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THE JOURNAL REPORT: TOMORROW'S TRANSPORT

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NEWS 3

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Queen unveils new U.K. government's plans



Queen Elizabeth II, sitting alongside her husband, Prince Philip, Tuesday in the Palace of Westminster, delivers her traditional speech, which outlines the new U.K. coalition government's plans for the next session of Parliament. **Article on page 6**

European bank lending gets pinched

Funding pressures on European banks intensified Tuesday amid signs that some key U.S. financial institutions, including money-market funds, are reducing exposure to the region.

By David Enrich and Sara Schaefer Muñoz in London and Mark Gongloff in New York

The so-called London Interbank Offered Rate, or Libor, continued its upward march, hitting its highest levels in 10 months, signaling banks' increasing wariness about lending to each other. Daily Libor quotes, however, may not reflect the full extent of concern because they don't include banks from Spain and Portugal, two of the euro zone's troubled periphery countries. In addition to Libor, short-term lending rates in the so-called commercial-paper market have also jumped.

The rising concerns about the ability of European banks to fund their daily operations triggered a broad selloff in bank shares, and the cost of insuring banks' bonds against default also jumped. While banks across Europe are under



Bank jitters

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varying degrees of funding pressure, the situation has grown most acute in deeply indebted euro-zone periphery countries such as Greece, Portugal and Spain.

The constricting bank-lending market in Europe stems from a combination of factors. All banks will face tougher capital and funding requirements because of new financial-sector regulations. *Please turn to page 4*

North Korea lashes back, severing ties with South

BY EVAN RAMSTAD

SEOUL—North Korea said Tuesday it will “totally freeze” relations with South Korea and pull out of a nonaggression pact with Seoul, marking the widest rift and highest tensions between the Koreans in two decades.

The North's announcement, made in the late evening local time, further severed inter-Korean ties after Seoul penalized Pyongyang on Monday for allegedly torpedoing and sinking a South Korean warship. News also emerged Tuesday that the North told its troops and people last week to prepare for confrontation with the South.

The statement said the North “formally declares that from now on it will put into force the resolute measures to totally freeze the inter-Korean relations, totally abrogate the agreement on nonaggression between the North and the South and completely halt the inter-Korean cooperation.”

North Korea's apparent withdrawal from armistice pacts marks a departure from an almost ritualized pattern of interaction with the outside world for about 20 years, in which Pyongyang creates a crisis, then seeks monetary and security concessions for ending it. Now, at the point in the cycle where the North would typically try to extract

favours, it appears to be ratcheting up tensions.

The motivations of the secretive and authoritarian regime in Pyongyang remain largely unclear. In mostly severing economic ties with the South, it cuts off a vital source of foreign currency. Such a move would suggest that Pyongyang is spoiling for war—or, that it is confident that it has implicit backing from its chief ally and economic partner, China.

Such questions, in turn, cast further scrutiny on Beijing's stance toward Pyongyang, a bilateral relationship that is perhaps the world's most secretive. U.S. Secretary *Please turn to page 9*

The Quirk



French teachers from Africa come to Cajun country's rescue. **Page 33**

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A comprehensive rundown of news from around the world. **Pages 34-35**

Editorial & Opinion

In the real world, art theft is no 'Thomas Crown' affair. **Page 13**

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PAGE TWO

They must think cabbages, not carats

[Agenda]

BY PATIENCE WHEATCROFT



On Monday evening, the grounds of London's Royal Hospital were thronged with business leaders, bankers and their partners. As they enjoyed the delights of the gala opening of Chelsea Flower Show in unusually balmy weather, the main concern for many was how best to counter the coughing and sneezing being brought on by a deluge of particularly gritty pollen, the horticultural equivalent of volcanic ash.

As the crowd perambulated among the hellebores and hostas, enjoying the plentiful supplies of champagne and canapes and admiring the elegant garden furniture and sculpture on sale, musicians played. Nero on his fiddle would not have been entirely out of place.

The morning after this colorful idyll brought a sharp reminder of what is going on in the real world, as stock markets in Europe, Asia and the United States headed south. To fears over sovereign debt and a potential new wave of bank collapses has been added nervousness about sabre-rattling in the Korean peninsula.

Skepticism about the effectiveness of the €750 billion (\$931 billion) German-led bailout package for ailing euro-zone states has now taken root. Research published Monday by Royal Bank of Scotland confirmed fears about the scale of the problems and the disastrous fallout that would ensue were the most profligate euro-zone countries to default. It is the exposure of other countries to Greece, Spain and Portugal that is the issue. The RBS research calculates that financial institutions outside those three countries hold about €2 trillion of their public and private sector debt. This "financial integration"



Security men at the Ace of Diamonds garden at Chelsea Flower Show Monday.

as Cailloux terms it, means that the collapse of any of these economies would have ramifications on a par with the subprime crisis.

Hence the panic occasioned at the weekend when a small regional bank in Spain had to be taken over by the state. Was this a signal of much worse to come? As Tuesday's equities selloff demonstrated, many investors

The age of austerity has yet to impinge on those who were looking at the show gardens at Chelsea.

were not prepared to wait around to find out the answer to that question.

But at Chelsea on Monday, the revellers weren't in the mood for gloom. The talk was not of deficits and defaults but of the outcome of the recent election. Almost unanimously, a crowd that previously would have numbered few Liberal Democrat enthusiasts within it, was professing optimism for the new coalition government. It would, they trusted, have the confidence to tackle Britain's massive deficit while lifting some of the regulatory burdens on business.

David Cameron's new government would, no doubt, have

appreciated the approbation but had the good sense to stay away from the Flower Show. Having just unveiled to the nation a package of spending cuts that included the abolition of the Child Trust Fund, a handout aimed to particularly benefit the offspring of the less well-off, it might not have seemed politic to then be photographed partaking of champagne with the well-heeled beneficiaries of corporate hospitality.

The age of austerity had yet to impinge on those who were looking at the show gardens, including one, named "The Ace of Diamonds Garden," which boasted a selection of genuine sparklers and a price tag of £20 million (\$28.7 million). Yet the cost of addressing the deficit must soon begin to have wide impact. The £6.2 billion of savings and cuts that Chancellor George Osborne announced Monday was just a taster for much deeper cuts that will have to follow.

Britons probably will take little comfort from knowing that much of Europe is suffering with them. Italy on Tuesday became the latest to introduce the increasingly standard early range of austerity measures, including pay freezes for public sector workers.

Yet concerns remain as to whether the gravely indebted European countries are moving far enough or fast enough to deal with their problems. The

consensus view seems to be that Greece is beyond being bailed out and, at some stage, will have to be allowed to default so that its debts can be restructured. European government and IMF economists must have worked that out just as private sector economists have. So why are they allowing the country to be kept on expensive life support that only adds to its debts?

The answer is possibly that in the interim, the ECB will be able to buy up Greek debt from European banks so that, when the default comes, the hit on the financial sector will not be as damaging as would otherwise have been the case. The rest of Europe will still carry the cost but a banking meltdown might be avoided. While the outcome of the Greek debacle remains a matter for speculation, markets will continue to be nervous. The ratings agencies are also eyeing other sovereign debtors with suspicion, poised for the slightest hint that governments are talking tough about tackling their deficits but failing to deliver.

For a government such as that of Silvio Berlusconi in Italy, whose popularity ratings have been falling fast, imposing an age of austerity is an invitation to court electoral defeat. The British government, though, has the advantage of being newly elected and the coalition gives it the added strength of meaning that potential opposition has been turned into support. For the time being, at least, it looks like a comfortable alliance, determined to do what is necessary to put right the wayward finances bequeathed by the governments of Tony Blair and Gordon Brown.

But despite the optimism that was blooming amid the flowers on Monday evening, the process will not be fun. As the age of austerity takes hold, perhaps people should think of planting potatoes and cabbages rather than diamonds in their gardens. At a time when ministers are being told to leave their limousines and take the Tube, bling seems very outdated.

