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# THE WALL STREET JOURNAL.

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# Brown resigns, sparking chaos

By Alistair MacDonald

British Prime Minister Gordon Brown said he will step down within months as leader of the country and his party, but the U.K.'s confused political landscape was thrown into further chaos as his Labour Party began talks to form a government despite finishing second in last week's inconclusive election.

Mr. Brown's announcement, delivered outside No. 10 Downing St., was the centerpiece of a day of high political drama in which the U.K.'s Labour and Conservative parties engaged in an aggressive and public tug-of-war for the support of the country's No. 3 party, the Liberal Democrats.

Mr. Brown's move to step aside was packaged with his announcement that Labour has entered formal talks on a power-sharing coalition with the Liberal Democrats and their leader, Nick Clegg.

In essence, he offered himself as a sacrifice whose timing was tactically designed to both bolster Labour's improbable attempt to stay in power and block the rival Tories from taking control of Britain's government. Many senior members of the Liberal Democrats had made it clear that they would be less inclined to a deal with a Labour Party still led by Mr. Brown.

Having won the most seats—but not a majority—in last week's vote, the Conservatives and leader David Cameron have spent the past few days attempting to forge an agreement in which they would run the country in a coalition government with the Liberal Democrats, a party with which it shares little common ground on key issues.

After Mr. Brown made his move, the Conservatives threw down the gauntlet to the Liberal Democrats, making a fresh and seemingly final offer to Mr. Clegg's team. Senior Tory official William Hague said the Conservatives would offer a referendum to overhaul the U.K.'s voting system, a key issue for the Liberal Democrats that is strongly resisted by many Conservatives.

The resulting picture of increasing political uncertainty

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Agence France-Presse/Getty Images

British Prime Minister Gordon Brown addresses the media outside of 10 Downing St. in central London on Monday.



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Penny-pinching plan for U.S. to mint nickel-free nickels.
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The true cost of the trillion-dollar euro bailout. Page 11

# Stocks cheer EU bailout plan

By Michele Maatouk

Stock markets around the world surged on a €750 billion ($954.83 billion) rescue package intended to stabilize the euro and prevent the Greek fiscal crisis from spreading to other members of the euro bloc.

The news initially sent the euro sharply higher against the dollar, before it gave up most of those gains. U.S. stocks posted their biggest gain in more than a year as the Dow Jones Industrial Average climbed 404.71 points, or 3.9%, to 10785.14.

"This bailout plan really avoided the worst-case scenario—it avoided contagion and the domino effect," said Cort Gwon, director of trading strategies of FBN Securities in New York.

Financial stocks put in Europe's strongest performance, with banks most exposed to Greek debt and those in the periphery nations gaining momentum following steep declines in the sector last week. Spain's **Banco Santander** rose 23% and **BBVA** climbed 22%, while Italy's **UniCredit** rose 21%. In London, **Barclays** added 16%, and **Lloyds Banking Group** advanced 14%.

The pan-European Stoxx 600 Index closed up 7.2% at 254.14, its highest closing level in a week and giving it a small gain for the year. Spain's IBEX 35 surged 14%, its biggest gain since at least Sept. 6, 1991. Italy's FTSE MIB climbed 11% to 20971.21, its biggest gain since Oct. 13, 2008.

Among other battered markets, Lisbon's PSI General Index climbed 11% to 2574.92, and the Greek ASE Composite jumped 9.1% to 1779.30. All four national benchmarks, however, remain deeply in the red for the year.

In France, **Société Générale** and **BNP Paribas**, two banks hit hard last week over fears over their exposure to Greece and other highly indebted nations, added 24% and 21%, respectively. The CAC-40 Index jumped 9.7% to 3720.29.

The U.K. market had closed when Prime Minister Gordon Brown said he would step aside as the Labour

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PAGE TWO

# Britain now sleepwalking to disaster as Brown plots coalition of the absurd

[ Agenda ]

By Iain Martin

You have to hand it Gordon Brown: he's persistent. Having lost the general election he announced to a baffled Britain on Monday that he plans to continue as prime minister for five months to oversee the transition to a Labour successor. He has resigned, in order to stay on.

"The guy can't even resign properly. Other people say 'I resign,' then they go. But not Gordon. He only sort of resigns," said one of a large crowd of MPs gathered along with a circus load of excited journalists at the House of Commons Monday. In front of them, in hastily organized press conferences and crisis meetings held by the various parties, a constitutional crisis was unfolding.

The Conservatives—the party with the largest number of votes and seats which it was widely accepted would have the first chance of forming a government after an election resulting in a hung Parliament—may now be headed back to the opposition benches.

That Mr. Brown's party on polling day recorded its lowest vote share since 1983 with 29% of the vote and that the Tories are by far the largest party with 306 seats compared with Labour's 258 are mere trifling details in the universe of someone as stubborn as the prime minister.

Monday, he spotted a last-minute chance to get a deal with the third party Liberal Democrats and Nick Clegg to keep Labour in power. He grabbed at it.

It had looked until midafternoon as though the Tories were on the brink of being able to form a coalition of some kind with the Lib Dems. The two parties seemed to have made good progress in talks. The Conservatives are opposed to changing the first past the post voting system, but David Cameron was prepared to offer a referendum on the subject.

Then it all changed.

By Monday morning Mr. Clegg was having serious difficulty selling any deal with the Tories to his own MPs and activists. The Lib Dem leader had kept open various lines of communication with Labour. Mr. Brown and Lord Mandelson met Mr. Clegg on Monday morning to suggest that he had an alternative option: a pact of some sort with Labour in which he would get an instant vote in the Commons on his desired aim of changing the voting system. It would not require a referendum.

Getty Images

David Cameron was still waiting Monday to take the reins after the. election.

> I thought the parties might wake up, realize the gravity of the situation and act swiftly. They are still asleep.

If Mr. Clegg needed his path smoothed to such a deal, then Mr. Brown would indicate publicly that he planned to step down in September. By then a Labour successor could be chosen.

At a chaotic Westminster, the Lib Dem group of MPs met for several hours and applied pressure to its leadership. There was great unhappiness at the thought of any arrangement with the Tories and backing for the idea of full talks with Labour. Into this chaos stepped the PM, with his non-resignation resignation statement. The Tory-Lib Dem deal looked off, a Labour-Lib Dem deal seemed on.

But Mr. Brown last night had serious problems. MPs wonder whether his survival in office for five months is remotely credible in a country that just voted him out. Such a coalition would not have enough seats combined for a Commons majority. Labour and the Lib Dems would need to secure the backing of the nationalists and various other small parties.

And even though the Prime Minister has told Mr. Clegg that there can be an instant Commons vote on electoral reform, it is highly questionable whether Mr. Brown can even deliver the votes of his own party. A significant chunk of Labour MPs, particularly from Scotland, see first past the post as non-negotiable. Only a handful would be required to vote against it to prevent Mr. Brown and his new friend Mr. Clegg forcing through reform.

The former Labour Home Secretary John Reid was first to speak up last night. He is no longer an MP but is a figure of considerable influence in his party. He denounced Mr. Brown's attempts at brokering an accommodation. He described any Brown-Clegg partnership formed with the support of minor parties as "inherently unstable" and a "potential disaster for the country".

During the election Mr. Clegg in particular made repeated references to a supposed "new politics". Unlike under the old two party duopoly of Labour and the Conservatives, if the Lib Dems had bargaining power there would be greater transparency and sensible deals could be done between parties in the national interest. As Mr. Reid put it: "If this is the new politics, I don't think the public is going to find it very attractive."

Indeed, one casualty of this farce is likely to be electoral reform. The British have had a voting system that has produced results needing coalition negotiations only twice since 1945. This glimpse of the Mr. Clegg's "new politics" is unlikely to make many want a system that makes it the norm.

What is any voter, interested observer or investor to make of this? One can only conclude that Britain—or much of its governing class—has lost its collective marbles in the face of an economic crisis.

I wrote during the election that it was as though the campaign was happening on another planet. As though the three parties were sleepwalking or too scared to tell the public the truth that the markets are hunting country's that have excessive debts and no serious plan to tackle them. I thought the various parties might wake up after polling day, realize the gravity of the situation and act swiftly. They are still asleep.

## ONLINE TODAY

### Most read in Europe

1. Zeal and Angst: Germany Torn Over Role in Europe
2. Currencies Hostage to Euro-Zone Debt Mess
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"This is shock and awe part II and in 3-D, with a bigger budget and a array of special effects."

**Marco Annunziata**, UniCredit chief economist, on the euro-zone bailout

### Continuing coverage

Follow the latest as efforts to build a U.K. government continue at **wsj.com/ukelection**

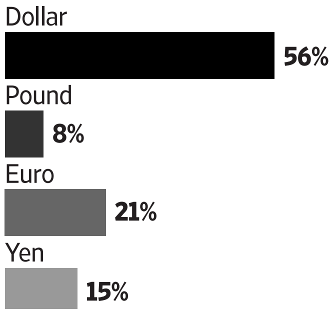
### Question of the day

Can a Conservative/Lib Dem coalition reassure the markets?

Vote online and discuss with other readers at **wsj.com/dailyquestion**

### Previous results

**Q:** Which currency do you have the most faith in?




## What's News

■ **Fannie Mae will need** $8.4 billion more in U.S. aid after losing $11.5 billion in the first quarter, the latest sign that the bailout of the mortgage investor and rival Freddie Mac is likely to be the most expensive legacy of the U.S. housing-market bust. 17

■ **A price-fixing case** collapsed against three former British Airways employees and one current employee. Meanwhile, cabin crew will stage 20 days of strikes later this month and next. 17

■ **RBS said it will cut** 2,600 jobs in its insurance and retail-banking divisions. 22

■ **Obama announced** the nomination of Solicitor General Elena Kagan to the U.S. Supreme Court, calling her a "trailblazing leader." 8

■ **BP hopes a smaller dome** will work after rapidly freezing natural gas and water derailed attempts to place a big dome on top of a well leaking oil into the Gulf of Mexico. 9

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EUROPE'S DEBT CRISIS

# ECB debt-buying sets a precedent

*Critics say move, a switch from a focus on fighting inflation, could weigh on bank's policy makers in the future*

By Brian Blackstone

FRANKFURT—The European Central Bank's stunning decision to purchase government debt of some euro-zone governments, just days after appearing to reject the idea, has pushed the bank further into the realm of politics, raising doubts about its independence.

