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# THE WALL STREET JOURNAL.

VOL. XXVIII NO. 111 EUROPE Friday - Sunday, July 9 - 11, 2010

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## Berlin steps into fashion spotlight


Associated Press

A model wears a creation from Allude's Spring/Summer 2011 collection at Berlin Fashion Week on Thursday. The German capital aims to become Europe's center of fashion. Articles, Weekend page W3.

# Alleged spies to plead guilty in Russia case

Ten members of an alleged Russian spy ring in the U.S. gave their true names and birth dates in court on Thursday as they prepared to enter guilty pleas to criminal charges as part of a plea deal with the U.S. government.

*By **Michael Rothfeld** and **Chad Bray** in New York and **Gregory L. White** in Moscow*

The defendants were expected to enter guilty pleas to a single count of conspiracy to act as an unregistered agent for a foreign government in federal court in Manhattan. Assistant U.S. Attorney Michael Farbiarz said the defendants were prepared to enter guilty pleas under agreements with prosecutors.

Seven of the 10 defendants in court gave different names than the identities they had been living under in the U.S.

Under the deal, the defendants would agree to be expelled from the U.S. in exchange for avoiding prison, one U.S. official familiar with the agreement said.

The agreement is expected to speed negotiations for a swap between the U.S. and Russia of the alleged deep-cover agents for prisoners being held in Russia. U.S. authorities are helping relatives of the alleged agents make arrangements for children of the accused to travel to Russia, a U.S. official familiar with the matter said.

It wasn't clear how many prisoners from Russia would be released as part of a swap or whether any of those would be announced publicly. In Moscow, government officials declined to comment on the case.

U.S. and Russian officials began discussing a possible swap within hours after U.S. federal agents completed their arrests of the alleged agents June 27, a U.S. official familiar with the talks said. Unlike the Cold War days, when Russia and the U.S. met in neutral territory such as Geneva, much of the negotiating occurred in Washington, the official said. Russian officials didn't attempt to deny links to the agents, the official said.

Relatives and advocates of Igor Sutyagin, a Russian convicted of spying for the U.S., said they believed Mr. Sutyagin has left Russia or would soon leave in what was likely to be the first step in a swap for the accused spies in the U.S.

"No one has solid information," his mother, Svetlana, said by phone from her apartment outside Moscow where she and other family were awaiting word. "Nobody has said anything officially and Igor himself hasn't called."

Earlier reports that Mr. Sutyagin been sighted in Vienna were based on unconfirmed reports from journalists calling the family for information, family members said. Austrian officials declined to comment.

*Please turn to page 5*

# Antibody discovered for 91% of HIV types

By Mark Schoofs

In a significant step toward an AIDS vaccine, U.S. government scientists have discovered three powerful antibodies, the strongest of which neutralizes 91% of HIV strains, more than any AIDS antibody yet discovered.

Looking closely at the strongest antibody, they have detailed exactly what part of the virus it targets and how it attacks that site.

The antibodies were discovered in the cells of a 60-year-old African-American gay man, known in the scientific literature as Donor 45, whose body made the antibodies naturally. Researchers screened 25 million of his cells to find 12 that produced the antibodies. Now the trick will be for scientists to develop a vaccine or other methods to make anyone's body produce them.

That effort "will require work," said Gary Nabel, director of the Vaccine Research Center at the National Institute of Allergy and Infectious Diseases, who was a leader of the research. "We're going to be at this for a while" before any benefit is seen in the clinic, he said.

The research was published Thursday in two papers in the online edition of the journal Science, 10 days before the opening of the large International AIDS Conference

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## The Quirk

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PAGE TWO

# Stress tests could be too little, too late

[ Agenda ]

By Simon Nixon

The European Union desperately hopes that its bank stress tests will restore confidence in the battered regional financial system. Policy makers are hoping that by demonstrating that the banks are healthy—and recapitalizing those that aren't—they can persuade foreign investors to reopen vital funding markets, restoring liquidity to the system.

But what if this exercise comes just too late? What if the problem now goes beyond simply mistrust of Europe's banks, or even the ability of individual sovereigns to meet their obligations? What if foreign investors have simply lost confidence in Europe itself?

The present situation is certainly serious. Dollar funding markets at maturities beyond three months effectively have been closed to European banks since at least April, reflecting the refusal of U.S. investors to lend money to Europe. U.S. banks also are refusing to lend to European banks on the interbank market.

A banker who recently returned from Asia said the first question from every banker he met there concerned European counterparty risk. Even within Europe, the repo market is shut to banks from Greece and Portugal regardless of their collateral, according to someone familiar with the situation.

The result is that parts of the European financial system remain heavily dependent on the European Central Bank, which three years into the financial crisis continues to provide unlimited liquidity to the markets at ultra-low rates.

Without this liquidity, European funding costs would go through the roof, most likely triggering a financial meltdown across the continent. The ECB can in theory carry on funding the banks like this for years, but as long as the euro-zone banking system remains on life support and private markets remain closed, euro-zone economies will remain vulnerable.


European Pressphoto Agency

Investors are finding their old fears about the euro are still relevant in 2010.

The snag is that the sheer scale of the damage to confidence caused by the euro crisis is beyond the capacity of a mere bank stress test—no matter how rigorous—to repair.

For years, global capital flows have been growing, with Europe attracting a large share of the funds. But much of the flow of capital into Europe was predicated on the belief that euro-zone markets were essentially fungible, reflected in the almost complete convergence of sovereign and bank credit spreads.

> The world needs Europe to tackle its credibility deficit so that it can attract global capital flows once again.

That belief has been dealt a mortal blow.

Suddenly, investors have discovered that many of the old reasons that made them steer clear of certain European markets—different political and legal systems, different languages and different regulators—remain in 2010. The euro zone's inadequate governance, widely acknowledged when the euro was created but subsequently forgotten during the boom, has been laid bare.

The restatement of Greece's national accounts damaged the credibility of the entire continent. The slow, uncoordinated response to the subsequent sovereign-debt crisis has left a lasting impression on investors that will take years to repair.

The risk that this loss of confidence in European assets might prove lasting was one the Bank of England identified in its latest Financial Stability Report.

It warned that European markets risked being squeezed between a flight to safety on the one hand and a flight East and West on the other, with investors increasingly looking to emerging markets in Asia, Latin America and the U.S. for their foreign exposures.

Such a redistribution of risk capital would weigh on prospects for growth in Europe, since funding costs would remain at current high levels, despite the liquidity provided by the ECB. Several European government, for example, are paying substantial yield premiums over German bonds, which increases the pressure on their fiscal position.

Longer term, a shift in capital allocations away from Europe toward emerging markets risks causing an overheating of some economies. Some emerging-market central banks already are facing a dilemma, balancing the need for interest-rate hikes to cool domestic conditions versus the risk that higher rates will attract further capital, creating unsustainable bubbles, and exacerbating the global imbalances that lie at the heart of the crisis.

The world needs Europe to tackle its credibility deficit so that it can attract global capital flows once again. But that's probably going to take a lot more than just a bank stress test.

## Ingenious solution

Buried away in the new European bank-bonus directive is a clause saying that banks can choose to pay bonuses in contingent capital rather than straight equity. This is unlikely to have been included by accident and is potentially very significant.

Contingent capital, bonds that convert into equity on hitting a preset trigger, are potentially a very useful tool to help prevent a repeat of the problems that emerged in the financial crisis, when banks turned out not to have sufficient loss-bearing capital. But the snag until now has been working out who will buy these bonds. Insurers, typically among the biggest buyers of bank bonds, are reluctant to buy anything that risks turning into equity and at the very least are likely to demand a very high price for their support.

But allowing banks to issue them to their employees is a potentially neat solution. The bank gets a cheap source of substantial funding, removing the need to go out and sell bonds in the market. That would enable it to reduce its cost of capital and boost its return on equity, to the benefit of both shareholders and employees who could expect higher bonuses in future. At the same time, the threat of conversion into equity should act as a major incentive to employees not to blow up the bank. Ingenious.