What's News

■ **Roland Koch**, one of Germany's most prominent state governors, is stepping down as premier of Hesse and won't seek re-election as vice chairman of Merkel's Christian Democratic Union. 6

■ **Italy's government** approved budget cuts of up to \$29.7 billion over the next two years in an effort to shore up public finances. 4

■ **German finance officials** proposed extending a ban on "naked" short selling to cover all stocks and euro-currency derivatives that aren't intended for hedging. 6

■ **Dell introduced** a touch-screen tablet computer called Streak in the U.K., the computer giant's much-anticipated foray into the emerging tablet arena. 17

■ **Volkswagen said** it will acquire a 90.1% stake in Italian car designer Italdesign-Giugiaro as part of the German auto maker's ambitious global expansion plan. 20

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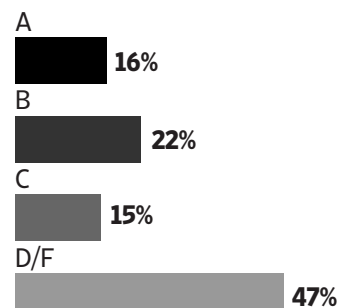
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NEWS

Gifts, porn use cloud drilling agency report

By STEPHEN POWER

WASHINGTON—Employees of a federal agency that regulates offshore drilling—including some whose duties included inspecting offshore oil rigs—accepted sporting-event tickets, meals and other gifts from oil and natural-gas companies and used government computers to view pornography, according to a new report by the Interior Department’s inspector general.

The report—published on the inspector general’s website—describes a culture in which inspectors assigned to the Lake Charles, La., office of the Minerals Management Service have moved with “ease” between jobs in industry and government, drawing on relationships that formed “well before they took their jobs” with the agency.

Although the report says that “all of the conduct” examined in the

report is “dated” and occurred prior to 2007, its publication comes at a sensitive time, with Interior Secretary Ken Salazar scheduled to testify before Congress Wednesday on his plan to restructure the agency following the April 20 explosion of the Deepwater Horizon oil rig. The accident led to the deaths of 11 workers and to the spill of thousands of barrels of oil into the Gulf of Mexico each day.

Mr. Salazar said he has asked the inspector general to expand her investigation to determine whether any of “this reprehensible behavior” persisted after the department implemented new ethics rules in 2009.

The inspector general’s report doesn’t specify how many MMS staffers accepted gifts from the oil industry, but says “this behavior appears to have drastically declined” since a former MMS supervisor, Don Howard, was terminated in 2007.

Mr. Howard, the former regional supervisor of the Gulf of Mexico region for MMS, pleaded guilty and was sentenced to a year’s probation in federal court in New Orleans last year for lying about receiving gifts from an offshore-drilling contractor.

Among other things, the report says that in 2005, 2006 and 2007, MMS employees attended a number of events either organized or partly funded by various offshore companies, including hunting and fishing trips and, golf tournaments. It quotes an industry official as describing how he arranged for two MMS inspectors to fly with him on a friend’s plane to the 2005 Peach Bowl and to get tickets to the game.

The report describes one MMS inspector as having admitted to using crystal methamphetamine, and says investigators found “numerous instances” of pornography and “other inappropriate material” on



U.S. Interior Secretary Ken Salazar in Galliano, La., on Monday.

the email accounts of 13 MMS employees, six of whom have resigned.

In a written statement Tuesday, Mr. Salazar said some of the employees referred to in the inspector general’s report have resigned, been terminated or referred for prosecution. He added that any remaining staffers accused in the report of questionable behavior will be placed on administrative leave pending the outcome of a personnel review.

The report doesn’t attempt to link the alleged activities of MMS employees in the Lake Charles office

to the accident involving the Deepwater Horizon. It does, however, say that an unnamed “confidential source” told investigators that some MMS inspectors had allowed petroleum company workers to fill out inspection forms in pencil. According to the source, the forms would then be completed by MMS inspectors who would write on top of the pencil in ink. The report doesn’t establish whether the allegation is true.

■ BP neared trying a ‘top kill’ to stem the oil leak in the Gulf of Mexico . 7

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EUROPE NEWS



European Pressphoto Agency

Prime Minister Silvio Berlusconi, shown on Friday, hasn't announced any tax increases, which would be deeply unpopular.

Italy sets budget cuts

Rome joins Europe's crisis-driven effort to reduce public spending

BY STACY MEICHTRY

ROME—The government of Italian Prime Minister Silvio Berlusconi approved budget cuts Tuesday of up to €24 billion (\$29.7 billion) over the next two years in an effort to shore up public finances.

The cuts come as other European governments try to reduce public spending in response to the growing levels of sovereign debt.

Spain last week approved measures valued at €15 billion for this year in an effort to trim a budget deficit equal to 11% of gross domestic product. Britain's new coalition government, which outlined \$9.05 billion in budget cuts on Monday, plans to unveil further cuts next month.

Italy is heavily indebted, with an outstanding public debt equal to 115% of GDP. However, the govern-

ment's budget deficit—forecast at 5.3% of GDP for this year—is relatively modest compared with other EU countries. The government expects its cuts to bring Italy's deficit down to 3.9% in 2011 and 2.7% in 2012.

As a result, investors haven't fretted over Italy's ability to pay its debts as they have in the case of Greece. Italy pays just 1.2 percentage points more than Germany to borrow from financial markets. That compares with more than five percentage points for crisis-stricken Greece.

The government will carry out half of the cuts by reducing the amount of funds that Italy's central government allocates to regions and cities. About €6 billion in cuts will be made through wage freezes and wage cuts for public-sector workers. The plan cuts current salaries of

government ministers and parliamentarians by 10% in 2011 and introduces a so-called "construction amnesty."

That measure will allow Italians who built houses without the approval of zoning officials to register their homes by paying a fine that is lower than the sum of the taxes that are owed on the property.

Mr. Berlusconi's government didn't announce any tax increases, an option that would have been deeply unpopular in Italy, where tax burdens remain heavy and evasion is rampant.

Cutting too deeply into Italy's public spending, however, also carries risks for the country's growth prospects as public spending generates a large swath of Italy's GDP.

The Italian Treasury forecasts GDP growth of just 1% in 2010, following a fall of 5.1% in 2009.

EU seeks bank-crisis tax

BY MATTHEW DALTON

BRUSSELS—The European Commission on Wednesday will propose legislation requiring European Union governments to create bank-crisis funds supported by up-front taxes on financial institutions, EU officials said Tuesday.

The proposal from the commission, the EU's executive arm, will likely become part of legislation to ensure that each EU government has the powers needed to "resolve" an ailing bank: wipe out its shareholders if necessary, impose discounted asset values or "haircuts" on creditors, orchestrate bank mergers and pay for the whole process without relying on taxpayer money. The idea is to maintain the crucial functions of a weak bank, without governments being forced to choose between repeated bank recapitalizations at taxpayer expense or a bank bankruptcy that could threaten the entire economy.

The commission in its proposal is adamant that national govern-

ments should be prevented from tapping these funds for other purposes, such as recapitalization or to boost general revenues, the officials said. Allowing funds to be used for recapitalizing banks could encourage banks to take risks, knowing that the money will be there if they run into trouble and need to be bailed out, EU officials say.

But the commission expects resistance on this point from national governments, because the proposals come at a time when they are desperately searching for revenue to cut their budget deficits.

After Lehman Brothers' collapse in the autumn of 2008 sparked a financial panic, most governments decided they couldn't afford to let another financial institution go bankrupt. But without proper legal mechanisms in place, pumping capital into the region's weak financial institutions was the only alternative to allowing them to fail.

The process envisioned by Michel Barnier, the EU commissioner in charge of financial regula-

tion, would allow national regulators to use these funds to, for example, create a "bridge bank" controlled by the government that would take over a troubled bank and continue its operations, the EU officials said. The funds could also be used to help finance a takeover of a weak bank by a stronger competitor or preserve vital bank functions, such as payment systems, they said.

The commission also suggests that national regulators may need the power to impose haircuts on the creditors of a bank that is near failure. Most EU bank creditors during the financial crisis have seen bank debts paid back in full, even as many banks only survived the crisis thanks to the capital provided by governments.