As part of Europe's response to its worsening debt crisis, the ECB said early Monday that, among other measures, it would purchase public and private euro-zone debt, essentially propping up the bonds of countries investors worry may not be able to meet their obligations.

The ECB wasted no time Monday in putting the new plan into action, buying government bonds of Greece, Ireland, Portugal, Spain and Italy, according to the Association for Financial Markets in Europe.

Critics say the move set a precedent that could put the ECB under political pressure to take similar action in the future.

The decision faced resistance even within the ECB's governing council. Axel Weber, president of Germany's Bundesbank and a leading candidate to become the next head of the ECB, publicly distanced himself from the decision, a rare act of defiance in an institution that normally takes pains to conceal internal divisions.

"I see this part of the governing council's decision critically, even in this extraordinary situation," Mr. Weber told German business daily Börsen-Zeitung.

The bond-buying program was endorsed by the "overwhelming majority" of the ECB council, President Jean-Claude Trichet said Monday.

The move is a first for the ECB, whose mandate is centered on fighting inflation. Even at the depths of the financial crisis, when its U.S. and U.K. counterparts were buying government debt, the ECB refrained.

Supporters of Monday's move say the ECB had little choice, given the intense pressure in financial markets in recent days and the steep slide in the euro.

The ECB's decision, which coincided with creation of a massive €750 billion ($955 billion) debt-stabilization backstop by EU governments and the IMF, led to a rally in global stocks, a plunge in bond yields—which move opposite to bond prices—on Europe's fringe and a rebound in the euro.

If the powerful mix of EU guarantees and ECB money can stabilize markets—and if the countries benefiting from the largesse live up to their deficit commitments—then Mr. Trichet's U-turn on debt-buying and other matters will be seen as necessary concessions.

Yet if governments see the ECB lifeline as an excuse to delay tough budget cuts amid social unrest—or if markets begin to doubt the credibility of ECB officials and what they say publicly—then the institution's credibility may be damaged.

In essence, Mr. Trichet has tied the ECB to the ability of Athens and others—despite years of profligacy—to successfully make some of the largest deficit reductions in modern times, against a backdrop of very weak growth or outright recession. "It's a risky game" if countries become "addicted" to the ECB lifeline and fail to deliver on budget reform, says Carsten Brzeski, economist at ING Bank.

After last week's rout in financial markets, the ECB was expected to take some aggressive steps to shore up the flow of credit, including a return to longer-term loan operations. Those types of facilities, which were in the process of being phased out before Monday, make it easier for banks to gain access to credit amid signs that interbank lending was drying up. The ECB also reactivated U.S. dollar swap facilities with the Federal Reserve.

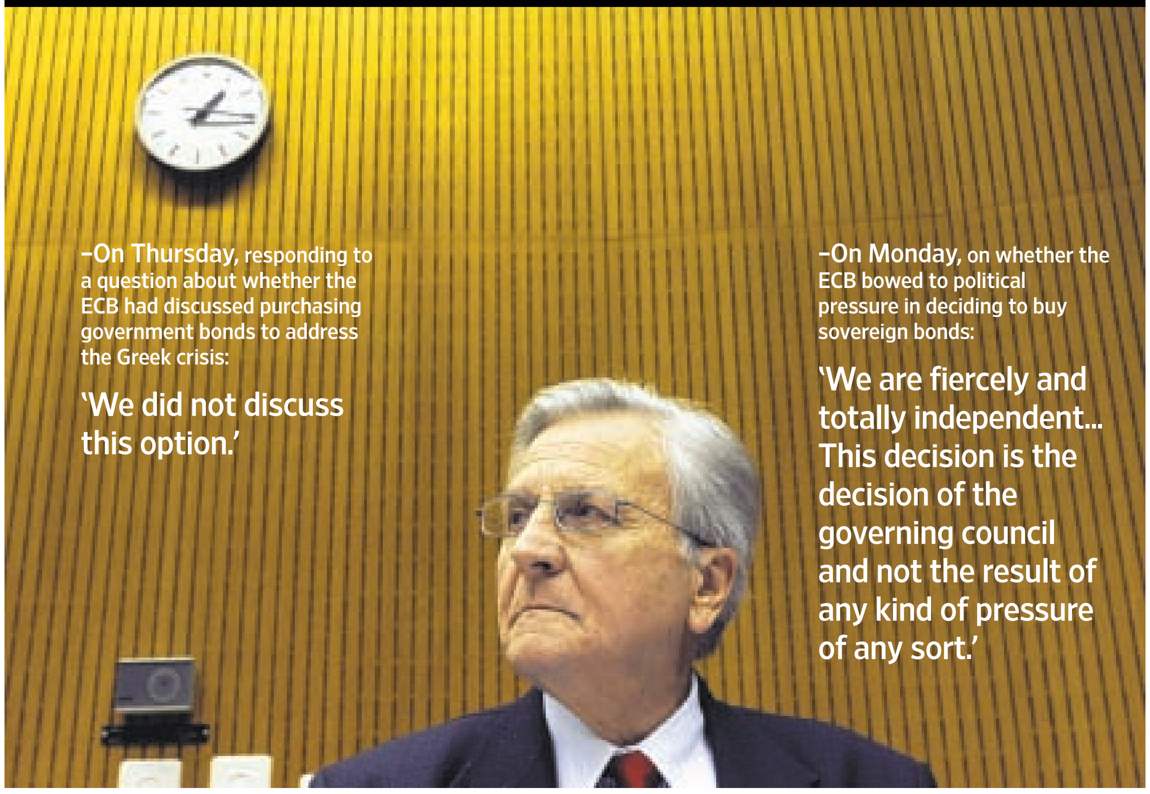
What shocked markets was the ECB's pledge to purchase government bonds, as well as private securities, from financial institutions. Mr. Trichet rejected those pleas at the ECB's monthly news conference on Thursday, saying the idea hadn't been discussed by the bank. European markets, and the euro, fell on the news, and some European debt markets effectively locked up.

The ECB's public resistance to intervention ended up forcing it to act . At the end of last week, the ECB saw "dysfunction" in financial markets that was hampering monetary policy, Mr. Trichet said Monday.

Mr. Trichet, who met with euro-zone leaders on Friday and was in contact with them through the weekend, insists that the ECB wasn't pressured by governments to act. "We are fiercely and totally independent," he said.

The ECB was designed to be shielded from politics, for fear that political influence would undermine its inflation-fighting mandate. "If the ECB's credibility is undermined, it is because they said it would be horrible if we do those things [such as bond buying] and then they do these things," says Paul De Grauwe, professor at the Catholic University of Leuven, who supports the decision to buy bonds.

**His word and his bond** | Jean-Claude Trichet's shift on buying government bonds




Agence France-Presse/Getty Images

# European markets rally on EU bailout package

*Continued from first page*

Party's leader in order to facilitate a power-sharing deal with the Liberal Democrats, but sterling pulled back from its highs. The U.K. has been unable to form a government since Thursday's election.

The FTSE 100 Index rose 5.2% to 5387.42, part of the broad relief after European Union finance ministers on Sunday agreed on a support plan for countries facing fiscal challenges. It will consist of as much as €440 billion in loans from euro-zone governments and €60 billion from an EU emergency fund, as well as €250 million from the International Monetary Fund.

In addition, the European Central Bank confirmed it will buy bonds in the secondary market to ensure market stability, and the Federal Reserve opened up a dollar-swap program to ease interbank lending pressures. That sent government bond prices climbing, pushing down yields, and the cost of insurance against a possible default tumbling.

The yield premium that investors demanded for holding Greek bonds instead of those from Germany, the euro-zone benchmark, halved to 4.87 percentage points, from 9.83 percentage points late Friday, when yields topped 12%.

But the rescue package dimmed the safe-haven allure of U.S. Treasurys. The benchmark 10-year note fell 29/32 to 100 22/32 to yield 3.541%, up from 3.431% late Friday.

While investors reacted positively to the European announcement, analysts warned that the rescue plan isn't without flaws, arguing that it merely offers temporary relief. Moreover, some of the day's sharp gains eroded late in the day, especially for the euro, as traders started to ask questions about the structure of the massive EU rescue effort, especially its heavy reliance on more debt.

"You cannot make any nation that is unable to service its accumulated debts more creditworthy by extending more credit!" said Jeremy Batstone-Carr, analyst at Charles Stanley. "If the EU lends Greece money, the loan will increase that country's public-sector debt. The interest on the additional loan, whatever it eventually proves to be, will increase the public-sector deficit. Total debt-servicing costs will rise, raising the burden on public-sector cash flows. At some point in the future, the loan will have to be paid back."

**European revival** | Performance over the past six days, five-minute intervals


Note: Currency data match trading hours in European markets

Source: Thomson Reuters

Late afternoon, the euro was at $1.2763, compared with $1.2731 late Friday, after surging to nearly $1.31 on the unexpectedly large emergency package and ECB efforts. The dollar was at 93.22 yen, from 91.41 yen, while the euro was at 118.93 yen, from 116.71 yen. The U.K. pound was at $1.4852, from $1.4821. The dollar was at 1.1110 Swiss francs, from 1.1084 francs.

In Asia, Japan's Nikkei Stock Average of 225 companies ended up 1.6% at 10530.70, part of a regional surge on the European package.

Crude for June delivery gained $1.69, or 2.3%, to settle at $76.80 on the New York Mercantile exchange. Gold for May delivery fell $9.80, or 0.8%, to settle at $1,200.40 per troy ounce on the Comex division of Nymex.

