have detained roughly a dozen human-rights activists and critics over the past year, including four prominent campaigners who were sentenced to lengthy prison terms in January after being convicted of attempting to

overthrow the government.

One of those dissidents, a U.S.-trained human-rights lawyer named Le Cong Dinh, was given a five-year sentence after admitting in court that he had broken the law by joining a banned political party.

The government also has instructed Internet-service providers to block access to social-networking

websites such as Facebook over the past year, prompting concerns that some international companies might be scared off by the tightening controls.

In December, U.S. Ambassador Michael Michalak told a donor conference that the Internet curbs were hindering the expansion of commerce in Vietnam. A bipartisan group of U.S. lawmakers this month pressed Mrs. Clinton in a letter to publicly raise Hanoi's human-rights record during meetings with Vietnamese officials.

Mrs. Clinton is visiting Hanoi both to commemorate normalized relations and to take part in a regional security conference involving Southeast Asian countries, China and Japan. It is her first visit to Hanoi since she accompanied her husband, former U.S. President Bill Clinton, on a tour of Vietnam in 2000.

The U.S. restored diplomatic ties with Vietnam in 1995, one of the Clinton administration's signature foreign-policy achievements.

Mrs. Clinton lauded Vietnam's economic growth and its commitment to cooperating with Washington on financial, strategic and environmental issues.

—Patrick Barta in Bangkok contributed to this article.

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EUROPE

NEWS FOR NEWS MAKERS

Ex-Kyrgyz leader's brother is arrested

BY KADYR TOKTOGULOV

Kyrgyzstan's Interior Ministry said Thursday it had detained one of ousted President Kurmanbek Bakiyev's brothers, suspected of involvement in recent deadly unrest in the country's south.

Akhmatbek Bakiyev, 50 years old, nicknamed the "shadow governor" of Jalal-Abad province, the Bakiyevs' stronghold, was caught late Wednesday by the Interior Ministry in the city of Jalal-Abad, the second-largest in southern Kyrgyzstan.

He had 75 cartridge shells, a pistol, a wig and a fake mustache and beard, the ministry said.

The ousted president's two brothers have been in hiding and are wanted by the new Kyrgyz authori-

ties. Janybek Bakiyev, who had served as chief of the presidential security service, is still in hiding.

"Akhmatbek Bakiyev started making confessional statements of his involvement to recent mass unrest in the country's south," the Kyrgyz government said, adding that he would be brought to the capital Bishkek later on Thursday.

Violent unrest has continued in the south of Kyrgyzstan since the overthrow of Kurmanbek Bakiyev in April. The interim government has struggled to control southern Kyrgyzstan where ethnic clashes between ethnic Kyrgyz and Uzbeks killed thousands.

The former president fled Kyrgyzstan after being deposed in April and is now in Belarus.

U.S. restores Jakarta tie

BY PATRICK BARTA

U.S. officials said they are restoring relations with Indonesia's military special forces after a decade-long freeze over alleged human-rights abuses, brushing aside a dispute that has poisoned relations between the two countries for years.

The U.S. cut off ties with Indonesia's military in 1999 after it was accused by human-rights groups of widespread abuses including kidnapping student activists.

Although the U.S. resumed some cooperation with the Indonesian

military a few years later, Washington maintained its restrictions on the elite Kopassus unit because of concerns that it hadn't yet fully reformed.

After a meeting Thursday with Indonesian President Susilo Bambang Yudhoyono in Jakarta, U.S. Defense Secretary Robert Gates said the U.S. was pleased with Jakarta's recent steps to change Kopassus, which has some 5,000 members. Those steps have included the removal, at Washington's request, of some members implicated in human-rights cases.