EU leaders will discuss Mr. Barnier's proposals next month at the meeting of the Group of 20 nations in Toronto.

The commission is aiming to introduce its legislation early next year.

Pressures on banks build

Continued from first page
and money-market funds have to deal with tougher restrictions on how much risk they can take. The new rules have combined with the euro-zone's roiling fiscal crises to create a challenging environment for the region's banks.

During the past few weeks, U.S. banks and money managers have pared their European positions. "Obviously with conditions in the euro-zone as they are, people will be responsive," said David Glocke, manager of \$150 billion in taxable money-market fund assets for Vanguard Group. "We've taken a second and third look at our exposures over there and adjusted our portfolio where appropriate."

U.S. money-market fund managers, which combined have some \$3 trillion in assets, aren't necessarily selling European debt. But given their importance in the market for short-term corporate lending, only modest changes in buying behavior can lead to major market upheavals.

Some large U.S. banks, meanwhile, also have scaled back their short-term lending to European banks, according to executives, bankers and traders in the U.S. and Europe. At the same time, European banks are increasingly nervous about making even short-term loans to each other.

Banks such as Spain's two largest lenders, **Grupo Santander SA** and **Banco Bilbao Vizcaya Argentaria**, recently have boosted the amount of funds they are stashing overnight at the European Central Bank, preferring to park their money somewhere risk-free rather than lend it to competitors, even if that means receiving a lower interest rate. The ECB reported Tuesday that its overnight deposits rose to €264 billion (\$327 billion), up from €253 billion Monday. That's below the roughly €290 billion that was parked at the ECB earlier this month but more than three times as high as a year ago.

Meanwhile, Northern European banks have been reviewing credit exposure to Spanish and Portuguese banks and, in some cases, reducing credit lines.

While most of the focus has been on seemingly high-risk countries, the pullback in lending has caused the cost of borrowing to rise for other European and U.K. banks as well. On Tuesday, it cost French bank **Société Générale SA** 0.545% to borrow dollars for three months, up from 0.345% a month earlier. The cost of three-month borrowing for **Barclays PLC** was 0.55% Tuesday, up from 0.32% a month earlier.

The situation has parallels to the financial crisis in fall 2008, when the collapse of Lehman Brothers caused markets to freeze around the world. But while Libor has risen every day but one this month, it re-

mains at a fraction of its October 2008 peak of 4.8%.

Still, Libor is a benchmark for interest rates on a range of consumer loans, including mortgages and credit cards. Its rise will push up borrowing costs just as economies in the U.S., U.K. and elsewhere are showing tentative signs of recovery.

In addition, roughly €700 billion of debt issued by European banks is maturing in each of the next three years, according to a report this week by Deutsche Bank. Replacing that debt in the current market environment, where buyers are extremely chary and demanding sharply higher yields, is likely to pose a significant challenge.

The increasing market jitters set off a cascade of rumors and speculation Tuesday about European banks that were facing liquidity challenges. Bank officials scrambled to reassure investors and clients that their exposure to risky sovereign debt was limited, and simultaneously pointed to other banks as facing their own liquidity problems. Bankers and traders said several European banks, unable to obtain funding through normal market sources, had turned to the ECB for liquidity. Data on such borrowings from the ECB aren't publicly available.

The tightening lending market is also being fueled by recent concern over Spain, the euro-zone's fourth-largest economy which has suffered from soaring unemployment and a massive property bust. The weekend seizure of one of its regional saving banks by Spanish authorities, Caja-Sur, as well as the consolidation of four others Monday, contributed to market jitters.

Tuesday's market upheaval led to speculation that the ECB would have to intervene for the second time this month to stabilize markets by pumping more liquidity into the system.

The pinch is being felt in the so-called commercial-paper market where companies take out short-term loans. BBVA, for instance, was unable to renew roughly \$1 billion of short-term funding in the U.S. commercial-paper market since the beginning of the month, according to people familiar with the matter. It still has substantial European-based funding and deposits and about \$9 billion in U.S. commercial paper.

European 30-day commercial-paper rates for top-tier borrowers have jumped in the past two days to 0.48%, the highest since last November, according to Tim Backshall, chief strategist at Credit Derivatives Research, up from about 0.3% at the beginning of April.

Such rates are still well below the worst of the 2008 crisis. But short-term funding pressures were a key component of that crisis.

—Carrick Mollenkamp in New York contributed to this article.

Jitters

Borrowing costs are climbing faster for European banks than American, as seen in Libor quotes, and the cost of insuring against default on debt issued by European financial firms is climbing.



Sources: Thomson Reuters; Markit

EUROPE NEWS

A tricky test case for trying pirates

Associated Press

Europe's first trial of alleged Somali pirates opened Tuesday with conflicting accounts from the five suspects, a notable lack of physical evidence and a shortage of witnesses, illustrating the difficulty of prosecuting piracy and why so many captured sea bandits are let go.

In an emotional outburst, one suspect also brought to light the core problem in trying to rein in the rampant piracy afflicting the Somali coast: poverty and the absence of any authority.

"If our children are hungry, who is responsible?" shouted Sayid Ali Garaar, 39 years old. "You sleep in your house, I am in prison. I have no country, no family, nothing," he said, wiping tears from his eyes. "I got into this situation because I am prepared to do anything."

The case, held in a top-security courtroom in this Dutch port city, was a landmark in the fight against the escalating incidents of piracy in the Gulf of Aden and the Indian Ocean, which prompted navies around the world to join in a task

force to protect one of the world's busiest sea lanes for merchant ships and oil tankers.

Hundreds of pirates have been detained and several have been brought to Europe since the international armada was mobilized, but the majority have been released at sea because of the cost and difficulty of bringing them to trial.

Other European countries will be watching the Dutch case closely to weigh the merits of bringing piracy suspects to trial. The trial is scheduled to last up to five days, and a verdict is expected next month. The pirates face a maximum 12-year sentence if convicted.

Dutch prosecutors charged the suspects with the 17th-century crime of "sea robbery," though they were allegedly armed with modern weapons—AK-47 assault rifles and rocket-propelled grenades—when they attacked a freighter in January 2009 that flew the flag of the Dutch Antilles.

The trial opened with conflicting statements from the suspects on what they were doing at the time of the alleged attack, and the lack of



Agence France-Press/Getty Images

A court drawing shows the five suspects seated in the front row

evidence because their skiff was sunk by Danish marines who came to the freighter's rescue.

Court-appointed defense attorneys also said they had been able to interview only one crew member of the attacked ship because they are at sea most of the year and Danish marines who flew over the pirates' skiff said they saw no weapons on

board.

"Such trials will not end piracy," said the spokesman for the European Union's antipiracy force, Cmdr. Anders Kallin.

"To end piracy you need to have a solution on shore. The problem is in Somalia. And we don't have permission to go there."

Still, Cmdr. Kallin said taking pi-

rates to court demonstrates they can be held responsible for their crimes. "It will show them that there is a big risk in going out to sea to hijack ships," he said.

In written testimony, the ship's crew said they used flares to hold off the attackers, who sped their skiff toward them, firing volleys from automatic weapons and at least one round from a rocket propelled grenade launcher.

Danish marines who flew over the pirates' skiff in a helicopter said they saw no weapons on board, but that the small boat was carrying a ladder with hooks at one end used for boarding ships. The helicopter pilot said there was no doubt that it was an act of piracy.

In Europe, piracy suspects are being held in France, Spain and the Netherlands, but the Dutch are the first to put any on trial.

Last week, a Somali man pleaded guilty in a New York court to hijacking the U.S.-flagged ship Maersk Alabama on April 8, 2009, and kidnapping its captain. He faces a minimum 27 years in prison. Sentencing was scheduled for Oct. 19.

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EUROPE NEWS



Agence France-Presse/Getty Images

German Chancellor Angela Merkel and Hesse Premier Roland Koch at a political meeting in Berlin earlier this year.