*—Sarah Turner contributed to this article.*

EUROPE'S DEBT CRISIS

A trader on the floor of the London Metal Exchange

**Surging shares** | A nearly $1 trillion plan to bolster the euro zone sent stocks soaring around the world.

| FRANCE CAC-40 | GREECE Athex composite | GERMANY DAX | SPAIN IBEX 35 | ITALY FTSE MIB | U.K. FTSE 100 | EURO BANKS Stoxx 600 | HONG KONG Hang Seng | U.S. DJIA* midafternoon |
|---|---|---|---|---|---|---|---|---|
| +9.7% | +9.3% | +5.3% | +14% | +11% | +5.2% | +14% | +2.5% | +3.9% |
| 3720.29 | 1779.30 | 6017.91 | 10351.90 | 20971.21 | 5387.42 | 212.91 | 20426.64 | 10785.14 |

Bloomberg News

# Rescue calms markets, remakes EU

Global financial markets roared back in response to the European Union's nearly $1 trillion rescue plan to save the euro from a public-debt crisis that has threatened to derail the worldwide economic recovery.

By ***Marcus Walker*** *in Berlin,* ***Charles Forelle*** *in Brussels and* ***David Gauthier-Villars*** *in Paris*

Relief that EU governments are taking massive action to prevent Greece's financial troubles from spreading throughout the region led to a surge in the euro, European bank shares and the U.S., and assets around the world ranging from oil prices to Brazilian stocks.

Even though the plan went a long way toward easing immediate fears of a spiraling financial-market panic, many economists warned that Europe's radical rescue plan doesn't address the region's underlying economic weaknesses, and could undermine the euro zone's rules and institutions.

A string of countries along the euro zone's fringe, from Greece to Portugal, still have deteriorating public finances and need painful overhauls to restore their competitiveness. Analysts warned Monday that blanket bankruptcy protection from Germany, France and other core euro nations could even reduce pressure on profligate euro-zone governments to mend their ways.

"This step was needed to calm financial markets, and it perhaps succeeded. But it opens fundamental questions about the monetary union," said Daniel Gros, director of the Centre for European Policy Studies, a Brussels think tank. "Now that the EU has said it will save everybody in sight, there may be no way to enforce fiscal discipline."

The euro rose to nearly $1.31 on Monday after sliding to just over $1.27 on Friday, as analysts broadly welcomed the €750 billion package by the EU and the International Monetary Fund to protect weaker euro-zone countries against defaults.

The massive plan was announced in the early hours of Monday in Europe. It followed marathon negotiations between EU leaders over the weekend and U.S. diplomatic pressure on Europe to take decisive action after months of division.

As analysts debated the merits of the plan, there was broad agreement that the sweeping measures would have a profound effect on how the 16-member euro zone functions, catapulting the bloc on a headlong course toward fiscal coordination.

In the span of a weekend, the euro zone has undone some of its founding principles, including its ban on governments bailing each other out, or the European Central Bank buying its member countries' debt, say analysts.

German Chancellor Angela Merkel, bleary-eyed after marathon negotiations Sunday night, stressed on Monday that aid for euro-zone governments would come with strings attached, including austerity programs designed together with the IMF.

For Germany, the EU's biggest economy and paymaster, the aid package is a decisive affirmation of political and financial commitment to Europe. Yet that commitment was born out of fear that the euro could fail, rather than enthusiasm for deeper union. Ms. Merkel's challenge now is to convince Germans of a course that could wind up leaving them on the hook for other euro members' debts.

"This package serves to strengthen and protect our common currency," Ms. Merkel said Monday. "We are protecting the money of the people of Germany."

The chancellor for months resisted pressure from France and indebted Southern European countries to bail out Greece, fearing a precedent that could undermine budget discipline throughout the euro zone and saddle German taxpayers with unpalatable burdens.

In 11-hour negotiations Sunday, after losing her parliamentary majority to a regional election, Ms. Merkel accepted a safety net for all euro members.

The €750 billion package comprises three elements. A government struggling to refinance its debts could first tap a €60 billion EU emergency fund.

If that proved insufficient, it could borrow from a €440 billion fund financed through a special-purpose vehicle whose borrowings will be guaranteed by other euro-zone governments. The IMF would lend about €250 billion and impose stringent budget cuts.

In practice, the special-purpose vehicle will be able to lend more than €440 billion, since it allows for the use of crisis-hit countries' bonds as collateral against further loans from the ECB.

**The EU's plan calmed markets and led to a surge in the euro and bank shares. But economists warned it doesn't address underlying economic weakness.**

The ECB, meanwhile, began buying debt of weaker euro-zone countries in bond markets Monday.

The radical set of measures marks a historic turning point for Europe's single-currency zone, which is now moving rapidly toward becoming a single debtor and a deeper fiscal federation, under heavy pressure from financial markets that have exposed the limits in a system in which 16 nations share a currency while operating separate national budgets.

European leaders now face questions about the longer-term impact of their emergency action—including whether nations have enough incentive to slash budget deficits, and on the ECB's credibility and independence.

Only on Thursday, ECB President Jean-Claude Trichet rejected pleas from European banks for the central bank to buy euro-zone government debt. He didn't rule out the option either, but the lack of a signal contributed to a plunge in the euro and global stock markets.

ECB officials say markets had turned "dysfunctional" by Friday, amid a rout in Portuguese government bonds and signs of a breakdown in trust between banks caused by fears of heavy potential losses on government debt.

On Friday evening, when euro-zone leaders gathered in Brussels to give their formal approval to aid for Greece, ECB President Jean-Claude Trichet spoke of a worsening pan-European crisis and called for swift action. As leaders sat down to dinner, the yield on Portugal's bonds rose to more than eight percentage points over what ultrasafe Germany pays to borrow for two years—reflecting investors' growing fears of a Portuguese default. EU officials realized that Portugal's trajectory put it just a few weeks behind Greece, which rapidly lost access to capital markets in April.

Leaders agreed something big was needed over the weekend to turn around market sentiment toward the euro zone. French President Nicolas Sarkozy, with support from most leaders present, pushed to announce a "European stabilization mechanism" that Friday night. Ms. Merkel resisted, insisting governments take the weekend to weigh options carefully and present a plan before markets opened Monday.

Mr. Sarkozy, who had for weeks agitated for bolder European action, pressed for the ECB to play a role too. Ms. Merkel retorted that the ECB couldn't take orders from national governments.

Consultations over the weekend reached an impasse over how to organize the bailout fund. France and a majority of euro-zone members wanted the EU's executive arm, the European Commission, to borrow funds on capital markets and lend them to a stricken euro-zone nation.

Berlin objected, fearing Germany would end up as the backstop for the region's debt without having control over the commission's issuance of debt. Germany wanted countries to lend bilaterally to a crisis-hit peer. That would give an effective veto to Germany, which would have to supply around 30% or more of the aid.

Several other countries, including Italy, rejected the German plan, saying they are already too indebted and might not be able to borrow enough money.

Talks in Brussels between euro-zone finance ministers to broker a deal were set for 3 p.m. Sunday. German Finance Minister Wolfgang Schäuble had barely arrived when he suffered an allergic reaction to his medication and had to be taken to hospital, German officials say.

Ms. Merkel dispatched her former chief of staff, German Interior Minister Thomas de Maizière, to Brussels to stand in.

When Mr. de Maizière arrived at around 8 p.m., he took a tough stance against letting the EC run the bulk of the bailout funds, according to EU diplomats. Meanwhile, Ms. Merkel and key cabinet ministers met in her Berlin chancellery to keep a tight leash on the negotiations.

Other governments warned that the clock was ticking, and markets were opening in Australia. Mr. de Maizière didn't give in.

Finally Germany and France settled on creating the special-purpose vehicle, allowing the package to be announced before Tokyo opened. The special-purpose vehicle reduced the burden of borrowing on indebted countries like Italy, while giving Germany control over disbursements of aid. Officials from several countries claimed credit for the breakthrough.

*—Brian Blackstone, Bob Davis and Pat McGroarty contributed to this article.*

EUROPE'S DEBT CRISIS

# Fed props up the euro

*Program last used during 2008 crisis is foreign bailout, critics say*

By Jon Hilsenrath

WASHINGTON—The U.S. Federal Reserve's decision to reopen swap lines with the European Central Bank and central banks in Japan, Switzerland, and England puts it in a delicate political position.

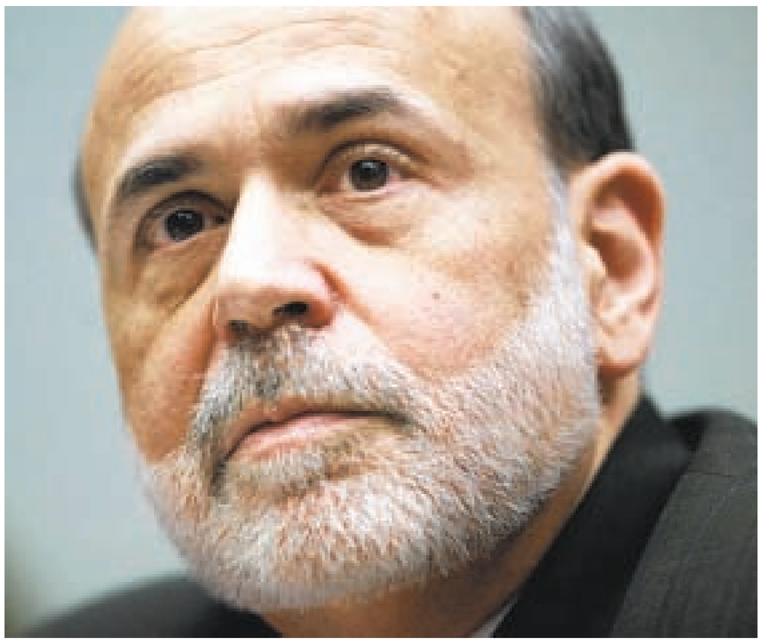
Congress is in the midst of rewriting a financial regulatory overhaul that could rein in the Fed amid sharp criticism of its actions before and during the financial crisis. The overseas lending program it reopened Sunday in response to pleas from Europe has been among the programs lawmakers have criticized, with some suggesting it is bailing out foreign banks, and other saying the Fed is secretive about details.