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3. EU Sets Stress-Test Criteria
4. BP Sets New Spill Target
5. The Joy of Getting There

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### The Source

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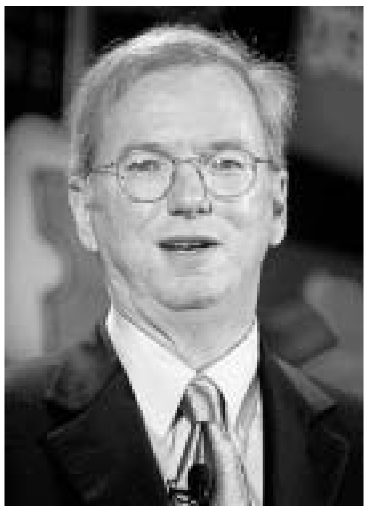
'Investors should see the bank stress tests as what they really are—pacifiers, not trouble makers.'

**Patricia Kowsmann** on the market's reaction to European bank stress tests

### Continuing coverage



Google's top brass hold court at the Sun Valley annual media conference. Follow at **europe.wsj.com**

### Question of the day

**Vote and discuss:** Spain or the Netherlands? Who will win the World Cup?

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

### Previous results

**Q:** Will U.S., Israeli and Palestinian leaders hold direct peace talks before the end of September?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■ **Greek lawmakers** approved sweeping changes to the pension system and labor laws as the government tries to cut its massive debt. 5

■ **The Czech central bank** governor said uncertainty surrounding the euro zone in the wake of the Greek debt crisis is so great that there is no point considering adopting the currency for now. 6

■ **Merck will close** eight research sites and eight manufacturing plants to hit cost-saving targets promised after it bought Schering-Plough. 17

■ **Nokia asked** Russian police to help it recover a prototype smartphone obtained by a gadget blogger, who wrote a critical review. 17

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NEWS

# Adidas spins its unpopular Cup ball

By Laura Stevens

BERLIN—**Adidas** AG named the ball it designed for the World Cup after the Zulu phrase "to rejoice," but players and coaches aren't celebrating the Jabulani, taking the gloss off the sports-equipment maker's marketing campaign.

Adidas has made the redesign of the tournament ball every four years a central part of its product strategy, selling 13 million Jabulani-themed balls so far. The company claims its engineering has transformed football technology and improves the standard of play.

Many players and coaches at the World Cup beg to differ: Winning and losing teams have complained that the ball moves in mysterious ways. Adidas says complaints about its World Cup balls come and fade like clockwork every four years. "It's a little bit of a joke," said Antonio Zea, director of football for **Adidas America**.

Reuters

England's goalkeeper, Robert Green, allowed the tying goal to the U.S. on June 12 when the ball bounced off his hands.

The Jabulani is the 11th World Cup match ball produced by Adidas and previous balls were also unpopular with players. The ball for the 2006 World Cup staged in Germany was "the worst-designed ball I have ever encountered," said England's goalkeeper Paul Robinson. Spanish players compared the 2002 World Cup ball to a beach ball. But in an unprecedented move, football's ruling body FIFA has vowed it will look into the issues after the tournament.

Goalies particularly hate the Jabulani. "Terrible," said the U.S.'s reserve keeper Marcus Hahnemann. Gianluigi Buffon of Italy called it unpredictable, while Brazil's Júlio César compared it to a ball you could buy at a "grocery store." David James of England said it is "dreadful."

While those losing players' complaints could be called sour grapes, even Iker Casillas—whose Spanish team has made it to Sunday's final game—said the ball is "appalling."

Many pundits agree that the ball wobbles weirdly in the air on long-range shots, causing goalies to miss what should have been easy saves, including in U.S. versus England, Slovenia versus Algeria, and Ghana versus Uruguay.

Slovenia's team captain, Robert Koren, scored the winning goal against Algeria with a shot from nearly 30 yards out and admitted that he benefited from the ball's unpredictable flight. "Every player, if he is being honest, will tell you there is something strange about the ball," Mr. Koren said.

The moaning hasn't affected sales of Jabulani-themed footballs, which range in price from $150 for the real thing to $12 for a mini replica ball. Adidas's ball sales in the U.S. have doubled since 2006.

The ball "is huge for us," Mr. Zea said by telephone from South Africa Thursday. "It's the icon for the tournament."

Adidas claims this year's ball is the most perfect sphere in football history, has tiny grooves to improve flight accuracy, and makes more optimal contact with players' boots thanks to having fewer seams.

However, FIFA Secretary-General Jérome Valcke acknowledged players' unhappiness in a news conference, saying "FIFA is not unreceptive to what's being said about the ball." The Jabulani is "very different" from previous balls, he said.

FIFA plans to talk to coaches, players and technical specialists after the tournament about the ball, but the governing body hasn't said what action it might take for future tournaments, if any.

Adidas' Mr. Zea said complaints are dwindling as players get more familiar with the Jabulani during the tournament. Mr. Zea noted that Dutch defender Giovanni van Bronckhorst's 35-yard drive during the Holland-Uruguay semifinal on Tuesday went into the net like a "laser beam...going exactly where he wanted the ball to go."

Adidas says it tested the ball extensively using robots, wind tunnels and other technology. It detected no problems with accuracy, Mr. Zea said.

But U.S. goalie Mr. Hahnemann said during a news conference in South Africa that technology isn't everything. "Scientists came up with the atom bomb, doesn't mean we should have invented it," he said.

# *Antibody neutralizes 91% of HIV strains*

*Continued from first page*

in Vienna, where prevention science is expected to take center stage.

More than 33 million people were living with HIV at the end of 2008, and about 2.7 million contracted the virus that year, according to United Nations estimates. Vaccines, which are believed to work by activating the body's ability to produce antibodies, eliminated or curtailed smallpox, polio and other once-feared viral diseases, so they have been the holy grail of AIDS research.

Last year, following a trial in Thailand, results of the first HIV vaccine to show any efficacy were announced. But that vaccine reduced the chances of infection by only about 30%, and controversy erupted because in one common analysis the results were not statistically significant. That vaccine was not designed to elicit the new antibodies.

The new discovery is part of what Wayne Koff, head of research and development at the nonprofit International AIDS Vaccine Initiative, calls a "renaissance" in HIV vaccine research.

Antibodies that are utterly ineffective, or that disable just one or two strains, are common. Until last year, only a handful of "broadly neutralizing antibodies," those that efficiently disable a large swath of HIV strains, had been discovered, and none of them neutralized more than about 40% of known HIV variants.

But in the last year, thanks to efficient new detection methods, at least a half dozen broadly neutralizing antibodies, including the three latest ones, have been identified in peer-reviewed journals. Most of the new antibodies are also more potent, able to knock out HIV at far lower concentrations than their previously known counterparts.

Dennis Burton of the Scripps Institute in La Jolla, Calif., led a team that discovered two broadly neutralizing antibodies last year; he says his team has identified additional, unpublished ones.

Some of the new antibodies attack different points on the virus, raising hopes that they could work synergistically. In unpublished research, John Mascola, deputy director of the Vaccine Research Center, has shown that one of Dr. Burton's antibodies neutralizes virtually all the strains that are resistant to the strongest new antibody, called VRC01, and vice versa. Only one strain out of 95 tested was resistant to both antibodies, he said. Dr. Mascola is one of the authors of Thursday's papers.

In a little-noticed study published earlier this year in the Proceedings of the National Academy of Sciences, scientists at Merck & Co. provided what Dr. Koff calls a "proof of principle" that other researchers can build on. Starting with an old antibody—one that is much weaker than the newly found ones—the Merck researchers created replicas of its target site. Eventually, Merck was able to produce experimental vaccine candidates capable of stimulating guinea pigs and rabbits to produce the antibody.

## EUROPE NEWS

# Trichet says market strain is diminishing

By Brian Blackstone

FRANKFURT—European Central Bank President Jean-Claude Trichet said strains in European financial markets are starting to ease, suggesting the ECB will continue to cut back on a program to help the region's most vulnerable countries get back on their financial feet.

Under the program, which was designed to jump-start dysfunctional segments of the financial markets, the ECB began purchasing government debt in May.

"What is needed in terms of interventions [in government-bond markets] has been progressively diminishing," Mr. Trichet said Thursday after the ECB's monthly meeting.

He rejected concerns that a weaker global economy, and fiscal belt-tightening in Europe, might push the region into another recession, saying investors have been too pessimistic on the currency bloc's economic prospects.

Mr. Trichet said he is happy with the central bank's monetary stance, suggesting the ECB may keep its main lending rate at a low of 1% for many more months.

