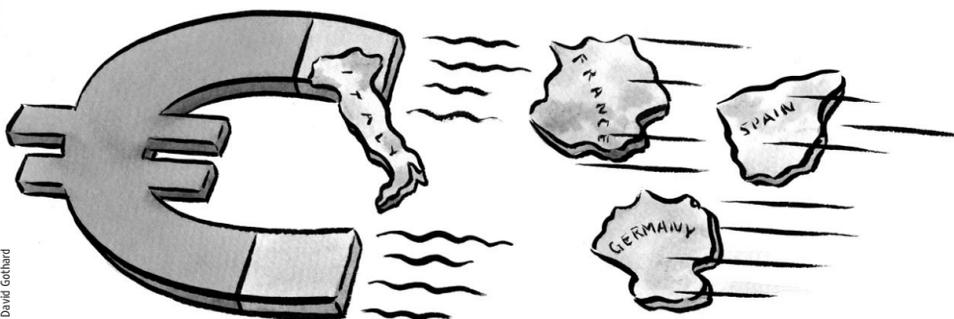


OPINION

'Europe' Turns 50



David Gotthard

By Jean-Claude Trichet

Frankfurt

Is there today a better symbol of peaceful European unity than the single currency, the euro, shared by 13 countries, 317 million fellow citizens and a single market across the whole continent?

Europe's successes were achieved only thanks to the political vision, leadership and determination of the people that built from the ruins of the Second World War and the Holocaust. As Jean Monnet writes in his memoirs, commenting on the project to create the European Coal and Steel Community in 1950: "Through the sharing of primary resources and the setting up of a new High Authority [today's European Commission] . . . this proposal will lay the first foundations for a European federation preserving peace on the continent."

A single market and single currency. What's not to like?

After Monnet's initiative, the most important milestone for European integration was the Treaty of Rome, signed 50 years ago this Sunday. The choice of Rome was symbolic. For a long time, the "Eternal City" symbolized a united Europe held together by a *Pax Romana* established by force. In 1957, the first six European countries turned their backs on their tragic past and voluntarily pooled parts of their national sovereignty into a supranational European body, laying the ground for a *Pax Europea* established by the rule of law. The Union can proudly point to the differences between the world then and the world now.

The Treaty of Rome was an unlikely achievement. We should not forget the downbeat atmosphere of the negotiations coming just after plans for European political and military union were rejected in 1954. In such a climate, the

transfer of core state powers to European bodies, which the creation of a common market entailed, was hugely controversial. Yet, three years later, this epoch-making treaty was signed. Nor should we forget the level of fear that the dismantling of trade barriers generated in business communities and national bureaucracies, as they realized that the wall of protection against foreign competitors would be torn down. Yet, by 1968, we had a customs union. In the next decade of oil shocks and economic difficulties, the economic policy responses of different European countries varied wildly. Europe seemed incapable of moving forward together. Yet, in 1986, a new treaty—the Single European Act—jolted new life into the freedom of movement of people, goods, services and capital inside the bloc, and the so-called Internal Market was born.

Today, the internal market helps almost half a billion people to prosper. It significantly stimulates trade between EU member states and is a major contributor to growth and jobs. When asked what the EU means to them personally, one citizen in two referred to the freedom to move, live and work anywhere in the Union.

Europe has achieved even more than the founding fathers of the Treaty of Rome could have hoped for. From six, the EU has grown to 27 members; more countries would like to join. This is unsurprising, as membership has also brought prosperity. Ireland is a shining example: Its GDP per capita rose from 61% of the EU average when it joined in 1973 to 125% by 2004. Democracy and prosperity are now spreading to Europe's southern and eastern borders, replacing dictatorships and poverty. Already, one ex-communist country, Slovenia, has joined the single currency area.

The Union has also moved into new areas, such as foreign policy, and police and judicial affairs. Closest to my heart, Europe has crowned its single market with a single currency. Originally, the Rome treaty did not mention monetary union. This was because Eu-

rope was part of the Bretton Woods global system of fixed exchange rates. The system's collapse in the '70s seriously threatened the process of economic integration in Europe. However, Europe's leaders rose to the challenge and eventually established Economic and Monetary Union, with a single currency and an independent European Central Bank, with a clear mandate of price stability as its primary objective.