Koch to leave politics

Premier of Germany's Hesse state says exit isn't due to any dispute

A Wall Street Journal Roundup

BERLIN—Hesse state governor Roland Koch, a powerful leader in Chancellor Angela Merkel's Christian Democratic Union, quit on Tuesday in a move that could take a sometimes rival of the German leader out of politics.

In a surprise announcement, Mr. Koch said he would resign as premier of Hesse, which includes the financial capital of Frankfurt, at the end of August.

He also said he wouldn't seek reelection as vice chairman of the Christian Democratic Union, of which Ms. Merkel is chairwoman, at the party's conference in November.

"I make this decision because it's right for Hesse, right for my party, and right for me," Mr. Koch said at a news conference in Wiesbaden, the capital of Hesse, the state where he has served as governor since

1999.

Mr. Koch has been one of Ms. Merkel's main rivals within the party, and has recently been seen as a potential successor to Finance Minister Wolfgang Schäuble if he were to resign due to health problems that have hampered him this year.

Mr. Koch and Ms. Merkel clashed recently over future budget cuts, as Mr. Koch proposed cutbacks in education and research that Ms. Merkel opposed.

However, Mr. Koch said his departure wasn't due to any dispute.

Mr. Koch, a trained lawyer, indicated that he planned to go into business in some capacity after taking "a few months to breathe."

A sometimes polarizing figure on his party's right, he was long viewed as a rival to Ms. Merkel but has largely worked smoothly with her in recent years. The 52-year-old was

sometimes touted as a possible future finance minister.

Mr. Koch, a talented orator, has a strong following on the conservative wing of the CDU. He is also widely regarded as one of the CDU's top authorities on economic and financial issues—and an important counterweight to Ms. Merkel's drift toward the left of the party.

Mr. Koch has governed Hesse since 1999, when he ousted a center-left administration following a campaign in which his party hit out at a proposal to liberalize German citizenship laws.

He said Tuesday he had fulfilled his aim of anchoring a "long-term center-right majority" in his state, once a center-left stronghold.

"Politics is a fascinating part of my life, but politics is not my life," Mr. Koch said.

There was no immediate word on his successor.

Wider short-selling ban

BY PATRICK MCGROARTY

BERLIN—Germany's Finance Ministry on Tuesday proposed extending a ban on "naked" short selling to cover all stocks and euro-currency derivatives listed in Germany that aren't intended for hedging. The expanded ban goes beyond the prohibition of naked short sales of certain financial stocks imposed last week.

Naked short selling involves the sale of an asset that isn't owned by the seller and isn't borrowed to cover the position while it is held. Some politicians have claimed the activity can be used to manipulate markets because the amount of naked short selling can dwarf sales of the underlying assets.

Germany last week surprised its European partners and financial markets by announcing that it will

ban naked short selling of certain euro-zone debt and credit-default swaps as well as some financial stocks.

"Naked short selling of stocks and the debt of euro-zone states

Some politicians have claimed that naked short selling can be used to manipulate markets.

that are listed on a domestic exchange in a regulated marketplace will be forbidden," the proposal says. The proposal, outlined by the ministry in a draft bill that will be discussed by the German cabinet next week, also includes a new "transparency system" for short

selling.

In its draft bill, the ministry described its vision of a two-tier system that would include oversight of some naked short-sale assets by Germany's financial regulator, BaFin, and mandatory public disclosure of larger short-sale holdings.

The short selling of credit-default swaps on euro-zone debt without ownership of the debt obligation and of euro currency derivatives not meant for hedging would also be prohibited, the ministry said.

The proposal outlined Tuesday will be reviewed by German business groups before Chancellor Angela Merkel's cabinet considers it next week. The cabinet's approval would be the first step for securing German parliamentary approval to create a new law.

—Andreas Kissler contributed to this article.

Factory orders surged in March

BY NICHOLAS WINNING

LONDON—New factory orders in the 16 countries that share the euro posted the sharpest monthly gain in nearly three years in March, in a sign that the economic recovery is gathering pace, data from the European Union's Eurostat statistics agency showed Tuesday.

Industrial new orders rose 5.2% from February and were 19.8% higher than in March last year—the strongest monthly rise since June 2007 and sharpest annual increase since May 2000.

"That shows the real economy's recovery is in progress," said European Commissioner for Economic and Monetary Affairs Olli Rehn. The challenge is to ensure that problems in financial markets don't upset the recovery, he added.

The March data were much stronger than market forecasts for increases of 2.5% from February and 15.0% from March of last year, based on a Dow Jones Newswires survey of economists. February orders were also raised to show gains of 1.9% from January and 12.5% from last February.

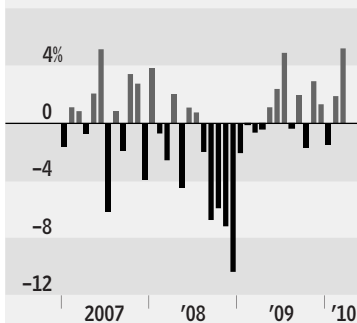
Economists said the figures bode well for the euro zone's industrial production and growth despite the sovereign-debt crisis in Greece. Euro-zone gross domestic product grew just 0.2% on a quarterly basis in the first three months of the year.

Eurostat said industrial orders excluding heavy transport equipment rose 4.5% in March, leaving them 20.2% higher than a year earlier—the strongest monthly gain since June 1997. Orders for heavy transport, including ships, and railway and aerospace equipment, tend to be volatile and have a limited immediate impact on production.

Orders of intermediate goods in-

Orders surge

Euro zone's industrial new orders, change from previous month



Source: Eurostat

creased 5.4% on the month in March, the sharpest rise since July last year. Orders for capital goods rose 5.7% and orders for durable consumer goods gained 2.4% for a second consecutive month. Orders for nondurable consumer goods gained 4.2%, the strongest monthly increase for three years.

On the year, orders for intermediate goods soared 31%, the sharpest increase since May 2000, while orders for capital goods were 15.6% higher. Orders for durable consumer goods gained 11.2%, the strongest annual gain since August 2006, and orders for nondurable consumer goods rose 6.5%, the sharpest rise since April 2008.

James Nixon, an economist at Société Générale, said euro-zone orders were still down some 20% from their pre-crisis peak, but added that industrial data should start to make a more significant contribution to growth. "We continue to believe this strength will largely be reflected in the second quarter," he said.

Queen's speech outlines U.K. plans

BY LAURENCE NORMAN

LONDON—U.K. Prime Minister David Cameron's new government laid out its legislative program for the next 18 months on Tuesday, including plans to redirect billions of pounds in revenue from the prior government's planned payroll-tax increase in an effort to lower the tax burden on most U.K. taxpayers.

The details were presented as part of the queen's speech Tuesday, which laid out the government's plans for the term, which lasts until late 2011. "The first priority is to reduce the deficit and restore economic growth," Queen Elizabeth II said in her speech at the formal state opening of Parliament.

The government plans a string of economic bills, all of which were flagged in advance by Mr. Cameron's Conservative-Liberal Democrat coalition. In addition to promising to accelerate deficit reduction, one bill would set up the Office for Budget Responsibility, which will police the government's tax and spending plans. The government said the national-insurance-tax bill would

"safeguard jobs and support the economy."

In its March budget, the Labour government reiterated that it would introduce a payroll-tax increases for employers and employees in April 2011, saying at the time that it would raise some £9 billion (\$12.99 billion) in revenue. To soften the blow on lower-income families, Labour set aside some £3 billion of that revenue to raise national-insurance-tax thresholds.

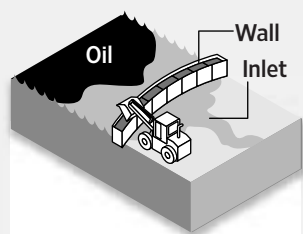
Fleshing out the details of one of the key election pledges of Mr. Cameron's Conservative Party, the new government said it will recycle the remaining £6 billion of expected revenue to increase the level at which people pay income tax and further increase payroll-tax thresholds for employers and employees.

The government said "under the full changes, most people would be better off relative to the previous government's plan."