He said that markets are showing increasing confidence in European officials' ability to manage the crisis.

The ECB has purchased nearly €60 billion ($75.6 billion) in government debt of Greece and other vulnerable countries such as Portugal since the program started on May 10. But the amounts have dwindled after a brisk start, averaging only about €4 billion a week since mid-June. The ECB bought more than €16 billion in bonds in the first week of the program.

"He sort of showed his hand a little bit that they are in the exit" phase, said Erik Nielsen, chief European economist at Goldman Sachs.

Government-debt purchases by central banks had been taboo in Europe, particularly Germany, where the practice stokes fears of a loss of central-bank independence and increases in the money supply, which could lead to inflation. Germany's central-bank chief Axel Weber, a member of the ECB's governing council, has been a vocal opponent of the plan, exposing a rift between the ECB and its largest member country.

Mr. Trichet declined to offer an end date for the program or to specify conditions in markets under which officials would terminate it, suggesting the ECB will continue to purchase bonds in small installments for at least a few more weeks, analysts said.

"They may be trying to buy some time" until a €750 billion EU-IMF stabilization fund is operational, said Nick Matthews, an economist at Royal Bank of Scotland. European leaders agreed to set up the fund on the same day the ECB started buying bonds, in order to prevent Greece's debt crisis from spreading.

Also Thursday, the Bank of England's Monetary Policy Committee left its key interest rate unchanged at a low of 0.5% to help cushion the economy against the effect of deep cuts in government spending.

The decision was broadly expected, with many economists also predicting the Monetary Policy Committee would maintain its bond purchases, made through its quantitative easing policy, at £200 billion ($303 billion).

Mr. Trichet declined to provide fresh details on bank stress tests, but gave the exercise a nod of support, saying, "We expect that the tests will be confidence-building." The Committee of European Banking Supervision, a London-based body that groups national authorities, said Wednesday that 91 European banks will undergo stress tests to see how their balance sheets would withstand shocks including a double-dip recession and a sovereign shock that generates losses on government bond portfolios.

The ECB president on Thursday continued to warn, as he has for many months, that the region's economic recovery will be "uneven."

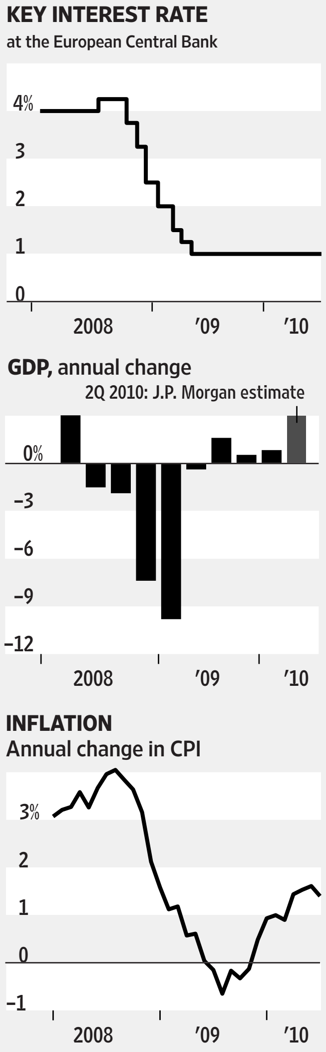
Still, after expanding less than 1%, at an annualized rate, in the first quarter, the euro-zone economy should grow around 3% in the April-June period, said Greg Fuzesi, economist at JPMorgan Chase. That's due in large part to a strong pickup in Germany, which accounts for about 30% of the region's gross domestic product. Reports Thursday on exports and factory output point to second-quarter growth of around 6%, at an annualized rate, says Ralph Solveen, economist at Commerzbank.

In a departure from his practice of speaking of the euro zone only in its totality, Mr. Trichet specifically highlighted the German figures Thursday. For the euro zone as a whole, "the second quarter is likely to be much better than the first quarter," Mr. Trichet said. He dismissed the chances of renewed stagnation or a double-dip recession.

*—Natasha Brereton contributed to this article.*

**No hurry**

ECB rates at record lows amid sluggish recovery, modest inflation




Sources: WSJ Market Data Group (interest rate); Eurostat (GDP and inflation); J.P. Morgan (GDP estimate) Photo: Bloomberg News

Jean-Claude Trichet at a press conference on Thursday.

# Details of EU stress tests sketchy; 'comfort tests'

By David Enrich

LONDON—While Europe's planned "stress tests" of its banks have received a mildly warm reception from investors, details of the program remain shrouded in secrecy as European regulators squabble over how to implement the tests.

The European Union agreed last month to conduct the tests of top banks and results are due July 23. The exercise was intended to mimic the U.S.'s stress tests last year, which helped instill confidence in its shaky banking system.

But the effort is off to a rocky start, primarily because officials from the 27-country EU have struggled to reach agreement on methodology. The difficulties are the latest illustration of how hard it is for the cumbrous bloc to respond to crises quickly and decisively.

"It lacks a bit of transparency," said Stefan Kolek, a Munich-based credit strategist at UniCredit. "The first impression is you have something to hide."

Hoping to quench investors' thirst for more information, the Committee of European Banking Supervisors, a tiny London-based organization that is coordinating the tests, on Wednesday divulged the identities of the 91 banks that are being examined. CEBS also disclosed that the test's worst-case scenario would involve the EU economy shrinking by about 2% this year and 1.25% in 2011, compared with current expectations of modestly positive growth in both years.

But the committee's two-page statement didn't address crucial details, including the degree to which the tests will probe banks' ability to withstand deteriorations in the values of certain governments' bonds. That is at the heart of investors' fears about European banks, many of which are sitting on hefty portfolios of sovereign debt issued by heavily indebted countries such as Greece, Spain and Portugal.

Another unknown is the fate of banks that flunk the tests. In the U.S., the 10 banks that were deemed capital-deficient under last year's tests could choose between raising private capital or collecting government funds via the Troubled Asset Relief Program. But there is no European equivalent of TARP, and it is unclear whether investors would be willing to pump money into a struggling European bank.

Nonetheless, European bank stocks rallied Thursday as some investors wagered that the sell-off this year is overdone and that the stress tests will restore confidence.

The EU doesn't include Switzerland, whose regulator, known as Finma, and the country's central bank regularly run stress tests on the country's banks, which include giants UBS AG and Credit Suisse Group, Werner Abegg, a spokesman for the Swiss National Bank said.

The stress tests have been hamstrung by disagreements over how to run the initiative. A key sticking point has been whether the tests should include a scenario in which an EU member defaults on its debts. Investors are worried about whether banks would be hammered by losses if a country such as Greece defaulted. But some European regulators are resisting the idea of including such a scenario in the test, fearful that investors would misinterpret that as a prediction that a default is likely.

"Any stress tests that do not look at the possibility of multiple sovereign-debt restructurings, with haircuts for creditors, aren't stress tests," said Willem Buiter, Citigroup's chief economist and a former Bank of England policy maker. "They are comfort tests."

**Stressing the point**

How the EU stress tests compare with the U.S. initiative last year

| | U.S. | Europe |
|---|---|---|
| Date of tests | May 2009 | July 2010 |
| Number of banks being tested | 19 | 91 |
| Tests' assumed GDP growth rates | −3.3% for 2009<br>+0.5% for 2010 | −2% for 2010<br>−1.25% for 2011 |
| Disclosure about tests' criteria | 21-page report listing three macroeconomic assumptions and loss rates on different types of loans | Two-page news release listing one macroeconomic assumption and not disclosing loss rates |
| Options for banks that "flunk" tests | Raise private capital or receive government funds | To be determined |

Sources: Committee of European Banking Supervisors; Federal Reserve

EUROPE NEWS

# Greece approves changes to pensions, labor laws

By Nick Skrekas

ATHENS—Greek lawmakers approved sweeping changes to the pension system and labor laws Thursday as the government tries to cut its massive debt.

The vote in Parliament was held during a peaceful but paralyzing 24-hour general strike called by unions in protest.

Among other things, the new legislation will raise the retirement age to 65 for most workers, cut pension benefits, relax rules on hiring and firing employees and lower basic salaries. The bill had been amended more than 50 times after objections from within and outside the government. The Athens Bar Association has argued that it is unconstitutional and promised to mount legal challenges.