I vividly remember the skepticism of 15 years ago when we were negotiating the euro's creation. Yet today our 317 million fellow citizens of the euro area walk around with a little piece of Europe in their pockets and enjoy a level of price stability which previously had been achieved in only a subset of the euro-area countries. This price stability is a direct social benefit to all, in particular the most vulnerable, who have no way to protect themselves against inflation.

The single currency has also bolstered Europe's resistance to external shocks. Living under the same roof gives us more solid shelter against turbulence coming from outside. We will never know how a Europe without the euro would have weathered events such as 9/11, the bursting of the high-tech bubble or the oil shock. Under the roof of the euro, we had no intra-European turbulence.

The euro not only protects against outside threats; it is a dynamic factor for the domestic economy. It has increased price transparency and compe-

tion, and boosted trade within the euro area. The ECB's credibility has allowed the solid anchoring of inflationary expectations, which in turn has brought a tremendous decrease in the cost of borrowing. This has helped investment and economic growth and boosted employment in the euro area. In the eight years since the euro's introduction, more than 12 million jobs have been created in the euro area, compared to significantly less than three million in the preceding eight years.

These achievements are real and momentous. And they are not mere historical facts: They continue to generate prosperity and stability today. However, the world does not stand still. This is no time for complacency. The economic challenges are daunting. The extraordinary advances of science and technology, together with the rapid development of emerging countries in the globalized economy, call on all continents to reform to take advantage of the new state of the world. To prosper in the next 50 years as much as we have in the last 50, Europe needs to take a big step up the knowledge ladder, reinforce training and education, promote research and development, and achieve the full integration of highly flexible goods, services and financial markets, while fostering job creation through open and dynamic labor markets.

* * *

On Sunday, Europe's leaders will cel-

brate the EU's 50th birthday in Berlin. For several decades, Berlin—more than any other city—exemplified the artificial division of the European continent. In 50 years, Europe has journeyed from political disarray and economic disorder to a high degree of economic and monetary integration and has become the world's brand-leader in peaceful political cooperation. The people of Europe can be proud of this metamorphosis. Surmounting all difficulties, leaders with vision, setting up solid institutions, have moved Europe ever forward.

For our future, I'm confident. Our continent is not made of "old Europe" and "new Europe" divided by a virtual curtain. Europe is both old and new. It has the wisdom of a 2,000-year experience and the energy of a 50-year entity, which is extremely young in historical terms. I am confident Europe will continue to engage more and more resolutely with the indispensable reforms to speed up the creation of jobs and ensure growth and prosperity. And I am confident Europe will surmount its present political difficulty as it has done in the past.

The European Union can count on the ECB to be an anchor of stability. Thanks to the credible delivery of price stability over the medium- and long-term, the bank will continue to pave the way for sustainable growth and active job creation.

Mr. Trichet is president of the European Central Bank.

The SEC's Fuzzy Math

By Robert C. Pozen

Almost 10% of U.S. public companies announced a record 1,420 financial restatements in 2006. It was a record—but continues an accelerating trend of financial restatements, from 2% in 2000 and more than 4% in 2004.

These restatements impose large costs on the capital markets. The GAO estimated that, between July 2002 and September 2005, the market capitalizations of restating companies decreased by a total of \$36 billion in the days immediately following the initial restatement. Two academic studies have shown that stock prices decline not only for the restating firm but also for its direct competitors—presumably because of fears about the financials of the whole industry. More broadly, as the SEC has noted: "Restating financial statements of prior periods may dilute public confidence in financial statements and may confuse those who use them."

The initial spurt of restatements during 2002 to 2004 was related partly to the more intensive reviews of internal controls mandated by Section 404 of the Sarbanes-Oxley Act. However, Sarbox is not the main problem. From 2005 to 2006, there was a 14% decrease in the number of financial restatements by the larger public companies required to perform internal control reviews under Section 404, according to a Glass Lewis study. Yet for the same period, that study found a 40% increase in the number of financial restatements by smaller public companies not yet required to implement Section 404.

The main problem is that many public companies are being forced to restate their financials for technical accounting reasons of dubious significance to investors. On March 12, 2007, for example, a Nasdaq company called Isle of Capri Casinos announced a delay in filing its SEC reports to complete the restatement of its financials for the prior three years because of adjustments to the amortization of its space leases.