Fed officials dispute both charges and plan to counter criticism on Capitol Hill by sharing more details and elaborating on the reasons that the U.S. economy and markets are at risk from turmoil in Europe. "These facilities are designed to help improve liquidity conditions in U.S. dollar markets and to prevent the spread of strains to other markets and financial centers," the Fed said Sunday.

Fed officials plan to provide additional information on the swap lines—including details about how the funds are used and the legal agreements behind them—to demonstrate they are not secretive.

Under the swap lines, the Fed makes loans to foreign central banks, which in turn use the funds to make U.S. dollar loans to financial institutions in home markets. Fed officials say they face little risk in these loans, because their counterparties are central banks and not foreign financial institutions.

"I think Europe has a severe challenge on its hands" with the Greek debt crisis and its reverberations across the global financial system, Charles Plosser, president of the Federal Reserve Bank of Philadelphia said in an interview on CNBC Monday. Citing the almost $1 trillion European effort, joined with the reopening of Fed currency swap lines, Mr. Plosser said "hopefully this is going to alleviate some of these concerns" and reduce the risks of contagion.



Associated Press

Federal Reserve officials say the use of swap lines isn't risky because the central bank is lending to other central banks, not to commercial banks. They countered charges the swap plan is secretive. Abovc, Fed chief Ben Bernanke.

Top Fed officials see the U.S. economy as recovering but vulnerable to another financial shock. They were alarmed last week by the sharp drop in U.S. stocks and signs of upward pressures on short-term interest rates. Rather than risk another shock to the global financial system, they decided to help the Europeans try to get out in front of it.

While the Fed's fundamental view about the U.S. economic outlook likely hasn't changed much, and thus the outlook for future interest-rate increases probably hasn't changed much, top officials have shown that their response to downside surprises has the potential to be strong. They continue to price in a slight increase in the fed-funds rate late in the year.

But some economists are rethinking their views. Richard Berner, Morgan Stanley's chief U.S. economist, said he expects the Fed to hold rates through year-end.

"We now expect that the Fed will be on hold until early in 2011; previously we thought that they would begin to raise rates in September," he said in an email to clients Monday morning.

Still, he adds, "Credit contagion won't materially slow U.S. growth, in our view, as U.S. domestic fundamentals are now taking over from global support. ... domestic strength is prompting us to revise our forecasts for U.S. real growth somewhat higher."

### How It Works

■ THE LOAN: Fed lends other central banks dollars for periods of one day to up to three months and gets their currency in return.

■ HOW IT'S USED: Other central banks lend U.S. dollars to local financial institutions with a slightly elevated interest rate to discourage overuse by banks.

■ PAYING BACK: After a set period, other central banks return dollars to U.S. and get their currency back at the original exchange rate plus interest.

# Merkel won't pursue tax cuts

By Patrick McGroarty

BERLIN—German Chancellor Angela Merkel said in the wake of a regional election defeat that her government won't pursue the tax cuts sought by coalition partners, at least for the next two years, and that she hasn't succeeded in her efforts to regulate financial markets and curb speculation against the euro.

"In my view, tax relief can't be implemented in the foreseeable future," Ms. Merkel told reporters in Berlin, adding that she doesn't see her government pursuing tax cuts before the end of 2012.

Ms. Merkel's Christian Democrats had agreed to pursue tax cuts in the platform they designed with the pro-business Free Democrats, as the parties assumed power last fall. Dropping the proposed cuts, currently for about €16 billion ($20 billion), will deprive the Free Democrats of their main policy objective. "That we, too, realize that the majority circumstances in the Bundesrat have changed is obvious," said Guido Westerwelle, the foreign minister and head of the Free Democrats.

Reuters

German Chancellor Angela Merkel's Christian Democrats received a setback in regional elections Sunday.

On Sunday, residents in North Rhine-Westphalia, an industrial state and Germany's most populous with almost 18 million residents, voted out of power a center-right government that largely mirrors Chancellor Merkel's coalition in Berlin. The loss dealt an immediate blow, because German states are represented in the upper house of parliament, the Bundesrat. It cost her coalition a majority there and will make controversial policy initiatives more difficult to push through.

The vote was seen as a referendum on an unpopular bailout for Greece and on Ms. Merkel's handling of the crisis, which spread this year from one profligate euro-zone member to threaten the whole currency bloc and shake markets world-wide.

"Certainly, the many gaps that remain in financial regulation and speculation against the euro are issues about which the public continues to ask, 'What sway can politics have?' " Ms. Merkel said. "I am determined that we will implement [financial reforms], but one has to say honestly that it hasn't happened yet. So, we in the federal government also have an essential assignment to fulfill."

# EU bailout spurs a new challenge

By Stephen Fidler

A €750 billion ($955 billion) bailout package for euro-zone governments facing debt troubles has created another urgent challenge for European policy makers: how to keep free-spending governments in line.

The rescue funds, together with a commitment from the European Central Bank to buy up government bonds, have "weakened incentives for fiscal discipline" in the euro zone, says Marco Annunziata, chief economist of UniCredit Group in London.

Economists say the euro zone needs more budget discipline and much greater fiscal coordination if the common currency is to survive. But past European efforts to interfere with governments' rights to tax and spend as they please have foundered. Eleven years of sharing a currency have pulled the 16 nations of the euro zone ever closer to one another. So close that when Greece, which accounts for just one-fortieth of the euro-zone economy, hit debt troubles, it started to threaten the entire currency union.

That is because the financial systems of euro-zone countries have become, almost unnoticed, more intertwined. Because there was no currency risk, banks, insurance companies and pension funds in every euro-zone economy became the biggest investors in the bonds issued by governments of other countries using the euro.

That meant that if Greece or another government defaulted, it would have severe knock-on effects on the financial health of banks across the euro area. That risk to banks elevated even small European economies to the "too big to fail" category.

Mr. Annunziata says it also became clear that a default in one country would force up the interest rates on bonds issued by other European governments, increasing their borrowing costs perhaps to prohibitive levels. "My debt problem thus becomes your problem," he says.

Although the budget policies of euro-zone members were tied together in this way, without people really noticing, there were no mechanisms to prevent governments from overspending. Fiscal responsibility in the euro zone was meant to be guaranteed by the European Stability and Growth Pact aimed at limiting government budget deficits to 3% of gross domestic product and their debt to 60%. But, in practice, the pact had no bite.

Now, in the space of two weeks, prospects for fiscal discipline have taken two further severe blows: the €110 billion rescue package for Greece and the mammoth bailout assembled over the weekend.

These packages circumvented rules that many people had assumed prohibited bailouts within the euro zone. They also weakened market incentives for governments to get their houses in order.

The weekend program was reinforced by the European Central Bank's decision to buy up bonds of euro-zone governments whose markets were "dysfunctional," leading the central bank to step in first thing Monday morning to buy government bonds.

"Profligate countries now can count on the ECB to alleviate the market pressure that could provide the only disciplining device before a crisis situation is reached," Mr. Annunziata says.

The main architect of fiscal discipline in the euro zone thus comes from an outside actor: the International Monetary Fund, which attaches budget conditions in return for its loans. But even this isn't so bad, given that the euro-zone funding increases threefold the financing that is available in a normal IMF loan program for countries outside the common currency.

This fiscal discipline vacuum is now readily acknowledged by European officials. As a step toward improving it, Olli Rehn, the EU economic commissioner, is set Wednesday to propose a set of rules, with clear enforcement mechanisms, to prevent excessive government debts and deficits, and to act more decisively in a debt crisis.

This would include a plan for fellow euro-zone members to examine budgets before they go to national parliaments. They could reject the budgets on the basis of a supermajority vote, without the country whose budget is under examination being allowed to vote.

### Lender of Last Resort

**The euro zone plans two measures, totaling €750 billion, to aid countries.**

For years, European governments refused to contemplate any attempt to interfere with what they saw as their sovereign right to set their own taxes and government spending. That resistance has begun to weaken in the face of the crisis, says Amadeu Altafaj Tardio, Mr. Rehn's spokesman. "A few years ago, you couldn't even raise these issues. You couldn't even have a discussion."

Mr. Rehn's proposals are unlikely to be the last effort to reintroduce some fiscal discipline into the euro zone. European Union President Herman Van Rompuy is heading a task force on the now-urgent question that has been ordered by government leaders to accelerate its work.

But putting changes into effect that would give the European Commission or other governments real control over national budgets is easier said than done, says Simon Tilford of the Centre for European Reform in London. Governments "are going to say all the right things," he says. But the controversy—particularly in Germany—surrounding the Greek bailout suggests the euro zone's crisis won't be resolved without rancor among its members.

In fact, the euro zone's problems run deeper than an uncoordinated fiscal policy. Fundamentally, Mr. Tilford says, the structure of economies in Southern Europe needs to be overhauled to make them more competitive so they can live in a currency zone with Germany. "This isn't an issue that's going to be resolved by one or two governments getting tough on public spending," he says.

EUROPE NEWS


Associated Press (left); European Pressphoto Agency

Left, an effigy depicting Britain's Conservative Party leader David Cameron before the U.K. vote. Right, Ted Linczak of Ohio protests U.S. President Barack Obama.

# *Messy vote in U.K. could be repeated in U.S., as nations are often in sync*

[ Capital Journal ]

By Gerald F. Seib

The British and American political systems often flash signals back and forth across the Atlantic about emerging trends, and last week's British voting might have done exactly that.

Consider what happened in the U.K.: A national election was staged before deeply engaged, economically stressed voters who suspected the political elites were out of touch and incapable of dealing with massive public debt. A pox-on-all-houses attitude emerged, producing an ideologically muddled outcome that failed to put anybody clearly in charge.