The vote was 157-134 in favor, with three abstaining and six legislators absent. The socialist government's 157 legislators all voted for the controversial bill despite earlier fears that some would break party ranks.

The radical shakeup to the pensions and the labor market has been seen as the toughest test for the solidarity of the government's party bloc because it is seen as very unpopular with voters, and harsh and contrary to the deputies' own socialist ideology.

"The future of our country is at stake. This is no time for narrow-minded political games. Voting in favor of the pension-reform bill is a vote of responsibility by all lawmakers toward Greek society and the next generations," the prime minister had said in the initial parliamentary debate Wednesday.

The government had promised the IMF and the EU that it would take tough measures in exchange for being able to establish and draw down from the €110 billion ($138.6 billion) bailout package to rescue the debt-laden Mediterranean state from bankruptcy.

*—Alkman Granitsas contributed to this article.*

Associated Press

A protester confronts riot police outside Parliament in Athens on Thursday.

## *Alleged spies to plead guilty in Russia case*

*Continued from first page*

Mr. Sutyagin, a physicist, told relatives during prison visits Wednesday that he had been hastily moved earlier in the week from the remote prison where he was serving a 15-year sentence to Moscow. He said the move was part of a deal to swap prisoners in Russia for the accused spies in the U.S. Mr. Sutyagin said he was told that he would be taken to Vienna and then the U.K.

Mr. Sutyagin has always denied the charges against him and has been called a political prisoner by human-right advocates. His family and his lawyer said he was compelled to sign a confession as part of the release agreement.

The spy arrests have threatened to chill the warming trend in U.S.-Russian relations seen over the past year or so and both capitals seemed eager to put the affair behind them. The U.S. and Soviet Union repeatedly swapped spies, as well as imprisoned Soviet dissidents, during the Cold War.

In total, 11 people have been accused by U.S. prosecutors in New York of secretly serving for years as unregistered agents for the Russian government in the U.S. Some of the defendants also have been charged with money laundering.

One of the defendants, Christopher Metsos, was taken into custody in Cyprus last week, but disappeared after he was granted bail

Federal prosecutors have alleged the defendants—many living under assumed identities—lived ordinary suburban lives. Mikhail Vasenko, who used the false name of "Juan Lazaro," and his wife, Vicky Pelaez, a columnist for Spanish language newspaper El Diario-La Prensa, lived in suburban Yonkers, N.Y., while Mikhail Kutsik, who used the false name "Michael Zottoli," and Natalia Pereverzeva, who used the false name "Patricia Mills," lived as a couple in Arlington, Va. Both couples have children living in the U.S.

Another alleged member of the ring, Anna Chapman, a 28-year-old redhead, ran an online real-estate business. While living in London before moving to the U.S. last year, she attended charity balls and worked at Barclays Bank PLC.

*—Evan Perez contributed to this article.*

# Spain nears cajas reform

*Rules should help local savings banks raise sorely needed capital*

By Jonathan House

MADRID—The Spanish government will approve an overhaul of savings-bank regulations on Friday, opening the door to private ownership of the mutually owned savings banks or "cajas," Prime Minister José Luis Rodríguez Zapatero said Thursday.

"This is the most important reform ever of our banking system," Mr. Zapatero said at a meeting with journalists.

With close ties to local communities and often controlled by local governments, Spain's cajas have borne the brunt of the collapse of Spain's decade-long housing boom. Their fast-rising bad debt levels, combined with a lack of transparency, have stoked investor concerns and created severe financing difficulties for both the cajas and the country's listed banks.

In an effort to shore up investor confidence on EU banks, the Committee of European Banking Supervisors said late Wednesday it will test 91 EU banks for their ability to maintain solvency in the face of adverse economic and financial conditions. Spanish authorities maintain that their banking system is basically healthy and spearheaded the push for the EU-wide stress tests in order to show that. Nearly one third, or 27, of the banks to be


Reuters

José Luis Rodriguez Zapatero, right, with cajas official Amado Franco

tested are Spanish.

"The Spanish financial system has shown it's solid ... though the savings banks have shown some failings," Mr. Zapatero said.

A key weakness affecting savings banks is their lack of instruments to raise capital. Existing non-voting shares had failed to attract investor interest as they offered no means for participating in management. The reform which Mr. Zapatero's Socialist-led government has hammered out with the opposition Popular Party will attach voting rights to these shares, though it will limit them to 50% ownership of the institutions. The rest will remain in the hands of savings banks' current stakeholders, which include depositors, employees and local governments.

But the new regulations will restrict local governments by prohibiting elected officials from sitting on cajas' boards of directors and by establishing new requirements for the qualifications of those who do.

Furthermore, cajas will be able to jettison their current governance structure altogether if they want. They can seek listing through mergers and by spinning off their social and community service activities into separate foundations.

# Czech banker backs off euro

By Gordon Fairclough
And Leos Rousek

PRAGUE—The new Czech central bank governor said uncertainty surrounding the euro zone in the wake of the Greek debt crisis is so great that there is no point considering adopting the common currency for now and expressed serious reservations about possible new Europe-wide regulations.

Miroslav Singer, a former vice governor of the Czech National Bank who was named to the top job last week, also said Czech interest rates are likely to stay at their current low levels "longer than people generally think." But he said further cuts were unlikely unless the economy slowed sharply.

"I feel very comfortable with the current level of rates," Mr. Singer said in an interview on Thursday with The Wall Street Journal. In May, the bank's rate-setting board cut the benchmark two-week repurchase agreement rate by 0.25 point to a record low of 0.75%.


Bloomberg News

Miroslav Singer in Prague Thursday.

The Czech economy is slowly recovering after a severe downturn last year, when recession-hit Western European consumers bought fewer Czech-made cars, auto parts, electronics and other exports. Gross domestic product shrank 4.3% in 2009, but grew 1.1% in the first quarter of this year from the year-earlier period.

The governor said government-debt problems in Greece and other euro-zone members and the group's subsequent bailout efforts showed that changes are likely needed in the currency bloc's institutions as well as the requirements it sets for new members.

"I don't even have a clue how long it will take to solve the problems of the euro zone," Mr. Singer said. And until that happens, he said, "there are simply too many hypotheticals for me to speculate" on whether joining would help the Czech economy.

The Czech Republic, the Baltic states of Estonia, Latvia and Lithuania, plus Poland, Hungary, Romania and Bulgaria are all required as a condition of their membership in the European Union to pursue the adoption of the euro, although there is no deadline.

The Czech Republic hasn't laid out a time frame for adopting the euro. The country would still need to substantially reduce its government budget gap in order to qualify under the euro zone's current rules.

"At the moment it is really difficult to be a euro-zone enthusiast and rush to adopt the euro," said Radomir Jac, chief economist at Prague-based PPF Generali Asset Management. "This is the deepest crisis in the euro zone's 10½-year existence."

The euro zone requires governments to have budget deficits smaller than 3% of GDP. The Czech Republic's budget deficit this year is projected to equal about 5.3% of GDP. The head of the new governing coalition has said he will aim to cut that significantly by next year.

Mr. Singer said he worries that the EU's approach to financial regulation is wrong. "We do not agree this crisis has been caused by a lack of international regulation," he said. "The blame belongs to national regulators, such as those in the U.S. and U.K., which failed to adequately police their financial sectors, he said.

He was especially opposed to proposals to levy a tax on banks across the EU. The move, aimed in part at limiting the growth of the banking sector, would be inappropriate for the Czech Republic which, he said, would benefit from more and larger financial institutions.



# *A tale of one downturn and two labor markets*

[ Brussels Beat ]

By Stephen Fidler

Two economies. Two very different unemployment stories.

Spain sinks into recession: the economy contracts by more than 4% from peak to trough. Unemployment more than doubles to 20%. Britain's downturn is even deeper: Output shrinks by more than 6%. But, using internationally accepted data, unemployment increases by less than 3 percentage points to about 8%. A million jobs that economists thought would be lost, based on what happened in previous recessions, weren't.

The explanation of the differences lies in part, argues Luis Garicano of the London School of Economics, in wages. In Spain, trade unions have secured increases in real (adjusted for inflation) wages; in the U.K., where 80% of the private sector is not unionized, real wages fell.