Yet, Standard & Poor's concluded that "we do not believe the issue caus-

ing the restatement and the filing delay to be material." No wonder ordinary investors are confused: how should they react to a financial restatement caused by an accounting adjustment to a non-cash item, which is declared immaterial by an expert firm?

Clear accounting standards could help companies avoid needless pain.

To be sure, some financial restatements are certainly justified, most importantly those resulting from the negligent or intentional misapplication of well-established accounting standards. Nevertheless, others are the result of significant reinterpretations of complex accounting standards that could not realistically have been foreseen by company executives.

While such reinterpretations may be an appropriate response to changing markets or new accounting perspectives, they should be adopted only with advance notice by the regulators together with an opportunity for public comment. Moreover, significant reinterpretations of accounting standards should be applied prospectively, not retroactively, to reduce the number of unnecessary financial restatements that damage companies and confuse investors.

The adoption and amendment of U.S. accounting standards occurs through a formal process led by the Financial Accounting Standards Board. This process, which often takes several years, involves the promulgation of a detailed draft, a lengthy period for public comment and careful decision-making by a board of distinguished members. By contrast, significant changes in interpreting existing accounting standards have episodically been announced through speeches or informal communications by the SEC staff—without any advance notice or public comment.

For example: A speech by the SEC's Chief Accountant, followed by a letter in February of 2005, articulated a significant reinterpretation of the accounting standard for leases. This speech led to a wave of financial restate-

ments by retailers, restaurant chains and other companies with a substantial amount of leased space. Indeed, revisions to lease accounting were the most frequent cause of financial restatements in 2005. Then, all these companies were cited by their auditors for material weaknesses in their internal control systems—because the companies had not previously applied this new perspective on lease accounting.

In 2006, the SEC settled an enforcement case with Fannie Mae based on its misapplication of FAS 133, a standard requiring companies to recognize quarterly changes in the value of derivatives used for hedging. Although Fannie Mae had undoubtedly committed material violations of FAS 133, this standard is so lengthy and complex that there is much debate about its application in many situations.

In settling with Fannie Mae, the SEC included a few sentences about its views on the proper interpretation of certain aspects of FAS 133. This precipi-

tated a round of restatements at other financial institutions.

Over the last decade, the SEC has unilaterally imposed significant reinterpretations of accounting standards by issuing Staff Accounting Bulletins (SABs). Most dramatically, SAB 99 changed the widely accepted practice that the materiality of an accounting error should be judged by a quantitative test—i.e., whether the impact of the error exceeds 5% of a company's net income for the relevant period.

According to SAB 99, even quantitatively immaterial accounting errors should be considered material—and therefore would require a restatement—if they had certain qualitative effects (e.g., they would allow the company to meet analyst earnings consensus or avoid a debt covenant violation). This change alone has led to hundreds of more financial restatements, as explained to me by a former head of the SEC's enforcement division: "I couldn't believe that the staff replaced

years of accounting cases based on the objective 5% test with a subjective approach that had no clear boundaries."

Everyone agrees that financial restatements are necessary to correct errors in applying established accounting standards where the results are material to investors. However, the recent flood of financial restatements includes many that are not actually material to investors, or that flow from new interpretations of existing accounting standards.

Two changes need to be made to restrain this latter category. The SEC should accept the 5% net income test for the materiality of accounting errors. And it should follow the procedures for rulemaking in the Administrative Procedure Act—including advance notice and opportunity for comment—before introducing a significant reinterpretation of any accounting standard.

Mr. Pozen is chairman of MFS Investment Management.

Africa's Poverty Trap

By William R. Easterly

There is a sad law I have noticed in my economics career: the poorer the country, the poorer the economic analysis applied to it. Sub-Saharan Africa, which this month marks the 50th anniversary of its first nation to gain independence, Ghana, bears this out.

There has been progress in many areas over the last 50 years—life-saving drugs, the Internet, air conditioning, Powerpoint slides, the iPod, the acting of Penelope Cruz—yet the same poor economics on sale to Ghana in 1957 are still there today. Economists involved in Africa then and now undervalued free markets, instead coming up with one of the worst ideas ever: state direction by the states least able to direct.