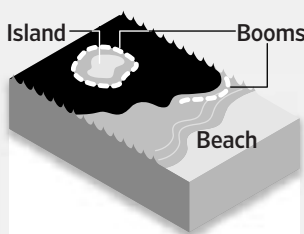
Acting Labour leader Harriet Harman said Labour wouldn't "pull its punches" and would oppose spending cuts that threaten frontline services or harm the recovery.

U.S. NEWS

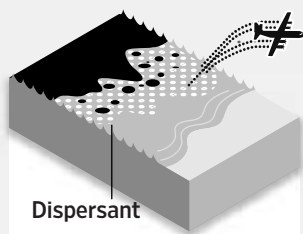
Fighting the slick | Some of the efforts to control the oil spill's spread:



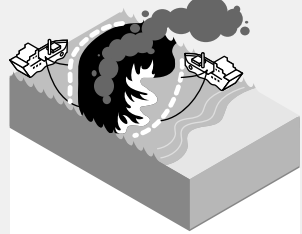
Berms and walls: Barriers are built on beaches or around narrow inlets to protect water further inland. Experts have questioned whether the berms can be built in time.



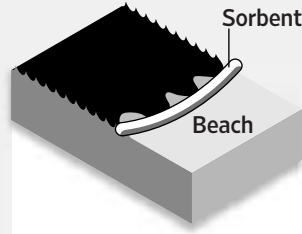
Booms: About 1.75 million feet of floating barriers are deployed around islands and in open water to stop surface oil. But oil can form into clumps that slip under booms.



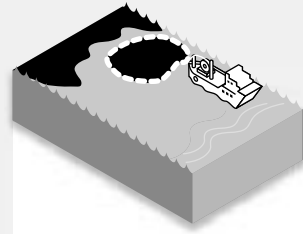
Dispersant: BP has sprayed 785,000 gallons of dispersant to break up the oil slick (685,000 gallons on the surface and 100,000 underwater). The EPA has told BP to use less toxic dispersants.



Burning: Ships corral oil with booms and set it on fire. Burning removes surface oil but releases sooty clouds. The EPA is monitoring coastal air quality.



Sorbent: 730,000 feet of polypropylene sponges are deployed on beaches or on the water's surface like a boom. When they fill with oil they must be replaced, making them more costly than booms.



Skimming: After oil is corralled with a length of boom, floating skimmers suck the oil onto a ship or barge. They are most effective skimming fresh oil.

Sources: BP; news reports

BP readies 'top kill'; cap on claims?

Oil company prepares to try to jam leaking well, as Congress clashes over bids to remove the limit on damages

By NAUREN S. MALIK AND SIOBHAN HUGHES

BP PLC said it had the equipment in place for a "top kill" procedure to stem the oil leak in the Gulf of Mexico and that it expected to start testing well conditions Tuesday.

As the British oil company prepared for the procedure, U.S. Associate Attorney General Thomas Perrelli called for raising—or eliminating—a cap on damage claims that BP and other companies would have to pay for oil spills like the one in the Gulf.

Testifying before the Senate Energy and Natural Resources Committee, Mr. Perrelli said the limit should be removed in some instances. He said the government needs to "ensure that there is no arbitrary cap on corporate responsibility for a similar major oil spill."

The Gulf spill started in a BP well about 5,000 feet below the surface of the water after an oil rig leased by BP exploded on April 20. The explosion broke a pipe far below the rig, sending thousands of barrels of oil a day into the ocean. After more than a month, the oil is now contaminating the coastal marshes of Louisiana, despite a huge containment operation, and threatening an environmental disaster.

Kent Wells, BP's senior vice president of exploration and production, said during a news conference Tuesday that vessels and subsea infrastructure needed for the top kill procedure were in place and that "we are in the final stages of pressure-testing it."

The diagnostic testing can take



A BP cleanup crew collects oil from a beach at Port Fourchon, La. Oil is now contaminating the state's coastal marshes, Getty Images

12 to 24 hours. If it is deemed safe, the procedure itself will take anywhere from half a day to a couple of days to complete, he said.

A top-kill operation involves pumping heavy drilling fluids known as mud into the well in the hope the pressure will cause it to go "static," Mr. Wells said. BP executives have warned that a top kill has never

been tried at 5,000 feet and put the chance of success at 60% to 70%.

If the top-kill procedure fails, BP will move to a backup plan to adjust the riser and five-story-high blowout preventer, and then lower a containment dome to capture the oil. BP could start this procedure a few days after deciding the top kill wasn't successful, Mr. Wells said.

The testimony of Mr. Perrelli, the associate attorney general, provides the most specific details to date of the Obama administration's thinking on the cap on damage claims. Initially, the administration had called for raising the cap without specifying a new threshold. Mr. Perrelli suggested that the government could, in some instances, entirely

remove a cap on damages, and do it retroactively.

Some Democratic lawmakers have called for raising the cap to \$10 billion or higher from \$75 million currently. On Tuesday afternoon, Sen. Jim Inhofe (R., Okla.) blocked an effort by a handful of Democrats to do away with the cap on damage claims.

Mr. Inhofe said eliminating the cap could shut out even the biggest oil companies from drilling in U.S. coastal waters. He said the cap "should be much higher" but that "plenty of time remains" to decide on an appropriate threshold.

As oil continues to flow from the well, lawmakers have come under increasing pressure over how high to raise the cap. Earlier Tuesday, Sen. Lisa Murkowski (R., Alaska)—who ran into criticism after becoming the first Republican to block the Democratic plan to raise the cap to \$10 billion—said that "maybe it needs to be unlimited."

The Interior Department, facing criticism from environmental groups, is also racing to explain its policies. On Tuesday, David Hayes, the No. 2 official in the department, said the government has put on hold permits that companies need to bore new wells in the sea floor.

Mr. Hayes said the Interior Department has continued to approve offshore oil and gas exploration plans while it reviews safety policies. The safety review is expected to be submitted to Mr. Obama on Thursday, White House spokesman Robert Gibbs said.

—Corey Boles, Mark Long and James Herron contributed to this article.

Home prices are stable, but remain weak

By SARA MURRAY

Home prices have pulled out of their recession free-fall, but remain weak as concerns linger about the strength of the U.S. economic recovery.

A composite index of 20 cities showed prices fell 0.5% in March from the prior month, not adjusted for seasonal fluctuations, according to an S&P/Case-Shiller report released Tuesday. The drop marked the sixth-straight month of decline.

But another report Tuesday showed consumer confidence

strengthened in May as the improving labor market buoyed Americans' hopes for further economic gains.

Despite the recent monthly decreases, March home prices in the 20-city index are up 2.3% from the same month last year.

A separate home-price index also released Tuesday showed prices nationwide were up a seasonally adjusted 0.3% in March from the prior month, the Federal Housing Finance Agency said. Prices fell 2.2% from March of 2009, according to this index.

While the two home-price in-

dexes diverged in March, they outlined the same overall trend of prices stabilizing after steep drops during the recession. But with the expiration of the home-buyer tax credit likely to pull down demand, and the potential for more foreclosures, the housing market is still bouncing along at low levels.

"We're just going to go through an adjustment period," said Patrick Newport, an IHS Global Insight economist. "After it settles, I think the market's going to start growing sustainably, because the [labor] market's starting to create jobs."

Prices have snapped back the most in San Francisco and San Diego in the past year, up 16.2% and 10.8%, respectively, the Case-Shiller report showed. Home prices took the biggest hit in Las Vegas, where they were down 12% for the year.

The index of consumer confidence shot up in May, to 63.3 from 57.7 in April, the Conference Board said. It was the third monthly increase and was led by improvement in consumers' expectations of where the economy was headed.

The surge in confidence was likely spurred by April's strong jobs

report, economists said. A smaller share of consumers said jobs were hard to get. Looking ahead, a larger percentage said there would be more jobs available, and a smaller percentage said there would be fewer.