The charts below that he's put together and posted on Spain's Nada es Gratis blog tell the story. In the U.K., the jobs market has adjusted in part through a fall in the price of labor.

In Spain—even in a recession—the price of labor has increased. Adjustment occurs entirely by cutting the numbers of people employed.

In a recent presentation to José Luis Rodríguez Zapatero, the Spanish prime minister, Mr. Garicano used these charts and others to argue Spanish labor-market reforms need to be deeper.

In Spain, says Mr. Garicano, the U.S. is regarded as "the ogre" because of the way workers are casually laid off. But Spain is worse, destroying far more jobs for every 1% fall of output than does the U.S.

Figures from a new paper by Paul Gregg and Jonathan Wadsworth of the Centre for Economic Performance at the LSE show that in the last recession U.K. unemployment increased by 0.45 percentage points for every 1% fall in gross domestic product.

For Spain, unemployment increased by 2.3 percentage points for every 1% drop in GDP—way higher than any other country in their small sample. For the U.S. it was 1.43, and for France, 0.78. For some countries, led by Germany, the ratio was lower than for the U.K. but their governments paid subsidies to companies to keep employing workers.

Spain's system of collective bargaining is a big headache, says Mr. Garicano. In years that wages go up less than inflation, an adjustment is made to ensure real wages don't fall. But if inflation is less than wage increases, there is no adjustment in the other direction. Spanish real wages therefore ratchet upwards.

Some 53% of wage contracts are also negotiated regionally at an industry level. Regional sectoral bargaining is "the worst of all worlds," says Mr. Wadsworth. It doesn't provide the mechanism that national wage bargaining does—as in Scandinavian countries—to moderate wages nationally. But neither does it offer flexibility of bargaining at a company or plant level. Only 10% of bargaining in Spain is done at the level of the firm. Spain's big companies can generate reasonable productivity despite these and other flaws in the Spanish labor market. But Mr. Garicano says small companies can't, and Spain has a lot of them. One reason for that is that the dysfunctional labor market stops small Spanish firms from growing into bigger ones.

The British story is more than simply a decline in trade-union power since the rule of Margaret Thatcher.

In their paper, Messrs Wadsworth and Gregg say one reason British workers moderated their push for higher salaries may have been because their spending power had been boosted by low mortgage rates and cuts in value-added tax.

Employers entered the recession in good financial shape, which encouraged them to hold on to workers rather than lay them off and retrain others in the upturn.

It's not clear therefore how much of the improvement from past recessions will be a feature of future downturns. Keeping on workers in a recession — economists call this labor hoarding — could also mean, they say, that job creation starts later and happens more slowly in the upturn.

## Taking the hit: employment or wages


Sources: Luis Garicano with data from Paul Gregg and Jonathan Wadsworth, LSE (U.K.); Samuel Bentolila and NadaEsGratis (Spain)

U.S. NEWS

# Netanyahu shifts tone over peace

Israeli Prime Minister Benjamin Netanyahu appeared to try to soften his image as a leader unwilling to compromise for peace with the Palestinians in a series of appearances and comments in recent days, beginning with his meeting with President Barack Obama on Tuesday.

*By **Charles Levinson** in Jerusalem and **Riva Froymovich** in New York*


Reuters

'I intend to confound the critics and the skeptics,' Israel's prime minister says.

In a speech to the Council on Foreign Relations in New York on Thursday, Mr. Netanyahu used some of his most forceful language yet to portray himself as a leader in the tradition of the Mideast's most-celebrated peacemakers. Mr. Netanyahu evoked Egyptian President Anwar Sadat and former Israeli Prime Minister Menachem Begin, who concluded the Camp David Peace Accords in 1978, and Yitzhak Rabin, the late Israeli prime minister, who signed the Oslo Peace Accords in 1993.

"Remember that moment when Sadat came to Jerusalem," Mr. Netanyahu told an overflow crowd gathered at the Council's headquarters on Manhattan's Upper East Side. "Remember that just a few years earlier Israel and Egypt fought a terrible war. People dismissed Begin, and people dismissed Sadat. I intend to confound the critics and the skeptics."

He compared himself with Mr. Rabin who, he reminded the audience, returned to a second stint as prime minister and concluded a historic peace deal. Mr. Netanyahu is similarly serving as prime minister for the second time.

"When you get to be my advanced age you don't come back to spend time in office," Mr. Netanyahu said. "You come back to do something. I'm prepared to do something. I'm prepared to take political risks."

The meeting with Mr. Obama at the White House showcased mended ties between the two leaders after their relationship got off to a rocky start due to disagreements over the peace process.

The recent comments by Mr. Netanyahu, who heads the conservative Likud Party and leads a coalition dominated by even more-conservative parties, represent a significant change of tone. Mr. Netanyahu is widely regarded as a hard-liner on issues dealing with the Palestinians, but he has kept his true intentions close to his chest, rarely revealing how far he may be willing to go for a peace deal.

In the 48 hours since his meeting with Mr. Obama, the Israeli leader has dropped other hints that suggest a greater flexibility on some of the core issues in the conflict than some had previously expected.

In an interview on Wednesday on CNN's "Larry King Live," Mr. Netanyahu pledged to tackle the issue of Jewish settlements in the West Bank "right away" once direct talks begin. During the early rounds of indirect peace talks, U.S. and Palestinian officials voiced frustration over Mr. Netanyahu's preference to begin negotiations with more peripheral issues.

That fed Palestinian fears that Mr. Netanyahu wasn't prepared to address the conflict's most sensitive issues, such as Jewish settlements, and that he may instead simply be seeking to stall and delay a peace deal while winning kudos from the international community for participating in direct peace talks.

Mr. Netanyahu's comments that piqued the greatest interest, however, came Wednesday evening in speech to American Jews at Manhattan's Plaza Hotel, where, according to the Jewish Telegraphic Agency, Mr. Netanyahu made comments that suggested he could agree to divide Jerusalem, long a red line for Israel's right-wing parties.

"Everybody knows that there are Jewish neighborhoods in Jerusalem that under any peace plan will remain where they are," Mr. Netanyahu said during the question and answer session, the agency reported.

"The implication of Netanyahu's remark—that other neighborhoods of Jerusalem may not remain 'where they are,' becoming part of an eventual Palestinian state—was the first hint that the Israeli leader may be flexible on the subject of Jerusalem," the influential Jewish news agency concluded.

The Palestinians remain skeptical. Chief Palestinian negotiator Saeb Erekat said the Palestinians hear Mr. Netanyahu talk but don't see him backing it up with actions, such as completely stopping building in Jewish settlements and in East Jerusalem.

# BP instructed to provide more updates

By Jared A. Favole

WASHINGTON—The Obama administration is demanding **BP** PLC provide the federal government with more information about its plans to stanch the Gulf of Mexico oil spill as cleanup efforts reach a critical stage with the peak of hurricane season looming.

The government wants updated timelines about when relief wells and other oil-response efforts will be complete, according to a letter sent Thursday to BP Chief Managing Director Bob Dudley by U.S. Coast Guard Adm. Thad Allen, who is coordinating the federal response to the oil catastrophe.

BP is considering replacing a damaged well-cap with a newly designed one to better plug the mile-deep well, which is leaking at least 10,000 barrels of oil daily into the Gulf.

There are risks to this plan, including that it might not work and will increase the rate of oil gushing out in the short run.

Mr. Allen said the government wants to ensure BP has contingency plans in case this move fails or hurricanes thwart response efforts.

Mr. Allen also wants an updated plan for how BP will maximize cleanup efforts, including skimming and burning the oil. BP and the government have struggled with cleanup efforts in recent weeks as weather created rough seas.

# IMF's U.S. forecast is more pessimistic

By Tom Barkley

WASHINGTON—The International Monetary Fund advised the Obama administration to consider raising taxes and reducing Social Security benefits as ways to contain the U.S. budget deficit and public debt.

In its annual review of the U.S. economy, the IMF forecast that the economy will grow 3.3% this year, and then not top 3% annual growth over the following five years, a more pessimistic outlook than that of the U.S. administration.

As a result, the IMF projections of the deficit and debt top White House forecasts.

"We see a less strong growth outlook over the medium term than the authorities," said David Robinson, the IMF's deputy director for the Western Hemisphere. "Correspondingly, we see over the medium term...a need for more fiscal measures than the authorities at present do."