African governments are not the only ones that are bad, but they have ranked low for decades on most international comparisons of corruption, state failure, red tape, lawlessness and dictatorship. Nor is recognizing such bad government "racist"—this would be an insult to the many Africans who risk their lives to protest their own bad governments. Instead, corrupt and mismanaged governments on the continent reflect the unhappy way in which colonizers artificially created most nations, often combining antagonistic ethnicities. Anyway, the results of statist economics by bad states was a near-zero rise in GDP per capita for Ghana, and the same for the average African nation, over the last 50 years.

Why was state intervention considered crucial in 1957? Africa was thought to be in a "poverty trap" since the poor could not save enough to finance investment necessary to growth. Free markets could not get you out of poverty. The response was state-led, aid-financed investment. Alas, these ideas had already failed the laugh test then, as the late economist P.T. Bauer pointed out. The U.S. in 1776 was at the same level as Africa today, yet it escaped the poverty trap. The same was also true for the history of Western Europe, Australia, Japan, New Zealand and Latin America. All of these escapes from poverty happened without a state-led, aid-financed "Big Push."

In the ensuing 50 years, there have been plenty more examples of poor countries which grew rapidly without much aid—China and India (who each receive around half a percent of income in foreign aid) being the most famous recent examples. Meanwhile, aid amounted to 14% of total income year in and year out in the average African country since independence.

Despite these reality checks, blockbuster reports over the last two years by the U.N. Millennium Project (led by Jeffrey Sachs), Mr. Sachs again in his book "The End of Poverty," the U.N. Development Program (UNDP), the Tony Blair Commission for Africa, and the U.N. Conference on Trade and Development (Unctad) have all reached what the UNDP called "a consensus on development": Today Africa needs another Big Push. Do they really think nobody is paying attention?

Africa's poverty trap is well covered in the media, since it features such economists as Angelina Jolie, Madonna, Bono and Brad Pitt. But even Bill Gates, at an appearance at the World Economic Forum in Davos, Switzerland in January 2007, expressed indifference to Africa's stagnant GDP, since "you can't eat GDP." Mr. Gates apparently missed the economics class that listed the components of GDP, such as food.

The World Bank and the International Monetary Fund have good economists who have criticized state intervention. Under the pressure of anti-market activists, alas, they have softened these views lately in favor of African governments producing National Poverty Reduction Strategies to meet U.N.-led Millennium Development Goals by the year 2015. The role of private businesses is to be the subject of bureaucrats' "sustained action." As Kofi Annan explained in a rare U.N. reference to the market, "Success will require sustained action across the entire decade between now and the deadline. . . to grow the small and large businesses able to create the jobs and income needed."

The cowed IMF and the World Bank never mention the words "free market" in thousands of pages devoted to ending poverty. Even the World Bank's

2005 World Development Report "A Better Investment Climate for Everyone" doesn't mention the forbidden words. World Bank economists are so scared of offending anyone on Africa that they recite tautologies. The press release describing the findings of the 2006 World Bank report "Challenges of African Growth" announces: the "single most important reason" for Africa's "lagging position in eradicating poverty," finally "has been identified." It is "Africa's slow and erratic growth." The next World Bank report may reveal that half a dozen beers has been identified as the single most important reason for a six-pack.

Today Unctad (in its 2006 "Big Push" report) still offers to make possible government "infant-industry policies" for "small, fragmented economies" by setting up a regional market, presumably so Burkina Faso and Niger can help absorb the potential output of the Togolese automobile industry. Unctad lacks everything but chutzpah: All aid to Africa, it said, should be moved into a new U.N. Development Fund for Africa, to which Unctad helpfully offered its "in-house experience," by creating a Commission on Aid and Development inside of Unctad. Unctad will thus permit the economics of Africa to at last "escape from ideological biases," so we can finally understand "why economic activity should not be left entirely to market forces."

The free market is no overnight panacea; it is just the gradual engine that ends poverty. African entrepreneurs have shown what they are capable of. They have, for example, launched the world's fastest growing cell phone industry to replace the moribund state landlines. What a tragedy, therefore, that aid agencies have foisted the poorest economics in the world on the poorest people in the world for 50 years. The hopeful sign is that many independent Africans themselves are increasingly learning the economics of how to get rich, rather than of how to stay poor.

Mr. Easterly, professor of economics at New York University, is the author of "The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good" (Penguin, 2006).

Letters

Mississippi's attorney general says that State Farm misled and confused policyholders after Katrina, page A9.

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