While it is still difficult to gauge whether economic uncertainty abroad will affect the U.S., "so far, consumers seem far less concerned by the European economic crisis and related stock-market turmoil that has developed over the past month," said Mark Vitner, a Wells Fargo Securities economist.

U.S. NEWS

Percentage change in crime from 2008 to 2009 for some big U.S. cities



Sources: FBI: Crime in the United States; BOC: County City Data Book via Moody's Economy.com Photos: Alamy (3); Getty Images (1); Bloomberg News (2)

Deal to end ban on gays in military takes shape

By Laura Meckler

The White House and leading lawmakers came to an agreement Monday about how to end the ban on gays and lesbians serving openly in the U.S. military, likely speeding the end of the "don't ask, don't tell" policy. Backers were optimistic they could this week attach the amendment to a broader defense funding bill expected to pass this year.

The bill wouldn't immediately repeal the Clinton-era policy. Rather, it would take effect as soon as a Pentagon review is complete and the president signs off on the military's recommendations for how to undertake the change in policy.

President Barack Obama and Pentagon leaders have already said they were committed to ending the policy and allowing gays and lesbians to serve openly in the armed forces. But in order to lift the ban, Congress must act as well. If the proposed legislation becomes law, the change can occur once the review is finished.

Gay-rights activists have been frustrated with the pace of the repeal effort and lack of progress on other items on their agenda, and they cheered Monday's development. "We are on the brink of historic action to both strengthen our military and respect the service of lesbian and gay troops," said Joe Solmonese, president of the Human Rights Campaign.

The amendment says the president, defense secretary and chairman of the Joint Chiefs of Staff must certify that the new policy is consistent with standards of military readiness, military effectiveness, unit cohesion, military recruiting and retention.

Those assurances were enough to satisfy the Pentagon, White House budget director Peter Orszag said in a letter to the congressional sponsors, Sens. Carl Levin (D., Mich.) and Joe Lieberman (I., Conn.) and Rep. Patrick Murphy (D., Pa.).

"Such an approach recognizes the critical need to allow our military and their families the full opportunity to inform and shape the implementation process through a thorough understanding of their concerns, insights and suggestions," he wrote.

Senate aides working on the matter said the amendment would be offered later this week on the National Defense Authorization Act.

If sponsors succeed in attaching the provision to the bill in committee, aides said, it would require 60 votes to remove it during the full Senate debate, which is unlikely.

"We are committed to repealing 'Don't Ask, Don't Tell,' a policy that has forced thousands of gay men and women from serving openly," said a statement Monday from Messrs. Lieberman and Murphy. "It is our firm belief that it is time to repeal this discriminatory policy."

Opponents of gay rights were dismayed. Family Research Council President Tony Perkins called the agreement "a backroom deal that disregards the views of our troops and uses the military to advance the political agenda of a radical special interest group."

Violent crime falls sharply

Decline of 5.5%, led by the biggest cities, challenges the belief that recessions drive up rate

By Evan Perez

Violent crime fell significantly last year in U.S. cities, according to preliminary federal statistics, challenging the widely held belief that recessions drive up crime rates.

The incidence of violent crimes such as murder, rape and aggravated assault was down 5.5% from 2008, and 6.9% in big cities. It fell 2.4% in long-troubled Detroit and plunged 16.6% in Phoenix, despite a perception of rising crime that has fueled an immigration backlash.

The early figures, from the Federal Bureau of Investigation, indicate a third straight year of decreases, along with a sharply accelerating rate of decline.

"It represents a break in the pattern of the relationship between crime increases and economic downturns," said Richard Rosenfeld, criminology professor at the University of Missouri-St. Louis. For example, violent crime rose nearly 5% in 1991, the FBI said.

The FBI said property crime fell 4.9% last year, according to the early data, from more than 13,000 police departments.

The declines were most pronounced in cities with populations over one million. Cities with fewer than 25,000 people saw violent crime fall 4.7%.

William Bratton, a former police chief in Los Angeles and New York who is now chairman of a New York consulting firm, said early crime figures from cities around the country

'Policing has advanced. We've gotten better at spotting crime trends,' said a top former police chief.

this year indicated that violent crime continued to fall. Mr. Bratton said the link between crime and the economy has been disproved in recent years.

"Policing has advanced. We've gotten better at spotting crime trends more quickly. We can respond much more quickly," he said. He expressed concern, however, that with budget cuts hitting police departments, crime could rise again,

though he said he doesn't expect a surge like the one seen in the 1980s.

Other police officials credited better policing for the decline. But researchers haven't yet assigned a cause. Mr. Rosenfeld noted that past crime-rate increases coincided with the rise of street drug problems. "It's possible [economic] stimulus funds, which allowed police to maintain or increase staffing, are responsible," Mr. Rosenfeld said. "It's also possible that it's because this recession is not coinciding with an expansion in street drug markets."

The rate of decline has accelerated in recent years. In 2007, violent crime fell 0.7% from the prior year. In 2008, it fell an additional 1.9%.

But it often takes time for falling crime rates to affect popular perceptions of how safe the streets are. Researchers note that it took years for the dramatic crime reductions in the latter part of the 1990s to register with lawmakers and voters.

In Phoenix, police spokesman Trent Crump said, "Despite all the hype, in every single reportable crime category, we're significantly down." Mr. Crump said Phoenix's most recent data for 2010 indicated

still lower crime. For the first quarter, violent crime was down 17% in the city, while homicides were down 38% and robberies 27%, compared with the same period in 2009.

Arizona's major cities all registered declines. A perceived rise in crime is one reason often cited by proponents of a new law intended to crack down on illegal immigration. The number of kidnappings reported in Phoenix, which hit 368 in 2008, was also down, though police officials didn't have exact figures.

Expectations that crime would rise in the recession were cited by Justice Department officials last year to support increased aid to police departments. Some gun owners cited an expected crime increase for the surge in weapons sales, though the perception that President Barack Obama would clamp down on gun rights also played a role.

The Justice Department received \$4 billion in stimulus funding last year, much of which it spent on grants to police departments.

"After the stimulus funds run out, it remains to be seen what happens to crime rates," Mr. Rosenfeld said.

U.S. backs immunity for Vatican in suit

By Ashby Jones

The U.S. government has largely sided with the Vatican's argument that a court erred in a closely watched lawsuit alleging sexual abuse by a former priest, a rare foray by Washington into the highly sensitive litigation.

In a filing made Friday, the solicitor general's office urged the Supreme Court to set aside a federal appellate court ruling in a case that had allowed the Oregon suit to go

forward against the Vatican. The solicitor general speaks for the government on Supreme Court matters.

The Supreme Court isn't required to follow the government's recommendation, which mostly rested on a technical reading of the law concerning sovereign immunity. But it is often heavily influenced by the judgment of the executive branch in cases that deal with delicate issues, including whether U.S. courts should be allowed to hear cases against foreign officials or na-

tions. The U.S. has recognized the Vatican as a foreign sovereign since 1984.

The lawsuit, Doe v. Holy See, was filed in 2002 on behalf of a man who claimed he was sexually abused by a priest in Oregon in the mid-1960s. The plaintiff named the Holy See as a defendant, in addition to a handful of other parties. Jeffrey Anderson, the lawyer for the plaintiff, said he remained heartened the government didn't recommend dismissing the case altogether.

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WORLD NEWS

Crisis hurts China's esteem in Asia

Japan and South Korea increase ties to the U.S. as traditional ally Beijing seems unwilling to take on Pyongyang

BEIJING—The Obama administration's talks with China this week won few new commitments from Beijing on global security challenges, particularly when it comes to looming showdowns with North Korea and Iran. But Beijing's increasing diplomatic and military assertiveness is unnerving its Asian neighbors in ways that could bolster the U.S.'s strategic position in the region.

By Jay Solomon,
Jason Dean
And Yuka Hayashi

Fears that China is siding with Pyongyang over North Korea's alleged sinking of a South Korean naval vessel in March has rattled South Korea's and Japan's governments and re-energized their commitments to military alliances with the U.S., officials from both countries said.

