Debt Valuation, Public Management and the International Public Sector Accounting Standards

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Good evening ladies and gentlemen,

I want to thank the Hellenic-American CC for the invitation to address this distinguished audience.

I would like to speak about public debt and accounting standards from the perspective of a financial economist. As past financial regulator who has been involved for a long time now in international standard setting in the areas of accounting and auditing, I am a firm proponent of high quality international standards as an indispensable element of the infrastructure for the governance and functioning of global capital markets. My comments are directed to the <u>long-term benefits from the adoption and implementation of high quality standards for the public sector in Greece and elsewhere.</u>

There is a general presumption that fair and accurate financial reporting is an absolute necessity for private firms. Across the world, disclosure and financial transparency are regulated by government. Not only is sound financial reporting necessary for investors; it is also fundamental for the exercise of successful management and value growth.

This general presumption does not carry over to the public sector. In fact, only a minority of governments around the world (although a majority of international institutions – UN, EComm, OECD for example)

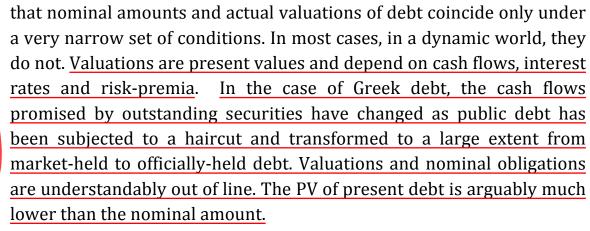
can boast a credible balance sheet, showing the evolution of their assets and liabilities. And yet, the management of public wealth is absolutely critical for national wealth and growth.

Why is there such an asymmetry between private and public-sector accounting? Historically, sovereign power has a lot to do with it. The power to impose taxes and to cancel public debts is part and parcel of public financial history. States are not profit-making entities, nor are they accountable to money-minded shareholders, of course. Their mission is to produce public welfare, and this may require policies that do not maximize public wealth. Hence, some can argue, company-type accounting may not be appropriate or necessary. Although logical-sounding, the argument has a dangerous flip side: political accountability is practically cancelled if accounts are opaque. Loose political language and vague promises can thrive with bad accounting but cannot survive with fair and transparent accounting, which has inter-temporal consistency.

In today's world, especially for small countries, sovereignty is restricted and public finance is subjected to market discipline and in cases such as ours in Greece, to external official strictures as well.

A <u>clear conclusion emerges</u>: We should support the introduction of accrual accounting and the application of high quality accounting standards to our public sector. This will furnish high quality information to those who participate in the sovereign security markets and who engage in valuations. From a more systemic viewpoint, an upgrade in the quality of information relative to public net worth is sorely needed for reduced reliance on credit-ratings and stability in sovereign debt markets as a whole.

All of us know that policymaking, internationally and in the EU, is based on the famous ratio of public debt to GDP. This is the ratio of the **nominal amount of gross public debt to GDP.** Basic finance teaches



Consider a simple example. Suppose two governments have each issued nominal debt of 100 million euros. One has a 5-year horizon and coupons that are exactly equal to current market rates. Its value at issue will be approximately the nominal value of 100 million. The other has a thirty-year horizon and coupons that are fixed at half the current market rates. Its value will be somewhere between 40 and 60 % of the nominal amount. Yet, the ratio of nominal debt to GDP will be the same and macroeconomic rankings will be similar.

At times of market calm, relatively stable interest rate structures and low or non-existent risk perceptions, present values are fairly well approximated by nominal values. At times of uncertainty and crisis, nominal values get out of line from present values, but market valuations, on the other hand, experience wild gyrations around the theoretical present values themselves. The temptation to find an 'anchor' at nominal values is admittedly strong, at those times.

Two common methods attempt to correct nominal values: (A) sustainability models that include macroeconomic dynamics, (B) credit rating models which attempt to quantify risk factors. These exercises are of value but are information-constrained. The lack of credible net wealth figures for the issuer of a sovereign security creates a large space for assumption and guesswork that undercuts the accuracy and stability of valuations.



I have seen a vicious circle at work: Because of the limited financial information provided by governments, market values become volatile and less reliable at times of crisis. This strengthens the use of nominal values, as a safe refuge for beleaguered policymakers. But the use of nominal values is information constrained, as I argued, and feeds back to volatility and unreliability of market values.

The way out is to cut the Gordian knot and jump to a system of value-based transparency and sound financial reporting by government which will enable four things: (a) better management, (b) higher quality of investor information and less reliance on Credit Ratings, (c) more realistic policy based on a more accurate valuation of debt, and (d) sounder democratic accountability and a more fact-based political debate. This system already exists as an authoritative body of standards: the IPSAS. Their adoption and implementation can produce better functioning government, better functioning markets and better functioning democracy.