The administration has pledged to halve the deficit by 2013 and to stabilize the public debt at 70% of gross domestic product by 2015. However, the IMF projects that current policies would push the debt level up to 95% of GDP by 2020 and above 135% by 2030.

Thus far, the U.S. has been able to borrow cheaply to fund its deficit in part because of fears of economic instability elsewhere in the world. Over the coming three to five years, though, the IMF believes that the interest rates on Treasurys will rise, as the U.S. government competes with the private sector in debt markets.

The IMF urged the administration to cut the budget deficit by about 8% of GDP by 2015, which is nearly three percentage points more than the administration plans.

Spending cuts aren't sufficient, the IMF said, and it suggested a number of politically difficult ways of reducing debt, including eliminating the popular deduction for interest on mortgages, raising energy taxes, reducing Social Security benefits or imposing a national consumption tax.

"The timing and composition of the adjustment will need to be carefully designed to minimize the impact on demand while ensuring credibility," the IMF said. The fund endorsed the 2% deficit reduction in the administration's budget for fiscal 2011, but said that should be followed by a commitment to take further steps in coming years and measures to deal with rising entitlement costs.

The IMF also estimated that the dollar is "now moderately overvalued from a medium term perspective," meaning over the next three to five years. Mr. Robinson suggested the greenback will depreciate "moderately" over that time.

The recent strength of the dollar didn't help U.S. growth, he said, "but it's not a deal breaker for the recovery, either."

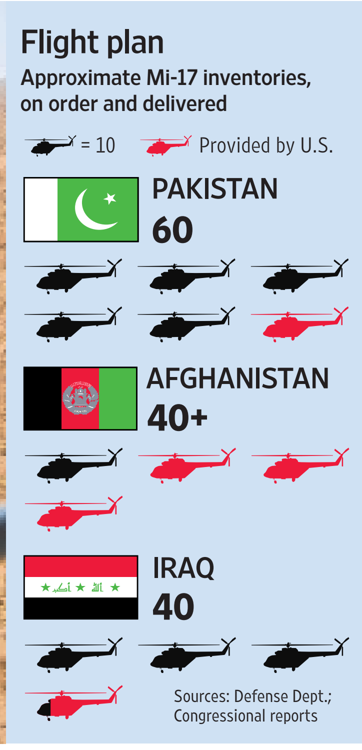
■ The IMF predicts world expansion will decline to 4.3% next year ........ 11

# On Pentagon wish list: Russian arms

*U.S.'s lifting of sanctions on state-owed exporter eases procurement of helicopters and other aircraft for allies*

By Nathan Hodge

Agence France-Presse/Getty Images




An Mi-17 helicopter prepares to land during a flight test for Afghan air force pilots, led by the U.S. Air Force in Kandahar, in October.

WASHINGTON—The Obama administration's recent lifting of sanctions against Russia's state arms exporter could boost orders for Russian aircraft from a somewhat-unexpected customer: the U.S. military.

As part of its effort to equip the militaries of Afghanistan, Iraq and Pakistan, the Pentagon has in recent years been snapping up helicopters and fixed-wing aircraft from the arsenals of its former Cold War rivals, including Russia. The goal is to help the three countries build air forces that are rugged, affordable and easy to operate.

Washington sanctioned Rosoboronexport, Russia's state arms dealer, in 2006 for its dealings with Iran, and lifted those restrictions in May as part of an effort to win Moscow's support for new Iran sanctions.

But even as the move could open the door to more purchases of Russian-made helicopters, U.S. lawmakers are complaining about a lack of oversight of the procurement process and asking the military to consider buying more American-made aircraft.

A Department of Defense spokeswoman said the Pentagon had received "several inquiries" from lawmakers about the purchase of Russian-made Mi-17 helicopters, adding that the department issued a report to Congress in March addressing the issue.

"Analysis conducted by [U.S. Central Command] in 2005 identified the Mi-17 as the most cost-effective means—at the time—for addressing the operational requirements of Iraq, Afghanistan, and Pakistan," the spokeswoman said.

The Mi-17 helicopter is a workhorse transport aircraft seen as versatile and easy to maintain. The U.S. has spent more than $800 million over the past several years to buy Mi-17s; a single Mi-17 costs around $12 million, according to the State Department, although figures vary depending on the contract, and congressional critics say the price tag can be higher.

The helicopters are mostly used for airlifting troops and equipment to fight insurgents in remote regions.

Richard Aboulafia, an aviation analyst with the Teal Group, an aerospace and defense consultancy, said Soviet-bloc aircraft are "cheap to operate because of simplicity of design," and the militaries of these countries have "worked with them before."

For Washington's allies to successfully fight in the counterterrorism fight, their militaries must become more self-sufficient and air-mobile, officials say. While the U.S. is helping to bankroll some aircraft purchases, U.S. officials hope the three countries can ultimately support and maintain the aircraft on their own.

Acquiring such aircraft wasn't easy after the 2006 ban on trade with Rosoboronexport. To meet the Pentagon's orders, private companies acquired civilian-model Russian-made helicopters and converted them for military use, said people familiar with the transactions.

With the lifting of the sanctions, more Russian helicopter purchases could be in the works. Following a June meeting between President Barack Obama and his Russian counterpart Dmitry Medvedev, the two sides announced in a joint statement they were "working on the possibility of assisting Afghan security forces by supplying Russian-made helicopters and spare parts." The Pentagon declined to provide further details.

The U.S. military's efforts to help its foreign allies build low-budget air forces are facing increased scrutiny in Congress, with some lawmakers questioning the approach. The Mi-17 procurement "either had uncoordinated oversight or simply none at all" by the government, Sen. Richard Shelby (R., Ala.) said in an interview. "The results have led to massive waste, cost overruns, schedule delays, safety concerns, and major delivery problems," he said. He urged the government to "analyze alternative airframes, and select the best helicopter for the mission."

In response, the military has argued that Mi-17s could be procured relatively quickly, while the production lead time required to get U.S.-made alternatives to field was lengthy, in some cases two or three years.

Some U.S. lawmakers want the government to consider buying American-made equipment to support the U.S. economy. The House version of the fiscal 2011 defense-authorization bill says U.S.-made helicopters should be among the options when the U.S. considers buying aircraft for the Afghan air force.

**The U.S. military's efforts to help its foreign allies build low-budget air forces are facing increased scrutiny in Congress.**

Pakistan has received 10 Russian-made helicopters at U.S. taxpayer expense, and U.S. counterinsurgency funds have paid for the overhaul of a dozen Pakistani Mi-17s.

Iraq's military operates a fleet of 18 Mi-17s, with another 22 on order, eight of which were paid for by the U.S. government. The Department of Defense has bought 31 Mi-17s for Afghanistan's security forces, and the pending defense budget for fiscal 2011, beginning in October, includes a $180 million request for the procurement of 10 additional Mi-17s for Afghanistan.

"I would love to transition this to all-Western [aircraft]," said U.S. Air Force pilot and aviator," said U.S. Air Force Brig. Gen. Michael Boera, who oversees the effort to strengthen Afghanistan's air forces. "But the fact remains I need to make decisions based on what's best for the Afghans."

U.S. NEWS

An excavator loads a truck with oil sands at a Suncor mine near Fort McMurray in Alberta in 2009.

# Oil-sands plan tests U.S-Canada relations

By Phred Dvorak
And Edward Welsch

A battle over whether the U.S. should curb its use of oil produced from Canada's oil sands is straining ties between the countries and comes amid a wider debate about the safest and cleanest ways to extract fossil fuels.

Rep. Henry Waxman (D., Calif.), chairman of the House energy committee, this week urged Secretary of State Hillary Clinton to veto the expansion of a giant pipeline that would roughly double the amount of oil-sands crude Canada ships to the U.S., calling it a "multi-billion dollar investment to expand our reliance on the dirtiest source of transportation fuel currently available."

Environmental groups are planning protests Thursday at the Canadian embassy in Washington, consulates and along the route of the proposed extension, sections of which run from Canada to Texas. A spokesman for **TransCanada** Corp., which is building the pipeline, said the company disagreed with Mr. Waxman's assertions and that the project would create jobs and revenue for states.