Japanese Prime Minister Yukio Hatoyama publicly cited the North Korean threat last week in recommending Tokyo to stationing U.S. Marines on the island of Okinawa.

Further afield, countries such as Malaysia and Vietnam have also been seeking closer ties to the U.S. in recent months, according to American and Asian diplomats. These countries are quietly voicing fears about China's expanding military and economic power. Analysts say that the more China has sought to assert its regional authority, the more many Asian leaders have pressed Washington to maintain—if not increase—its military and diplomatic presence.

South Korea's strong ties with Beijing have been tested by China's reaction to Pyongyang's alleged torpedoing of the South Korean vessel, the Cheonan.

China waited nearly a month to send condolences to South Korea for the loss of 46 of its servicemen. Chinese President Hu Jintao ranted



An undated photograph released in May shows Kim Jong-il bidding farewell at the Beijing Station

Seoul by hosting North Korean leader Kim Jong Il this month in a string of meetings in Beijing. South Korea President Lee Myung-bak had visited China just days earlier and hadn't been told of Mr. Kim's visit, according to South Korean officials.

Last week, South Korea made public its investigation into the Cheonan's sinking and formally charged North Korea with launching the torpedo. But China's government continues to express skepticism toward the results of Seoul's probe, which included input from American, Australian, and Swedish investigators. North Korea has denied any involvement in the attack.

China has "taken note of the result of the South Korean investigation," Foreign Ministry spokeswoman Jiang Yu said Tuesday. "We have also taken note of the DPRK's

response," she added, referring to the North's formal name, the Democratic People's Republic of Korea.

Chinese scholars reject criticism of Beijing's handling of relations with Seoul. Shen Dingli, a professor of international relations at Fudan University in Shanghai, says China needs to maintain its neutrality over the Cheonan incident because it isn't sure the outcome of the investigation is accurate.

He says Seoul could have fabricated the investigation's results to frame Pyongyang.

"The chance of fabrication might be 1%. The chance that this is real is maybe 99%. But this is the difference between peace and war. So we need to be 100% certain," said Mr. Shen. "From the first day, South Korea should have invited China and North Korea to participate in this

investigation," he said.

Beijing's public paralysis on the Cheonan feud may flow from what it sees as a lack of good options. It doesn't want to position itself on the wrong side of the international community, but it also doesn't want to facilitate any action that could destabilize the North Korean government and lead to chaos that could spill into its territory and, potentially, lead to control of the North by Seoul, putting a military ally of the U.S. directly on China's border.

Mr. Shen says China will likely to remain loyal to North Korea for a simple strategic reason. "We need North Korea to check and balance the American military presence in South Korea and Japan," he says, just in case, for example, there were a conflict with the U.S. over Taiwan.

Recent tensions between Beijing and Tokyo offer another stark example of how China's growing assertiveness has rattled the region.

Mr. Hatoyama entered office last year pursuing a policy line very much in China's interest: a more "equal" relationship between Tokyo and Washington, and the removal of American troops from Okinawa. Japan's leader has also repeatedly discussed the idea of creating an "East Asia" community modeled after the European Community.

Still, China-Japan relations have soured significantly in recent months. In early May, Japan filed a formal protest to Beijing after a Chinese ship chased a Japanese coast guard vessel that Tokyo says was conducting marine surveys within a Japanese zone. Japan filed another protest a month earlier after a Chinese helicopter buzzed a Japanese ship sailing near the location of Chinese military exercises.

On May 15, Japanese and Chinese diplomats publicly sparred at a meeting in South Korea, after Tokyo's Foreign Minister Katsuya Okada pressed Beijing to shrink, or at least not increase, its nuclear-weapons arsenal.

Chinese Foreign Minister Yang Jiechi countered that Beijing's nuclear strategy was clear and its position on disarmament widely recognized. But Mr. Okada repeated his remarks at a trilateral meeting with South Korea's chief diplomat.

According to people familiar with the exchange, Mr. Yang became so upset that he started yelling at Mr. Okada. A Chinese foreign ministry spokesman later called Mr. Okada's remarks "irresponsible."

Mr. Okada said such accusations were groundless. "The Chinese side stated various things during our exchange, but I didn't hear them say once they weren't building up" their nuclear arsenal, Mr. Okada said.

—Sue Feng
contributed to this article.

Seoul props up the won

By MIN-JEONG LEE
AND ALEX FRANGOS

Mounting tensions on the Korean peninsula sent the South Korean won tumbling Tuesday, prompting a major government intervention in currency markets and rattling investors in the region already on edge over Europe's debt problems.

The won's move added to a broader shift in currency markets in recent weeks that has implications for South Korea and Japan, as well as other Asian exporters. A rising yen could put Japan's companies at a disadvantage to South Korean rivals just as they looked to put a long period of unprofitability and a stronger currency behind them. Shares of major Japanese exporters Sony Corp. and Toshiba Corp. fell 5% and 4.5%, respectively, Tuesday.

The yen for much of the last decade traded at around 9 to 10 won before strengthening sharply during the crisis. It had been edging down in recent months toward around 12 won per yen. But Tuesday it shot back to 14 as the Bank of Korea intervened.

The South Korean central bank didn't explicitly confirm the inter-



vention but indicated broadly it was moving to stabilize its currency.

"The dollar's surge against the won today was overdone," said Bank of Korea Senior Deputy Gov. Lee Ju-yeol, in a speech meant to shore up market confidence. "The authorities will try to prevent one-way currency moves."

Pyongyang raises the stakes against South Korea

Continued from first page
of State Hillary Clinton, in Beijing this week for a round of economic talks, has failed to coax China's leaders to publicly condemn North Korea's alleged attack. Analysts and U.S. officials see a Chinese leadership that is split over how to handle North Korea but presented with few good options.

South Korea last week formally accused the North of the March 26 sinking of its patrol boat, the Cheonan, after a joint military-civilian panel presented the results of its investigation, including parts of a North Korean torpedo recovered from the scene.

North Korea issued its fullest response yet to the allegations and penalties in an announcement in state media late Tuesday, well outside of its normal announcement hours and a sign that the North's leadership likely made the decision at a late hour.

Seoul had no immediate response. South Korean officials planned to host Mrs. Clinton Wednesday and Chinese Premier Wen Jiabao and Japanese Prime Minister Yukio Hatoyama on Friday.

During meetings in Beijing, Mrs. Clinton and her aides discussed

North Korea's internal political situation with Chinese leaders, senior U.S. officials say. They said they discussed leader Kim Jong Il's health and the results from his trip to Beijing earlier this month. But these officials said Washington still doesn't have enough information to understand the full rationale behind an attack on the Cheonan.

U.S. officials said that Chinese leaders often appear split on the North Korea issue. Some officials appeared "frustrated" by North Korea's recent actions, a senior U.S. official said, and more outward-looking members of Beijing's Foreign Ministry often acknowledge the threats posed by Pyongyang. But the PLA is much more protective. As many as one million Chinese died fighting on the side of North Korea during the 1950-53 Korean War.

Beijing's public neutrality on the Korean feud may flow from what it sees as a lack of good options. It doesn't want to position itself on the wrong side of the international community. But it also doesn't want to lead to any destabilization of the North Korean government, which could unleash chaos and refugees that could spill into its territory and potentially lead to Seoul's control of

the North, putting a military ally of the U.S. directly on China's border.

Pyongyang's Tuesday statement called for a full halt of cooperation between the two Koreas, and said the North will expel South Korean officials from the joint industrial park that is the largest economic project of the two countries. Some cooperation would evidently remain: The North didn't say it would expel South Korean workers at some 120 South Korean companies in the zone, which employs 40,000 North Koreans.

The North's statement also didn't specify which of several nonaggression pacts forged with the South since the 1970s it was abrogating.

Most recently, the North's cycle of provocation and favor-seeking appeared to be repeating itself in November when a North Korea warship engaged in a firefight with South Korean patrol boats near the inter-Korean maritime border in the Yellow Sea. South Korean boats badly damaged the North Korean vessel.

Instead of seeking a meeting and demanding money or concessions from the South, North Korea appears to have launched its surprise attack on the Cheonan, killing 46 sailors.