If that sounds like a precursor to this fall's midterm election in the U.S., well, that conclusion is plausible enough. Not only are attitudes and trends in the two nations similar, but this kind of cross-Atlantic preview has been seen before.

In 1979, the rise of Margaret Thatcher and her unflinching conservatism foretold the rise of Ronald Reagan a year later. Likewise, the emergence of Bill Clinton in the U.S. and his "third way" of governing from the center, betwixt the ideological right and left, showed the way for the rise of Tony Blair as Britain's prime minister in the 1990s.

In the years that followed, Mr. Blair's Labour Party on the left managed to hold on to power while Mr. Clinton's Democrats gave way to Republicans as they roared back in the U.S.

Still, by this year, the two nations seemed back in political sync in many ways. The party of the left was in full control in both places, even as fatigue over its governing style set in, and economic crises with similar causes and contours shook voters' faith in the competence of the ruling class in general.

The result in Britain, of course, wasn't a clear victory for either Prime Minister Gordon Brown or Conservative Party leader David Cameron, or a turn toward the tantalizing alternative of Liberal Democrat Nick Clegg. Conservatives won more seats than did Labour, but not enough to form a majority, while Mr. Clegg's neither-of-you alternative fizzled at the end and underperformed expectations.

Britain now has a hung Parliament, and is likely on its way to a coalition government run, uneasily, by Mr. Cameron trying to ride herd on the Liberal Democrats.

To say that anybody is "in control" seems an overstatement. Trying to govern under these conditions won't be a pretty sight to see.

It isn't hard to envision similarly jaundiced American voters producing a similarly messy outcome in November. Clearly Republicans in the U.S., like Conservatives in Britain, are going to pick up seats in the House and the Senate, but maybe not enough to take over. Whichever party actually holds the majority figures to do so by the slimmest of margins, making the task of running Congress difficult.

Even if Republicans take control of the House, which is possible, Democratic President Barack Obama obviously isn't going anywhere.

To say that anybody will be "in control" also figures to be an overstatement. Trying to govern under those conditions won't be a pretty sight to see. Trans-Atlantic symmetry will be intact.

American political analyst Frank Luntz, who conducted focus groups with British voters during heavily watched televised campaign debates, said this outcome was a sign that voters simply didn't feel good enough about anything they saw to wrap their arms around one candidate, one party, or one set of ideas.

"This wasn't an embracing election," Mr. Luntz said. "It was a rejecting election. ... It really became the lesser of three evils."

Thus, while British voters have probably thrown out the old ruling party, they didn't clearly pick a successor, in large measure, Mr. Luntz says, because Mr. Cameron failed in the debates to convince average Britons he understood their values and fears. Mr. Luntz, who often works with Republican leaders to frame messages to voters, thinks there is an important lesson in that for the GOP.

"This is where Republicans don't get it," he says. "Nobody is voting for the GOP. They are voting against Democrats. That's the sentiment here just as over there."

There may be a couple of other lessons to be learned as well. The late decline of Mr. Clegg and his Liberal Democrats as an alternative to the two major parties underscores just how tough it is, in Britain as well as in the U.S., for a third party or independent candidate to break the major parties' stranglehold, even in a time of ferment. That's a sobering thought for the tea-party movement, and for Florida Gov. Charlie Crist, who is trying to win an important Senate seat as an independent.

Oh, and one other thing: Cranky voters show up to vote, even if their message comes out muddled. Turnout was up in Britain. "We're going to have a huge turnout in November," Mr. Luntz predicts.



# Retail sales fell in April during run-up to the election

By Paul Hannon And Natasha Breteton

LONDON—Retail sales fell in April from a year earlier while house prices rose as the U.K.'s inconclusive May 6 election loomed, surveys showed.

**'Given the political and fiscal uncertainty enveloping the country, and a mixed bag of evidence on the strength of the recovery ... markets didn't need any surprises.'**

The data, released Tuesday, followed the Bank of England's monthly rate-setting meeting. The central bank left its key interest rate unchanged at 0.5% and its stock of purchases unchanged at £200 billion ($300 billion).

Opinion polls had pointed to a hung Parliament for many months and measures of consumer confidence had weakened, reflecting increased uncertainty about how the tax increases and spending cuts necessary to reduce government borrowing would end up affecting consumers.

According to the British Retail Consortium's monthly survey, sales in April were down from April 2009, the first such drop since December 2008.

The BRC said total sales fell 0.2% from a year earlier, while same-store sales fell 2.3%.

Home buyers appear to have shrugged off uncertainty about the outcome of the elections, according to a survey by the Royal Institution of Chartered Surveyors.

The survey found that the rise in house prices in England and Wales picked up for the first time in five months in April.

The RICS headline price balance—calculated by subtracting the percentage of surveyors reporting falling prices over the previous three months from those reporting rising prices—rose to plus 17 from plus 9 in March.

The Bank of England's Monetary Policy Council will need to know how quickly and by what means the new government will reduce borrowing.

"Given the political and fiscal uncertainty enveloping the country, and a mixed bag of evidence on the strength of the recovery, financial markets didn't need any surprises," said Graeme Leach, chief economist at the Institute of Directors.

The BOE will release new forecasts for economic growth and inflation Wednesday, when it publishes its quarterly inflation report.

However, given that the new government's fiscal plans may not be clear for a number of weeks, the BOE may not be able to make a fully informed judgment about how the economy is likely to perform until it publishes its August inflation report.

"We do not expect any monetary policy tightening until early 2011, when the economy will be in better shape," said Hetal Mehta, senior economic advisor to the Ernst & Young ITEM Club.

EUROPE NEWS

# A coalition deal is hard either way

*Conservatives may be having difficulty in negotiations, but Labour has its own problems with Lib Dem policy*

By Joe Parkinson
And Laurence Norman

LONDON—A number of the key stumbling blocks that could frustrate a Liberal Democrat deal with the Conservatives could also scupper a deal with Labour. O
n defence and immigration, Gordon Brown's party is at odds with Liberal Democrat policy to scrap the U.K.'s submarine-based nuclear weapons system, Trident, and offer an amnesty to illegal immigrants living in the U.K. for more than 10 years.

While Labour and the Liberal Democrats both want a fully elected House of Lords and voting reform, Labour supports an electoral system that falls far short of the proportional representation system that Clegg's party wants. Some within Labour back a purer form of PR, including possible leadership contenders Alan Johnson and David Miliband, but the issue remains divisive.

And despite Labour's recent overtures to Mr. Clegg's party, historical relations between the parties are more testy.

A number of Labour heavyweights who could emerge as the next party leader have taken a vitriolic attitude to the Liberal Democrats, particularly Cabinet ministers close to Mr. Brown, like Ed Balls and Yvette Cooper.

There are a few issues where Conservative policy is closer to the Liberal Democrats than Labour is. Mr. Clegg has strongly attacked Labour's approach to civil liberties, joining the Conservatives in calling for the scrapping of a plan to introduce ID cards and in moderating down anti-terrorism legislation.

Mr. Clegg's party has urged breaking up large banks while the Conservatives want to prevent retail banks engaging in risky activities. Labour has opposed capping banks' size or banning them from certain activities. They want to link risky activities with higher capital and liquidity requirements.

Labour has also attacked the Liberal Democrats' proposal to exempt from tax the first £10,000 ($15,000) in income, saying it was unaffordable. They also attacked the Liberal Democrats for promising to cut child tax credits to pare down the deficit.

In the U.K.'s first televised leadership debates, Mr. Brown repeatedly accused Mr. Clegg of anti-Americanism for his avowedly pro-European stance.

Reuters

Nick Clegg speaks on the phone as he leaves the Houses of Parliament on Monday

# *Brown to step down, throwing talks into chaos*

*Continued from first page*

quickly rattled markets, and the pound and government bonds fell back after the announcement.

Now, there is the question of whether either of the potential coalitions deals can be struck—and whether they would work in practice. Liberal Democrat negotiators were set to meet with both Labour and Conservative officials Monday evening and report back to their lawmakers.

One problem for any deal between Labour and the Liberal Democrats is that, even together, they would lack a majority in Parliament, forcing them to turn to other small parties in a bid to construct what some call a "progressive coalition" and what others call "a coalition of losers." Even some Labour officials say it doesn't make sense.

Mr. Brown's move to fall on his sword comes as Labour is on the brink of losing control of the government it has ruled for 13 years. In Thursday's election, it lost nearly 100 seats, a reality to which Mr. Brown bowed in saying he would step aside.

"As leader of my party I must accept that is a judgment on me," Mr. Brown said Monday.

While most Britons assumed Mr. Brown would step down, he didn't announce resignation plans immediately, leading some to believe he would try to remain leader if his party succeeded in forming a government with the Liberal Democrats.

Mr. Brown's move now sets up a scramble for the future leadership of the Labour Party. The prime minister said a leadership contest will begin with the idea of completing the process by the time of the party's annual conference this fall.

That sets up a competition in which there is no obvious candidate to take over. Front-runners include Foreign Secretary David Miliband, Education Secretary Ed Balls, and Harriet Harman, deputy leader of the Labour Party.

Mr. Brown was able to make his move because talks between the Tories and Liberal Democrats are fraught with obstacles.

Earlier Monday, the Liberal Democrats said that while there has been progress with the Conservative Party, they want the Tories to come back with more on the issues of taxation, education and electoral reform. Now, the offer of an electoral-reform referendum was pitched as a final offer to the Liberal Democrats by the Tories.

Such a reform would change the voting system that resulted in the current mess. In the U.K., it is the number of seats won in the House of Commons, rather than the proportion of the vote, that wins the day. Under the alternative vote system, the electorate numbers their candidates in order of preference and it is the one with more than 50% of the vote that wins the seat.

The Tories are making a calculation that the public would reject this. Even if accepted, it wouldn't be too bitter for the Tories to take, as it falls shorter of a greater overhaul—proportional representation—favored by the Liberal Democrats.