The northeastern part of the Canadian province of Alberta is home to a vast deposit of oil sands, also known as tar sands, that produce a densely compacted petroleum called bitumen, which is difficult to extract and energy-intensive to refine. Environmental groups say production of crude from the sludge can emit about three times the greenhouse gas that more conventional operations do. Oil-sands companies counter that when emissions from burning the gasoline refined from the crude are included, their oil is only 5% to 15% more carbon-intensive.

Mr. Waxman's statement follows a similar letter last week signed by 50 members of Congress, and is the latest volley in a struggle between environmentalists, lawmakers and Canadian oil producers over the rising amount of fuel imported from Canada's oil-sands reserves. The groups are already clashing in U.S. courts over everything from permits to ship or refine oil-sands oil to legislation that could effectively prevent the federal government from buying Canadian oil.

The arguments over future sources of oil for the U.S. are coming to a head amid furor over the Gulf oil spill that has raised scrutiny of all aspects of fuel.

Environmentalists at public hearings over the pipeline project—a $7 billion extension of TransCanada's Keystone line—argued that all oil projects are getting riskier and need tighter oversight, as sources of crude get scarcer and companies go to greater lengths to procure it.

"The entire project is being viewed in the context of the ongoing tragedy in the Gulf Coast," said Robert Jones, who oversees the Keystone project, during a conference call last week.

The extension must be approved by the State Department. A decision could come as soon as in the next month, but Mr. Waxman and others are asking for a delay until emissions evaluations are done. A spokeswoman for the White House Council on Environmental Quality said Tuesday that the council was reviewing the pipeline proposal and working with the State Department. Other government agencies will weigh in on the plan this month.

Attacks on oil-sands production could complicate relations with Canada, the U.S.'s biggest trading partner, where energy makes up about a quarter of exports. Canadian executives and politicians have said if the U.S. doesn't take the fuel, nations like China will. The government of Alberta last week took out a full-page ad in the Washington Post defending the oil sands, stating, "A good neighbour lends you a cup of sugar. A great neighbour supplies you with 1.4 million barrels of oil per day."

For years, the processing difficulties made oil from the oil sands too costly to pursue. That has changed during the past decade as refining technology improved and easier-to-use reserves were tapped out, pushing up prices. Most new oil-sands projects can make money at prices of around $50 to $60 a barrel, according to research by BMO Capital Markets.

Oil-sands production in Canada more than doubled from 2000 levels to 1.5 million barrels a day last year. This year, Canada's oil sands are poised to become the biggest single source of imported crude to the U.S., and volumes could triple or quadruple during the next 20 years, forecasts IHS Cambridge Energy Research Associates, a consultancy.

Environmental groups like the Sierra Club are trying to make sure that doesn't happen, with lawsuits aimed at stopping U.S. refineries from processing the oil and pipelines from shipping it. The group last month also sued the Department of Defense, saying it ignored a section of the 2007 Energy Independence and Security Act that prohibits federal agencies from buying "alternative or synthetic fuel" unless it produces the same amount or less greenhouse gas as conventionally produced fuel. Oil-industry officials and the Department of Defense, the biggest U.S. purchaser of Canadian crude, argue that the section of the law doesn't apply to purchases of commercially available oil-sands fuel.

*—Stephen Power contributed to this article.*

Agence France-Presse/Getty Images (2)

The Suncor oil-sands extraction facility near Fort McMurray last year.

# *Pentagon's next mission: cutting back on spending*

[ Capital Journal ]

By Gerald F. Seib

When people from opposite ends of the political spectrum come together to agree on something in Washington, you can be pretty sure a trend is taking shape.

And so it was this week when Rep. Ron Paul, conservative/libertarian Republican of the right, and Rep. Barney Frank, liberal Democrat of the left, co-published a commentary on the Huffington Post website titled: "Why We Must Reduce Military Spending." Amid rising government deficits, it said, there should be "substantial cuts in the projected levels of Pentagon spending."

Failure to curb defense spending, the two congressmen warned, would "do substantial damage to our economy and dramatically reduce our quality of life."

Reps. Paul and Frank are doing more than writing a blog post. They and some colleagues have convened what they call a Sustainable Defense Task Force of defense analysts that has recommended $1 trillion in spending cuts over the next decade. Most come from eliminating Cold War weapons systems and—watch for more of this—cutbacks in defense commitments in Europe and elsewhere abroad.

These two odd-fellow members of Congress are harbingers of things to come. Annual defense spending has more than doubled over the last decade, largely because of the wars in Iraq and Afghanistan. But now the deficit is high, the debt is growing, and those wars are winding down, one way or another.

So the parallel move to wind down Pentagon spending is coming. The only questions are how big the urge to curb will be, and what form it will take.

Paradoxically, the man who seems to recognize this most clearly is someone you might expect to be in denial: U.S. Defense Secretary Robert Gates.

For two years, sometimes quietly and sometimes from atop a soapbox, Mr. Gates has been telling his own Pentagon, the military services and Congress to get ready for the squeeze.

His simple message: We are going to have to tighten our belts, so let's do so in a sensible way, one that reduces the nation's defense bill without cutting its defense structure.

Washington being Washington, it's a surprisingly difficult message to get across.

In many ways, Mr. Gates's push started in September 2008, when he was serving as Pentagon chief for President George W. Bush, and before President Barack Obama had even been elected. The financial sector was only beginning its freefall. Mr. Gates gave a speech at the National Defense University saying that "resources are scarce" and that the military needed to divert more of those limited resources away from old programs and toward preparing for the kind of "small wars" being waged in Iraq and Afghanistan.

Mr. Gates really got down to business in 2009, when he essentially stopped the Pentagon in its tracks for weeks to prepare a budget for 2010 that he considered the first designed to take into account the new fiscal reality.

That budget—his budget, he made clear—went after some sacred cows. It stopped production of the ultra-expensive F-22 fighter jet, cut back on some missile-defense programs he thought unrealistic, and killed an Army combat system considered out of sync with today's counter-insurgency warfare.

The reaction in Congress: revolt. Lawmakers develop their attachments to pet programs as much as military leaders and defense contractors do, and they hold on tight.

**U.S. Defense Secretary Robert Gates for two years has been telling his own Pentagon, the military services and Congress to get ready for the squeeze.**

So Mr. Gates responded by going public with a scolding. He flew to Chicago to give a speech saying that cutting unnecessary things was essential for saving necessary things. "In total, by one estimate, our budget adds up to about what the entire rest of the world combined spends on defense," he said. "Only in the parallel universe that is Washington, D.C., would that be considered 'gutting' defense."

Now the Gates quest to get out in front of the fiscal clouds continues. He argues that the smart approach is to increase spending on the forces in the field, and on the new weapons they need, by 2% to 3% a year, which can keep the force structure intact while allowing for inflation.

But to do that in an era of tighter budgets, he says, the Pentagon will have to fund some of that 2% to 3% increase by cutting overhead and unnecessary programs—by not buying a second brand of engine for the F-35 fighter jet, for example, and by finding ways to curb health costs for military retirees.

His most recent high-profile attempt to drive home the message came in a speech at the Eisenhower presidential library in Abilene, Kan., in May. There, he said of defense spending: "The gusher has been turned off, and will stay off for a good period of time."

But if the gusher is to be turned off, Mr. Gates is pleading, let's at least be smart about how it's done.

# BOJ targets growth areas for loans

*New program aims to reverse declining bank lending and help boost small-business activity in 18 business sectors*

By Atsuko Fukase

TOKYO—The Bank of Japan is straying into uncommon territory with a new lending facility that encourages banks to provide loans to targeted growth sectors.

The central bank program is aimed at reversing declining bank lending and helping boost activity in the corporate sector and in the economy as a whole. Three of Japan's largest banks said Thursday they will tap funds from the new BOJ facility, announced by the central bank in June.

The central bank said it will make a total of three trillion yen ($34.19 billion) available to banks at a 0.1% interest rate.

Under the program, private banks will have to explain to the BOJ how they will extend loans. Applicants are expected to lend to smaller companies in 18 growth sectors, including environment-related businesses and child-care services, and will be able to keep the funds for up to four years.