WORLD NEWS



Bloomberg News

U.S. Secretary of State Hillary Clinton, right, in Beijing Tuesday with Chinese State Councilor Liu Yandong, left.

Summit highlights shift

U.S.-China meeting balances relationship, but yields no big deals

BELJING—The most wide-ranging dialogue in the history of modern U.S.-China relations ended with some accord on contentious issues of currency and trade, and gave both sides the forum to recast their relationship as a partnership between equals.

Although China offered few ma-

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major concessions in two days of discussions at the annual Strategic and Economic Dialogue, which ended on Tuesday, officials from both sides hailed the outcome.

China pledged to gradually reform its currency-exchange rate, without offering any timetable. On Beijing's drive to promote "indigenous innovation," which foreign companies fear is a protectionist ploy, China held out hope of a resolution within the World Trade Organization. And Beijing promised to "work together with the U.S. and other parties" to resolve the crisis over allegations that North Korea torpedoed a Southern patrol vessel, but it gave no specifics.

"This is progress," said U.S. Treasury Secretary Timothy Geithner, referring to China's response to American complaints about "indigenous innovation" policies that threaten to exclude foreign companies from a government procurement market worth billions of dollars each year. "It does not fully resolve our concerns, but it gives us a set of basic principles on which to

move forward," he told a closing ceremony.

Chinese Vice Premier Wang Qishan was also enthusiastic. "We are now able to manage the differences and problems arising in the course of our relationship in a more rational and mature manner," he said.

Still, the Obama administration's expectations for an all-embracing and energetic partnership with the potential to address global challenges such as climate change and reshape the world economy has been tempered by plodding progress on key issues.

Pressure is likely to grow on Mr. Geithner to secure more than just soothing words from Beijing on the yuan. U.S. lawmakers may allow China more latitude given the sovereign-debt crisis in Europe and the fall in the value of the euro, which have combined to damage Chinese exports to its largest market. But lawmakers who say China is weakening its currency to benefit exporters are likely to press for it to be declared a currency manipulator if there is no movement by Beijing.

The choreographed theater surrounding the dialogue, which involved some 200 U.S. officials, illustrated China's new sophistication in managing its public image. Without any significant compromise, the Chinese government garnered plaudits from top U.S. officials and signaled to a domestic audience its new importance in global affairs.

For its part, Washington's gestures of gratitude were partly designed to give cover to Chinese officials as they prepare to give real

ground on issues such as the currency-exchange rate.

Instead of openly prodding China over issues such as currency, U.S. officials are pursuing patient diplomacy. In part, this reflects the reality that Chinese officials are less likely to budge if they are seen by a domestic audience to be caving to American pressure.

Even though Washington won Beijing's agreement on a draft United Nations sanctions resolution against Iran this month, it did so only after watering down its original proposal to suit China.

In Beijing, the gap between Chinese and U.S. strategic interests was on stark display over North Korea. On Tuesday, Mrs. Clinton said the U.S. and China must "work together to address the crisis provoked by the sinking of a South Korean ship," referring to North Korea's alleged torpedoing of a patrol vessel.

Chinese State Councilor Dai Bingguo wouldn't be drawn, offering only stock phrases of concern.

Later, Vice Foreign Minister Cui Tiankai went slightly further, offering to "work together with the U.S. and other parties and continue to stay in close touch on the situation in the Korean peninsula."

Whatever differences were aired behind closed doors at the dialogue were papered over in public remarks. Mr. Geithner offered a positive assessment of China's response to virtually the entire list of prominent complaints that the U.S. brought to the meeting.

—Deborah Solomon
contributed to this article.

EU team finds fault with Ethiopia vote

BY SARAH CHILDRESS

Ethiopia's prime minister is heading for re-election, even as a European Union observer mission in the country said Tuesday the vote "fell short" of some international standards.

Official results for Sunday's parliamentary vote aren't expected until late June, but preliminary figures released on Monday by the National Electoral Board of Ethiopia showed that Prime Minister Meles Zenawi is likely to win by a huge margin. His party, the Ethiopian People's Revolutionary Democratic Front, was leading in nine out of 11 regions, the board said.

But the EU said that the electoral process lacked transparency and that state resources—such as government vehicles to transport campaign materials—were used to bolster the ruling party and tip the balance in favor of Mr. Zenawi.

Still, the EU mission said that those shortcomings didn't discredit the results and that it considered the polling process "good" or "satisfactory" in 87% of cases it observed.

The report from the EU mission, the only Western observer team in the country, isn't likely to alter the political outcome.

The U.S. ally has fiercely defended its democratic process and has urged other countries to recognize the result.

"The people's vote will not be overturned by foreign forces," Mr. Zenawi told a rally in Addis Ababa on Tuesday. "We urge them now to give recognition to the people's vote," Reuters reported him as saying.

The election is the first national vote since 2005, when nearly 200 people were killed in protests against what the opposition said was a rigged election. That election had followed the most openly contested campaign period in Ethiopia's recent history. The ruling party has

effectively been in power since it led the charge to overthrow a brutal military regime in 1991.

Ahead of Sunday's vote, Ethiopian officials predicted the ruling party would win another five-year term because of its investment in agriculture and aggressive fight against poverty. One in four Ethiopians lives on less than \$1 a day.

But opposition parties and human-rights groups complain the likely victory of the ruling party is tainted by what they call a violent crackdown on supporters and party members. The Ethiopian government disputed those charges, saying they were planted by opposition parties to discredit the government.

The EU said the electoral process lacked transparency and that state resources bolstered the ruling party.

In its report, the EU mission said the voting day had been calm and orderly, apart from some isolated irregularities. But it criticized "a degree of overlap" between electoral officials and the ruling party in some areas of the country that contributed to a perception of bias.

Officials from Medrek, the largest opposition party, said earlier that they believed the results were fixed and that the ruling party had used state resources to pressure people into supporting the party.

Another opposition-party official said he believed the process had been rigged. "The election process is not democratic," he said. "In towns, it is bought by cash, and in rural areas it is taken by force."

He said his party wouldn't contest the results. "Why go to court? The court [and the] electoral board all belong to the ruling party," he said.



Reuters

Ethiopian Premier Meles Zenawi, center, with backers in Addis Ababa Tuesday.

Deadly battle escalates between Jamaican police, armed groups

BY JOEL MILLMAN
AND NICHOLAS CASEY

At least 26 people were said to be dead after a third day of violence in Kingston, Jamaica, as security forces assaulted the slum stronghold of armed groups believed to be in the pay of accused Jamaican drug lord Christopher "Dudus" Coke.

Mr. Coke, the son of one of Jamaica's most influential gang lead-

ers, is fighting extradition to the U.S., where he is wanted on drug and gun-trafficking charges.

One member of the security forces had been killed and seven injured in the confrontation that broke out following Prime Minister Bruce Golding's decision to extradite Mr. Coke, according to local media reports. Mr. Golding, perhaps fearing violence, had wavered on the extradition, but issued a warrant for Mr.

Coke's arrest last week.

Shooting, looting and attacks on Jamaican police soon followed. On Sunday, the government declared a state of emergency.

On Tuesday, the violence centered mainly in the Trench Town area, a notorious warren of shantytowns and public-housing projects celebrated as the birthplace of reggae legend Bob Marley. Fighting has also been reported in Spanish Town,

a suburb west of Kingston.

"Security forces are under extreme pressure now," said Mark Shields, the island's former deputy police commissioner. "We have urban war going on." A spokesman for Jamaica's police department declined to comment.

Airlines on Monday canceled a number of flights to and from Kingston. Air Jamaica said it was calling off three flights, two of which were

headed to Fort Lauderdale, Fla., and the other bound for New York. American Airlines suspended service between Kingston and Miami.

U.S. officials have attempted to keep a low profile. On Tuesday, U.S. State Department spokesman Charles E. Luoma-Overstreet said the U.S. was cooperating with Jamaica to counter illegal trafficking on a continuing basis, but didn't offer specifics.