If the Liberal Democrats and Labour Party were to form a government with a Labour leader, that would once again leave Britain with a prime minister it hadn't elected. Mr. Brown took over from Tony Blair midterm, meaning that his nearly three years as prime minister weren't mandated by the public—a charge that hurt him throughout his short tenure.

With investors now less sure of a Conservative and Liberal Democrat coalition, the pound traded down to $1.4865 against the dollar from $1.4970 before Mr. Brown's statement and Britain's borrowing costs edged higher.

Regardless, the end of Mr. Brown's eventful political career is now in sight. Along with former Prime Minister Blair, Mr. Brown was one of three main architects of the New Labour movement that used the pro-business, pro-markets policies of the right to raise tax revenue that could be pumped into reformed public services, shedding many of the socialist principles that had made Labour unelectable for nearly 20 years.

Mr. Brown managed Britain's economy for 10 years under Mr. Blair, the longest period for a chancellor of the exchequer in modern British politics, and the nation enjoyed a decade of almost unprecedented growth, low inflation, high employment and increased productivity. But many of the factors behind that boom—the debt-fueled consumer binges, the financial-services sector—would propel it to its crash, and the high public spending would make it harder for the U.K. to spend its way back into health.

Though he was widely blamed for driving Britain into its worst postwar recession, Mr. Brown clawed back some respect with his sure handling of the aftermath, bailing out Britain's failing banks and keeping unemployment and housing foreclosures low.

*—Laurence Norman and Neil Shah contributed to this article.*

**Job candidates** | A look at the contenders to succeed Gordon Brown as Labour Party leader

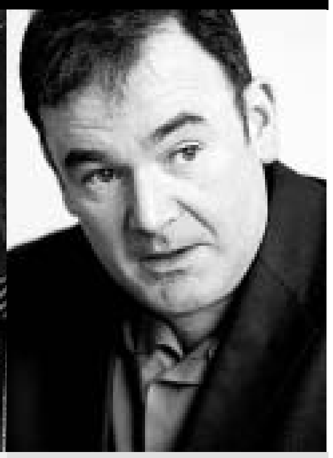
**David Miliband, 44**
**Current position:** Foreign secretary
**Strengths:** Favored by party's centrist Blairite wing
**Weaknesses:** A policy specialist perceived as too academic; youthful looks have been said to undermine his gravitas

**Alan Johnson, 59**
**Current position:** Home secretary
**Strengths:** Easy charm has made him popular with voters; broad party appeal through a Blairite pedigree mixed with a union background
**Weaknesses:** Has consistently rebuffed calls to run for the top job

**Ed Miliband, 40**
**Current position:** Secretary for energy and climate change
**Strengths:** Smart, charismatic, unencumbered by political baggage carried by other candidates
**Weaknesses:** Virtually unknown outside Parliament; hasn't headed a major government department

**Ed Balls, 43**
**Current position:** Education secretary
**Strengths:** Heavyweight intellect; recognized political operator
**Weaknesses:** Brown's key lieutenant; narrow parliamentary majority

**Harriet Harman, 59**
**Current position:** Deputy leader of the Labour Party
**Strengths:** Popular with party faithful, women voters
**Weaknesses:** Less popular with the public than with the party



**Jon Cruddas, 48**
**Current position:** Member of Parliament for Dagenham
**Strengths:** Darling of the party's left wing; popular with grass-roots voters
**Weaknesses:** Little-known by public at large; perceived as old Labour

Source: WSJ research

Photos: Agence France-Presse; (Balls) Bloomberg News; (Cruddas) European Pressphoto Agency; (Harman) Reuters; (D.Miliband, Johnson, E. Miliband)

U.S. NEWS

# Obama taps Kagan for high court

*Nominee wins praise from Democrats as some Republicans say they need to learn more; 'the honor of a lifetime'*

By Laura Meckler
And Jess Bravin

WASHINGTON—President Barack Obama announced the nomination of Solicitor General Elena Kagan to the Supreme Court, calling her a "trailblazing leader" who could build consensus across ideological lines.

If confirmed by the Senate, Ms. Kagan would be the first justice in nearly 40 years to join the court without previous experience as a judge.

She beamed at the side of the president in the White House's East Room and called her nomination "the honor of a lifetime."

Ms. Kagan would succeed retiring Justice John Paul Stevens, the 90-year-old leader of the court's liberal wing.

The nominee quickly won praise from Democrats and warm words from one Republican on the Senate Judiciary Committee, Sen. Lindsey Graham (R., S.C.). Other Republicans, including some who voted to confirm Ms. Kagan as solicitor general, withheld judgment, saying they need to learn more before deciding whether she deserves the lifetime appointment.

"I've urged the president to look outside the judicial monastery, and I told the president I was glad to see he did," said Sen. Patrick Leahy (D., Vt.), chairman of the Judiciary Committee. On her prospects in the Senate, he said flatly, "She will be confirmed."

Mr. Graham, the lone Republican on the committee to vote in favor of Sonia Sotomayor's nomination to the Supreme Court last year, also praised Ms. Kagan. "I have been generally pleased with her job performance as solicitor general, particularly regarding legal issues related to the war on terror," he said.

Other Republicans said they found Ms. Kagan's lack of judicial experience troubling. Senate Minority Leader Mitch McConnell (R., Ky.) said Republicans would examine her "brief litigation experience."

In making his choice, aides said the president looked for someone with not only a top legal mind but also the ability to bring people of differing views together. With the Supreme Court closely divided ideologically, the president is hoping his pick will be a leader who can build majorities in close cases.

Getty Images

President Barack Obama, with Vice President Joseph Biden, introduces Elena Kagan as his choice for the Supreme Court.

He saw that quality in Ms. Kagan, who earned a reputation for bridging divides as a policy adviser in the Clinton White House and, in particular, over six years as dean of Harvard Law School. At Harvard, she went out of her way to make sure conservatives felt comfortable on the left-leaning campus, a point noted by the president in his remarks. She won accolades from colleagues and students across the political spectrum.

Conservatives with whom she has worked are likely to endorse her nomination, providing helpful support as the Senate considers the matter. The White House has already lined up people willing to speak out on her behalf, including conservatives, women's groups and public-interest law advocates.

Some people active in judicial policy, including both liberals and conservatives, say they have concerns because Ms. Kagan lacks a public record on issues that are important to them. Opponents of her nomination are certain to raise questions about her decision, as Harvard law dean, to sign a friend-of-the-court brief arguing that law schools did not have to allow the U.S. military to recruit on campus because the don't-ask, don't-tell policy barred gays from serving openly.

She and other law deans argued the rule violated their antidiscrimination policies, and Ms. Kagan called the policy "profoundly wrong." But they were overruled by a unanimous Supreme Court.

The official announcement on Monday kicked off a months-long effort to sell the nomination to the public and to the Senate, where Democrats hope for a final vote before the August recess. Mr. Obama called on the Senate to confirm Ms. Kagan quickly.

Advocates on both sides of the political spectrum predicted that, absent new information coming to light, Ms. Kagan would probably be confirmed with at least a handful of Republican votes. Last year, the Senate confirmed her as solicitor general on a 61-31 vote, with seven Republicans voting yes.

Mr. Obama has known Ms. Kagan since they were law professors together at the University of Chicago in the early 1990s. At age 50, she would be the youngest justice on the court, and she could provide Mr. Obama a legacy for decades to come. She was the youngest of the four candidates Mr. Obama interviewed.

The other three all serve on the federal appellate bench, the farm team for Supreme Court nominees in recent decades. They were Merrick Garland of Washington, D.C.; Diane Wood of Chicago; and Sidney Thomas of Billings, Mont.

Mr. Obama called Ms. Kagan Sunday night at 8 p.m. to give her the good news, an administration official said. The president then followed up with calls to the three judges who didn't get the job, as well as to the dean of Harvard Law School, Martha Minow, who was also on the list of candidates.

Mr. Obama said Ms. Kagan understood the law "not as an intellectual exercise or words on a page, but as it affects the lives of ordinary people," highlighting a theme that Democrats hope will animate the confirmation hearings: what they describe as the need to check the dominance of powerful interests.

Ms. Kagan, a native of Manhattan, is a graduate of Harvard Law School and former clerk to Supreme Court Justice Thurgood Marshall. She was a domestic-policy aide in the Clinton White House before returning to Harvard as a professor and then dean.

In earlier eras, Supreme Court justices came from a variety of backgrounds, but Ms. Kagan would be the first nonjudge since Nixon appointees Lewis Powell and William Rehnquist in 1972.

Ms. Kagan would be the third woman on the nine-member court, a record, and just the fourth in U.S. history.

But Mr. Obama bypassed the opportunity to diversify the court in other respects. Like the eight justices she would join, Ms. Kagan was educated at Ivy League universities, earning her undergraduate degree at Princeton and attending law school at Harvard. The court is dominated by people from the East Coast; she, too, was born in New York City and has spent most of her career in Washington and Boston.

She is Jewish, meaning the court would, for the first time, have no Protestants. With her, membership would include three Jews and six Catholics.

*—Naftali Bendavid contributed to this article.*

# A life rooted in the pursuit of education

By Dionne Searcey

President Barack Obama is counting on the 50-year-old Elena Kagan's people skills on a Supreme Court that is often sharply divided between liberal and conservative wings. She is a longtime Democrat, going back to her days working on Michael Dukakis's presidential campaign, but has also built ties with influential conservatives.

As dean of Harvard Law School and solicitor general in the Obama administration, Ms. Kagan endeared herself to students and employees for making little improvements—free coffee and a skating rink for students, better eating quarters for faculty at Harvard and dual computer monitors for assistants in the solicitor general's office.

Ms. Kagan was born in New York City on April 28, 1960. Her father was a lawyer and former chairman of a community board on Manhattan's Upper West Side, while her mother taught for many years at Hunter College Elementary School.