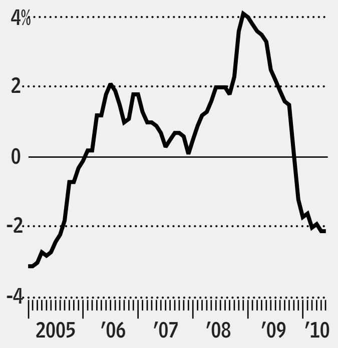
Japanese banks, still wary of loans that can sour in the current economic climate, have been cautious about lending to companies. But corporate demand for funds also has been sluggish because of a gloomy outlook. BOJ data released Thursday showed lending by Japanese banks, excluding smaller credit unions, dropped 2.1% from a year earlier in June, the seventh straight month of decline.

The central bank hopes the new plan will encourage lending to key corporate sectors.

Analysts have said that the loan program isn't likely to give much of a lift to the overall economy—the three trillion yen on offer is a fraction of the around 400 trillion yen of outstanding loans held by Japanese banks—but that it could help smaller firms that need funds to expand their businesses.

**Low lending**

Total lending by Japanese banks, change from previous year




* Excludes credit unions
Source: Bank of Japan

Taking advantage of the BOJ's new facility, **Mitsubishi UFJ Financial Group** Inc's. banking unit said Thursday it plans to launch a fund this month to extend loans to companies in growth sectors. Borrowers can receive from 10 million yen up to a maximum of five billion to 10 billion yen for terms of up to four years, the bank said in a statement. The fund is valued at 150 billion yen, the maximum amount a single bank can take out of the BOJ facility.

**Sumitomo Mitsui Banking** Corp. also said it will borrow 150 billion yen to set up two core funds of 50 billion yen each this month. One will lend to environment-related businesses and the other to companies that plan to expand or start operations in China.

For the fund supporting environment-related businesses, each borrower can receive between 300 million yen and five billion yen, while there is no explicit loan limit for the China-related fund, the bank said.

The remaining 50 billion yen will go to small funds the bank plans to create, according to the bank's unit, Sumitomo Mitsui Financial Group Inc.

**Mizuho Financial Group** Inc. said its retail banking unit, Mizuho Bank, plans to launch a fund of as much as 150 billion yen for businesses in growth sectors such as environment and resources companies, and medical and health-care businesses. It plans to lend between 100 million yen and 10 billion yen, for terms of up to seven years.

Although Japan's economy recovered strongly in the early months of the year, worries about a global economic slowdown and a stronger yen that hurts exports have made companies less confident about the outlook.

Thursday's data showed that one key gauge of future capital investment trends, core machinery orders, fell 9.1% month-to-month in May, the sharpest drop since August 2008.

But a BOJ report on regional economies released the same day indicated central bank officials don't feel the country is due for a deceleration.

Eight out of nine regions upgraded their economic assessments from the previous assessments in April, the central bank said in its July quarterly regional economic report, released Thursday at the BOJ branch managers' meeting.

Bloomberg

The Bank of Japan headquarters in Tokyo, which plans to make available $34.19 billion in loans at a special rate.

# High-stakes weekend vote for Kan

By Yuka Hayashi

TOKYO—The ruling Democratic Party of Japan faces an uphill battle to secure its long-sought parliamentary majority in Sunday's national elections. Failure to do so would hamper the government's ability to pursue its agenda, as coalition partners stall proposals to raise taxes and reduce massive government debts.

A weak performance could even threaten Prime Minister Naoto Kan's hold on power, just over a month after he took office when his predecessor was forced to quit nine months into his term. A strong performance, however, could bolster Mr. Kan's chances of staying in charge through the next scheduled elections in 2013, giving him power—and time—to implement his policies.

A total of 438 candidates are competing in Sunday's elections, where half the 242 seats in Japan's upper house are up for grabs. To secure a majority, the DPJ and its current coalition partner need to win at least 57 of the 121 contested seats. Mr. Kan's goal is to defend the DPJ's existing 54 seats.

Hurt by the performance of the predecessor, Yukio Hatoyama, and his own insistence on a big tax increase, Mr. Kan has struggled to garner popular support for his party in recent weeks. Polls this week show approval ratings for his cabinet falling to about 40% from around 60% soon after his appointment on June 8.

That is a sharp contrast from the last time the DPJ faced voters, when the party scored a landslide victory and rose to power last August, as Japanese voters backed a transfer in power for the first time after half a century of one-party rule.

"What we are asking you to do in this election is to decide whether you want to keep pushing the clock forward and allow us to re-energize Japan," Mr. Kan said in a campaign speech in Kumamoto in southern Japan last weekend, hoping to remind voters why they first embraced the DPJ. "Or would you already give up on the DPJ and let the clock slip backward?"

Upper-house votes in Japan are similar to the midterm elections in the U.S. in significance. The DPJ will remain the ruling party regardless of Sunday's outcome—it has a huge majority in the more-powerful lower house, thanks to its victory last year. But to tighten his grip on power and to realize his policy goals, Mr. Kan needs to increase his party's presence in the upper house, which is needed to pass some—but not all—legislation.

Some polls have suggested the DPJ could lose several seats, resulting in the loss of the laser-thin majority that the party and its small coalition partner currently enjoy.

A poll conducted by Kyodo News this week showed the DPJ could win fewer than 50 seats. The Mainichi Shimbun daily, meanwhile, predicted on Monday a range of 49 to 59 seats for the DPJ, saying Mr. Kan's goal may be achievable.

The results could have important policy implications. A major win would give the DPJ a free hand to pursue its agenda, allowing Mr. Kan to lay the groundwork for an increase in the national sales tax as a way to tackle Japan's mounting government debts.

If the DPJ loses five or more seats Sunday, the talk in Tokyo could focus on Mr. Kan. "If the DPJ falls below 50 seats, Mr. Kan might face trouble," said Yasunori Sone, a political-science professor at Keio University. "Anti-Kan forces within the party could start making noises."

Should the DPJ fall short of a majority, the need to find coalition partners could have a big impact on policies, as the party saw during its first months in office.

The alliance with the left-leaning Social Democratic Party of Japan was a factor in Mr. Hatoyama's insistence on trying to move an American military base off the southern island of Okinawa. His breaking of that pledge led the SDPJ to leave the government, one reason he cited for his sudden resignation in June.

The tie-up with the other coalition partner, the People's New Party, drove the DPJ to embrace the PNP's primary cause of reversing the privatization of Japan Post, the postal and financial-services giant, a position sharply criticized by financial-services companies in Japan and abroad. Without the PNP, Mr. Kan might change the government's current stance on Japan Post—a shift that would win cheers from the U.S. and Japan's bankers.

Under perhaps the most-likely scenario for Sunday's vote—in which the DPJ loses several seats—the ruling party might be forced to find new coalition partners and make policy compromises. For example, Your Party, a start-up making waves with its small-government platform, is a possible partner, political experts say. But it opposes the sales-tax increase.

New Komeito, another possible partner that emphasizes populist policies, might block steps considered painful for lower-income earners, such as curtailing subsidies paid to families and farmers.

As it looks for new partners, the DPJ may also decide to drop the PNP, as being too small.

A growing difference between Mr. Kan and PNP head Shizuka Kamei has been exposed recently, fueling the speculation of the PNP's departure. "Debating a tax hike when our households are so shaky," Mr. Kamei told Mr. Kan and other party heads at a televised debate last weekend, "is like building a sand castle."

# Japanese data show recovery is losing steam

By Andrew Monahan

TOKYO—Fresh signs that Japan's economic recovery may be losing momentum emerged Thursday, as a gauge of future business investment fell, the broadest measure of the country's trade slipped, bank lending continued to decline and worker sentiment deteriorated.

The results highlight how Japan, which relies on exports to fuel its growth, remains vulnerable to a slowdown in the global economy. The apparent cooling of Japan's recovery, moreover, could hurt Prime Minister Naoto Kan and his ruling Democratic Party of Japan in Sunday's upper house election.

Core machinery orders fell 9.1% in May from the month before, the sharpest drop since August 2008, the Cabinet Office said Thursday. That was the first fall in this leading indicator of capital spending in three months, and came after orders rose 4% in April.

Separate data released Thursday by the Ministry of Finance showed that Japan's current-account surplus fell 8.1% to 1.205 trillion yen ($13.7 billion) in May from the year-earlier month, as export growth slowed due in part to the fading effects of economic-stimulus measures overseas.

Exports rose at their slowest pace in five months.