Ms. Kagan attended Hunter College Elementary and graduated in 1977 from the selective Hunter College High School, where her brother, Irving, teaches today. She was known as a top student as early as grade school.

At Princeton, her social life revolved mainly around studying, friends said. Her social circle included several people who have gone on to prominence, including Microsoft Corp. General Counsel Brad Smith and Anne-Marie Slaughter, director of policy planning at the State Department. She and friends spent hours studying in Princeton's library carrels, small study closets below ground, staying until the library closed at midnight.

Friends said she was an independent thinker who would ask tough questions, whether about college courses or movies they had seen. During her senior year, she carted around piles of index cards where she had scribbled research for her senior thesis.

She lived in a freshman building her senior year, serving as a resident adviser to younger students.

In her senior year, Ms. Kagan was chairwoman of the Daily Princetonian, the college newspaper. Friends said her position required her to be a consensus builder on the three-person board, and she was good at it.

Ms. Kagan received her bachelor's degree, summa cum laude, from Princeton in 1981. She then attended Worcester College, Oxford, until 1983, where she was on the crew team. A friend recalled she was a tiny figure who served as the coxswain, sitting in the stern and barking orders to coordinate the rhythm of the rowers.

After Oxford, Ms. Kagan went to Harvard Law School, where she was supervising editor of the Harvard Law Review, and graduated magna cum laude in 1986.

From 1986 to 1987, Ms. Kagan clerked for Judge Abner Mikva of the U.S. Court of Appeals for the D.C. Circuit. The next year, she clerked for U.S. Supreme Court Justice Thurgood Marshall. She worked as an associate in the Washington, D.C., law firm of Williams & Connolly from 1989 to 1991.

Ms. Kagan began her academic career at the University of Chicago Law School, where she became an assistant professor in 1991 and a tenured professor of law in 1995. It was there that she met Barack Obama, who was teaching as an adjunct professor. She was known in Chicago as an intense lecturer who paced up and down and fired off questions to her students.

From 1995 to 1999, Ms. Kagan served in the White House, first as associate counsel to the president in 1995-96 and then as a domestic-policy aide. She worked on the White House response to the settlement of tobacco suits reached by state attorney generals.

An issue that has dogged Ms. Kagan in Republican circles is a friend-of-the-court brief she and other law-school deans filed in support of blocking the military from recruiting at law schools. The deans said the military's don't-ask, don't-tell rule on gays violated their schools' antidiscrimination policy.

The Supreme Court rejected the argument unanimously, upholding a federal law denying federal funds to schools that blocked the military recruiters.

Last year, Ms. Kagan, who is single and doesn't have children, returned to Washington as solicitor general, the lawyer who represents the government before the Supreme Court.

WORLD NEWS

# BP faces Senate scrutiny on what led to Gulf spill

*Company officials said key issue is why blowout preventer failed*

BY GUY CHAZAN
AND NEIL KING JR.

**BP** PLC's track record as the leader in pushing oil exploration offshore will come under intensified scrutiny Tuesday as U.S. lawmakers and regulators begin public hearings on the circumstances that led to the huge Gulf of Mexico oil spill at a BP well.

BP and its many partners and suppliers in the Deepwater Horizon project are beginning to jockey over where to assign blame for the April 20 blowout, which killed 11 workers, sank a huge floating oil platform, and left a damaged well leaking an estimated 5,000 or more barrels a day into the Gulf.

BP said it has already spent $350 million in cleanup costs, and paid out $3.5 million in initial claims to businesses along the Gulf Coast. BP's effort to stop the flow, which already involves an additional rig drilling a relief well to ease pressure on the leak and will soon include another rig, could also cost well over $1 million a day. The company also faces dozens of lawsuits for damages.

The question of who shoulders the blame for the disaster will loom large Tuesday at the first set of congressional hearings on the oil spill. Testifying will be Lamar McKay, chairman of BP America Inc.; Steven Newman, chief executive of **Transocean** Ltd., which owned and operated the Deepwater Horizon rig; and Tim Probert, a top official at **Halliburton** Co., which was brought in to cement the well.

BP officials said Monday that the main question was why the huge multivalve system known as a blowout preventer hadn't stopped the oil flow. "What has caught us all by surprise and turned this into a tragic incident is that this blowout preventer failed to work," said BP Executive Vice President David Nagel.

Halliburton planned to say in Senate testimony Tuesday that its workers didn't set a cement well plug before the blowout and explosion aboard the Deepwater Horizon last month. Halliburton, which was one of several contractors on the rig, handled the cementing process and other duties.

While Halliburton had finished cementing the casing—the area outside the pipe—it hadn't yet been able to set a cement plug to block up the pipe before the well, which would be necessary before the well could be temporarily abandoned, according to testimony from Tim Probert, Halliburton's president of global business lines. BP planned to close the well for a time while it devised a plan to bring it onto production.

"Prior to the point in the well construction plan that the Halliburton personnel would have set the final cement plug, the catastrophic incident occurred," Mr. Probert will say, according to a copy of the planned statement reviewed by The Wall Street Journal.

Setting a cement plug is fairly routine before other well-shuttering operations occur. It is unclear why the plug wasn't set.

The reverberations from the disaster could clip BP's global ambitions to expand its already huge footprint in deep water.

"The industry has been exploring in deep water for over 20 years," said BP Chief Executive Tony Hayward, defending his company's track record to reporters Monday. "The industry globally has drilled over 5,000 wells in greater than 1,000 feet of water, and has not hitherto had an issue of this sort to contend with."

But BP's efforts to control the spill have so far failed, calling into question the company's capability to respond to a catastrophic failure in a well nearly a mile underwater.

No other company has invested as heavily in the high-risk, high-reward business of deepwater oil exploration as BP. Among the supermajors it is now the largest deepwater producer, with huge interests offshore Angola and Libya and the West Nile Delta in Egypt.


European Pressphoto Agency

Researcher Lisa Pfau tests for oil Sunday near Pass Christian, Miss.

The U.S. Gulf of Mexico is the heart of BP's business, accounting for 10% of the company's worldwide output. The jewel in its crown is Thunder Horse, the second largest oilfield in the U.S. after Prudhoe Bay in Alaska. Its exposure to deepwater got even bigger in March when it spent $7 billion on Devon Energy Corp's assets in Brazil, Azerbaijan and the Gulf of Mexico.

Like other oil companies, BP had little choice but to go offshore. Petro-nationalism shut it out of the big, onshore oilfields in places like the Middle East. The Gulf of Mexico and the waters off the coast of Angola and Brazil are among the last big oil-bearing areas accessible to the majors.

Yet the technological challenges are formidable. Often operating in waters some three kilometers deep, they have to drill over six kilometers down into the seabed, into rock formations jumbled up by enormous pressures and searing temperatures.

BP's focus on deep water has long been seen as a strength, especially after a string of big discoveries in the Gulf of Mexico in the past 10 years or so that confirmed its reputation as one of Big Oil's most successful explorers. Only last year it announced a huge new find there, Tiber, that could contain between four and six billion barrels of oil.

*—Russell Gold and Stephen Power contributed to this article.*

# Hayward says firm will try a smaller dome

BY ANGEL GONZALEZ

HOUSTON—After a rapidly freezing mix of natural gas and water derailed attempts to place a big underwater dome on top of a deepwater well leaking oil into the Gulf of Mexico, **BP** PLC hopes a smaller dome will do the trick, Chief Executive Tony Hayward said Monday.

The big dome failed because "there's a lot more gas involved in the leak than we had hitherto believed," which combined with water to form hydrates that clogged a 12-inch opening at the top of the structure, said Mr. Hayward.

The new steel dome, about 1.5 meters in diameter and 1.5 meters tall and shaped like a "top hat," will be ready to deploy within 72 hours, the executive said in a meeting with reporters at BP's Houston campus. The company will pump methanol into the new dome to keep ice from forming. The smaller size of the structure also should keep water out, he said.

Mr. Hayward's comments come after several attempts to shut off the 5,000 barrel-a-day spill—from the giant subsea dome to shutting off a giant underwater blowout preventer using robots—have failed. But BP is still trying to fight the spill both on the surface, at the shoreline and at the well site, Mr. Hayward said.

While trying to deploy the smaller dome, BP is drilling a relief well to kill the leaking well, an effort that is expected to take months. A second, backup relief well will be drilled starting at the end of the week, "probably Friday," Mr. Hayward said.


Reuters

A cleanup crew combs the beach on Dauphin Island, Ala., on Monday after tar balls washed up on shore.

"The relief wells will ultimately be successful," Mr. Hayward said. He added that the company will solve the problem—"it's simply a question of how long it takes," he said.

The spill resulted from the explosion and sinking in April of **Transocean** Ltd.'s Deepwater Horizon drilling rig, which was finishing a well for the London-based oil giant. Eleven crew members were killed by the blast, and the spill threatens the shore of several Gulf Coast states. It also risks undermining U.S. appetite for offshore drilling.

Much of the difficulty in containing the leak lies in the rig's depth. Mr. Hayward called the incident "unprecedented in over 20 years of deep-water exploration, and said the lessons learned here "will have profound implications for the industry."

The London-based giant is also planning a "junk shot" of diverse materials in an attempt to block off the blowout preventer. The shot would contain pieces of tire, knots of rope and other items, and will be tried in the next two weeks, said Kent Wells, a senior exploration executive for BP.

Mr. Hayward said that the company resumed injecting dispersant at the source of the leak on Monday, a process that concerned environmentalists and federal authorities due to the toxic nature of the chemicals involved. But its use "seems to be having a very significant impact" in dispersing the leak, and is being carefully monitored, he said.

Challenges with the dome come as White House officials, U.S. lawmakers and others in the industry ask whether BP failed to foresee and prepare for a disaster of this scale, as doubts deepen over the company's ability to handle the spill.

BP assured regulators last year that oil would come ashore only in a small area of Louisiana, even in the event of a spill much larger than the current one. But as of Sunday evening, authorities reported that black, gooey balls were washing up on beaches in Alabama, farther than the company's original calculation.

BP had spent Sunday trying to determine how to proceed with the huge metal-and-concrete containment dome, after it got clogged with crystallized gas about 1,500 meters below the surface. The contraption was designed to sit over the leaking pipe and funnel as much as 85% of the oil to the surface, where it could be captured.

The four-story, 98-ton dome took the company two weeks to build and deploy—evidence, critics say, that the company didn't envision or prepare for the sort of blowout that occurred last month.

BP defended its actions. "You have here an unprecedented event—never before have you seen a blowout at such depth and never before has a blowout preventer failed in this way," BP spokesman Andrew Gowers said. "The unthinkable has become thinkable, and the whole industry will be asking searching questions of itself."

*—Guy Chazan and Neil King contributed to this article.*

## WORLD NEWS

# Currency woes dog Venezuelans

*Black market still rules as Chávez struggles to control flight to the U.S. dollar*

By Darcy Crowe

CARACAS—Four months after enduring a currency devaluation, Venezuelans continue to see the value of their money evaporate under the weight of foreign-exchange controls that play a key role in President Hugo Chávez's socialist economic policies.

The "strong bolívar," as the currency is officially named, is anything but. It has dropped 26% this year, to 8.05 per U.S. dollar on Friday in black-market trading, which sets the currency's real market value.

The plunge is an embarrassment for the government. Mr. Chávez announced in January that the country would slash the value of its currency, then officially pegged at 2.15 to the dollar, in half.

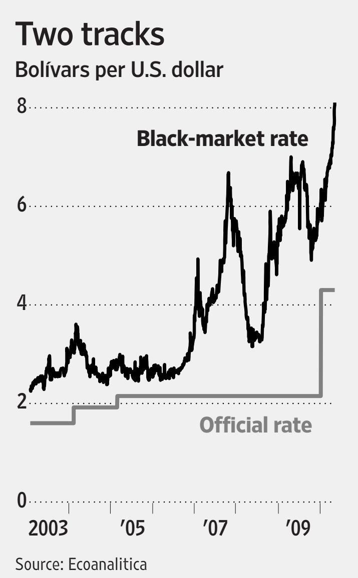
He vowed the bolívar would strengthen in the black market to match the new official peg of 4.3 bolívars to the dollar.

Supply and demand, however, have not cooperated. Venezuelans, afraid of inflation and accustomed to recurrent devaluations, continue to take their money out of the country by paying the black-market rate for dollars. The government, meanwhile, doesn't sell enough dollars at the official rates to meet demand.

On Sunday, Mr. Chávez promised swift action on inflation, including unleashing the military on merchants who unfairly raise prices, after consumer-price data Friday showed a 5.2% increase in April—the highest monthly jump in years. That brings 12-month inflation to 30%, the highest in the region.

With congressional elections just four months away, the president said, businesses loyal to the opposition are hoarding goods so prices will rise, in the hopes of stirring panic and pulling voters away from the ruling Socialist party. Mr. Chávez said in a statement that he has told "civilian and military intelligence and all state entities" to be on the lookout for speculative merchants and hoarders. More specific measures are expected.

Last week, the government sent agents to examine the books of several trading firms and threatened to close the legal loophole that allows them to do dollar-bolívar trades. The fears of tighter controls generated more demand for dollars—sending the Venezuelan currency past the threshold of 8 to the dollar, its weakest since Mr. Chávez imposed currency controls in 2003. The finance ministry and central bank declined to comment for this article.




Venezuela's President Hugo Chávez visits the Dominican Republic last week,

"Currency controls usually serve to prevent capital flight. In Venezuela, that has not been the case," said Orlando Ochoa, an economics professor at Universidad Andrés Bello in Caracas.

The controls instead spawned a baffling foreign-exchange system in which dollars are sold at three different rates. There is the official rate of 4.3 bolívars per dollar. There is also a subsidized rate of 2.6 per dollar, extended to certain importers to help keep down the price Venezuelans pay for priority international purchases such as food and medicine. But everything from home prices to restaurant menus tracks the black-market rate, making it a key economic variable.

"For simple things like travel abroad, you need dollars and the government doesn't sell enough," said Hector Blanco, who owns a small construction firm. "Nobody saves their money in bolívars."

Not all has gone wrong for the government since the devaluation. The move has allowed Venezuela to avoid a cash crunch by getting more bolívars for every dollar of oil revenue it earns. The effect is likely to be temporary, however, as government spending is expected to rise.

But the devaluation has failed in most other ways—demonstrating increasingly complicated trade-offs for Mr. Chávez after more than a decade of short-term populist policies.

The devaluation was meant to breathe new life into Venezuela's moribund economy by giving companies a chance to compete against imports.

But most have opted to continue importing food and other goods at the subsidized rate instead of producing them domestically, eroding the long-term competitiveness of Venezuelan industry. That adds drag to an economy already reeling from a recession that the International Monetary Fund says is likely to last another year, with a 2.6% contraction forecast in 2010.

Retailers use the black-market rate as a gauge to set prices. So the surge in the black-market rate has been followed by a jump in inflation.

In January, some observers also predicted that changing the peg would allow the government to sell more dollars—its proceeds from international oil sales—to importers and companies that need to repatriate their profits. But so far the amount sold at the official rates has increased only slightly. That has forced companies and residents to continue paying black-market rates.

The gap between the official and black-market rates opens the door to arbitrage opportunities.

The government controls the amount of dollars Venezuelans can buy for foreign travel and requires importers to demonstrate that dollars were used for specific goods. But those who can work around the rules can buy dollars at a preferential rate and sell them for a profit on the black market, at the government's expense.

The government has all but acknowledged the existence of the black market, a reversal from two years ago when it decreed it illegal to publish the rate, and has pledged to tame it by selling dollar-denominated bonds through the central bank. But the small amounts issued pale in comparison to the estimated $100 million a day traded in the black market.

The central bank is unlikely to increase the sales as it struggles to protect its international reserves, which stood at about $28 billion on May 5, almost $8 billion less than at the start of the year.

*—Dan Molinski contributed to this article.*

# Bombings, shootings kill dozens in Iraq

By Ben Lando

BAGHDAD—Assailants killed more than 60 people in bombings and shootings across Iraq on Monday, the deadliest day yet this year in a series of attacks that officials say are aimed at influencing efforts to form a new government.

Prime Minister Nouri al-Maliki campaigned on a law-and-order platform, and while he was inched out by a slate led by former Prime Minister Ayad Allawi, Mr. Maliki has burnished his security credentials since the polls. The attacks could affect political negotiations over whether he will be allowed to lead a new government.

Mr. Maliki scored a significant security victory last month in the killing of two top leaders of al Qaeda in Iraq, the local affiliate of the global terror group. Officials on Monday blamed al Qaeda in Iraq for the day's carnage.

Iraqi police search cars in Baghdad on Monday amid a spate of attacks.

Several of Monday's attacks appeared orchestrated, and concentrated on the Iraqi government and security forces. Gunmen killed seven Iraqi police or army officers at several Baghdad checkpoints, and a suicide car bomber killed two Kurdish militia fighters at a checkpoint in the northern city of Mosul. All of the checkpoint shootings occurred from 6 a.m. to 7:30 a.m., according to an Interior Ministry official.

The deadliest attack Monday, however, appeared to kill mostly civilians. Two car bombs exploded near a textile factory in Hilla, in central Babil province south of Baghdad, as workers were leaving for the day. The bombings killed 36 and injured more than 140, the official said. A third explosion ripped through the area as emergency-service personnel were responding, according to the official.

In Basra, Iraq's second city and its southern oil hub, at least 13 people were killed and 20 injured in a pair of motorbike bombings in different parts of the city, the Interior Ministry said. In the small eastern town of Suwayrah, a pair of bombs killed eight passersby and wounded 71, the Associated Press reported.

In Baghdad Monday night, two policemen and two civilians were injured in roadside bombings.

# Court rejects terrorism case against Mugabe foe

Zimbabwe's High Court rejected terrorism and weapon charges against Roy Bennett, a white Zimbabwean farmer who is accused of plotting to overthrow the country's president, Robert Mugabe.

*By **Farai Mutsaka** in Harare, Zimbabwe, and **Peter Wonacott** in Johannesburg, South Africa*

The acquittal clears the way for Mr. Bennett, an ally of Zimbabwe's prime minister, to join the nation's fragile coalition government as the earlier-appointed deputy agriculture minister. In delivering judgment, Judge Chinembiri Bhunu concluded that evidence against Mr. Bennett was weak, and that witnesses called by prosecutors were unreliable.

"The State has failed to prove its case," he said. "The State's key witnesses said nothing which may be construed in implicating the accused," the judge added, prompting cheers from a packed courtroom of Mr. Bennett's supporters Monday.

Mr. Bennett, who was arrested in February 2009 after returning from exile in South Africa to join the new Zimbabwe government, said he will fight on for political change. "I will continue to stand firm against dictatorship," he said.

Mr. Bennett's court victory threatens to drive another wedge between Zimbabwe's two top leaders at a time when the economy is sputtering and the political situation remains volatile. Though they've maintained a "unity government," and even shared a stage last week at an investor conference, President Mugabe and Prime Minister Morgan Tsvangirai have failed to paper over deep divisions in their coalition, which was formed last year in the wake of violent elections.

Mr. Mugabe and his allies have refused Mr. Bennett's appointment on the basis of insurgency and weapons charges—charges that could have carried the death penalty if proved. A spokesman for Mr. Mugabe's ZANU PF political party declined to comment on the ruling.

Mr. Bennett, a former coffee farmer, is a longtime activist who fought Mr. Mugabe's violent land seizures earlier in the decade. His supporters in Mr. Tsvangirai's political party, the Movement for Democratic Change, or MDC, say Mr. Bennett was targeted because he brought to light corruption in Mr. Mugabe's government during the land reform campaign.


Agence France-Presse/Getty Images
Roy Bennett leaves the Harare court.