PREDICTING THE FUTURE
THE NEW ROLE OF THE SUPREME AUDIT INSTITUTIONS

Introduction

The Supreme Audit Institutions have a new role: to predict the financial future. Before the fiscal crisis, their core business was limited to assess accounts describing events of the past. The fiscal crisis has revealed that this was not enough. Reliable are not the governmental accounts which are just true. They should also provide a fair view on the financial position of the government. They should inform on financial and systemic risks which threaten the reporting entity. To review the correctness of that kind of information, Supreme Audit Institutions have to be able to make their own projections to the future. They should foresee upcoming fiscal crisis and appropriately inform State authorities and the public on that.

I

In our days full sovereignty of a State means its capacity to borrow from the markets at a sustainable rate.

When a sovereign debt arrives at its maturity national governments don't tax their citizens in order to pay it back fully. They just contract with investors a new load using as intermediaries private financial institutions, the so called financial markets. That kind of operation is internally of purely accounting nature, should the interest rate of the new load be the same or almost the same as the previous one. But, if the financial markets start to doubt on the ability of the government to pay back its debt, they require to be compensated for the risk taken with higher interest rates. Interest rates become too high when the borrowing government feels that fulfilling its debt obligations will become unsustainable by continuing contracting loans.

This was exactly Greece's situation in April 2010, when the country became unable to continue refinancing its debt at a sustainable way. During October 2009 information coming out from Greece indicated that the foreseen budget deficit for the current year would be multiplied by four and, furthermore, that suspicions of financial data misreporting were confirmed. Greece had already constant macroeconomic imbalances, a huge sovereign debt, and a political tradition of lax economic policies. The only positive element in the picture was Greece's economic growth amounting to an average 4% for the last decade. However, reports indicated that for 2009 a recession was probable. Bad figures and mistrust were enough for the financial markets to react violently. From October 2009 to spring 2010, borrowing cost for refinancing Greek debt rocketed sky high. Rejected by the private investors, the country had to be bail-out by Euro-zone member States and the International Monetary Fund submitting itself to a tough re-adjustment program.

The lesson learned from the Greek experience is that, generally speaking, national governments are not only accountable to their Parliament for the fiscal policies they are running, but also to the financial markets, especially when governments are under economic distress.

II

Financial markets have a broader notion of sustainability of State's finances, including systemic risks and macroeconomic imbalances.

This is exactly the lesson learned from the Irish experience, very different from the Greek one at its origins, which led however to the same results.

The Irish government had no deficit in 2007 and no big ratio in its public debt. There were no problems with complex derivatives or shadow banking systems as in the United States. It appears that Ireland's only reason to become hard hit by the crisis was that during the previous decade, the country had turned into a nation of property developers. The Irish construction industry had swollen to become nearly a quarter of Irish GDP compared to less than 10% in normal economy. Ireland's fall began when property prices started falling in 2006-2007 and it continued with the crash of shares in Irish Banks. The Irish government was about to guarantee all the obligations of the six biggest Irish Banks. This decision transformed the banking crisis into a sovereign debt crisis with a big rise in Irish borrowing costs and culminated in Ireland's acceptance of a bail-out from the EU and IMF in November 2010.

The Irish case made evident the limits of assessing sound financial management on the basis of data such as public deficit, debt as a percentage of GDP and inflation rate. From a limited financial perspective, Irish fiscal management was sound. However, serious macroeconomic imbalances had appeared in the Irish economy from the middle of the past decade and public audit mechanisms proved themselves unable to anticipate the risk on fiscal policy which these imbalances presented.

Economies like those of Ireland, Spain and Cyprus have faced or are still facing serious fiscal problems because public authorities, and among them Supreme Audit Institutions, had failed to foresee the contamination effect of unhealthy banks to fiscal management.

III

Financial markets pay close attention when assessing the soundness of fiscal policies on one basic criterion: the ability of a State to pay its bills back in the near and remote future.

This criterion changes fundamentally the way we perceived accountability of State managers until now. In our democratic societies, governments were accountable to the Parliament for the execution of the budget the latter had voted, and, in order to obtain discharge for their management, they had to prove after the end of a fiscal year that their management had been made legally and had produced the expected results.

Financial markets care mainly about the future. They are sensitive to any kind of risk which may affect the reimbursement capacity of a State. Every time a State comes to the markets to ask them for loans a vote of confidence of the markets toward this State takes place. Trust or mistrust is reflected on the borrowing costs.

Accountability in public financial management is now understood in the context of the influence financial markets have on the sovereign states' daily life. Accountability includes now not only what is used to mean under our democratic traditions but also fiscal responsibility vis-à-vis the financial markets if and when national States need their money.

IV

The recent developments, as described above, redefine the role of State's financial management. The central idea of the new system of organization is that of control.

Control in the sense of the pilot of a plane who must have control of it. Establishing a management system which guarantees the control of public finances by the government means putting in place as in the pilot's cabin, an instrument panel where all the significant data appear in real time and the control levers permit the solving of solving in due time. At any given time, each autonomous element of the system and the system as a whole must be able of demonstrating, if so required, that the risks to which they are exposed are under control. A government which does not have such an instrument panel at its disposal does not master the situation.

The Greek financial crisis is mainly due to the lack of an effective internal control system allowing the Government to pilot the country out of turbulence zone.

The level for the Greek public deficit for 2009 is a striking example of this lack of control. Here are four figures for comparison. By April 2009, the expected public deficit in Greece for 2009 was calculated at 3.7% of GDP. Just after the parliamentary elections held in October of the same year the Greek government announced a revised public deficit at 12.5% of GDP. By April 2010 the European Commission established the deficit for 2009 at 13.6%, and this figure was again revised in November 2010 to 15.4% of GDP.

These figures indicate that the Greek government was not sufficiently able to get correct financial information and consequently to measure the real impact of its decisions. The government was not in full position to identify at first, and then to avoid or mitigate the risks related to the reporting of the deficit figures. As it has been said above, the mistrust of the markets towards Greece's public financial management started when the real deficit figures were revealed.

V

The above define the challenges Supreme Audit Institutions are facing in order to maintain relevance within the new economic landscape the crisis has shaped. Their institutional relevance should now on pass a very simple test: are they able to foresee and therefore to appropriately inform public authorities on financial and systemic risks which threaten governmental fiscal sustainability?

The most appropriate reporting vehicle by which modern government may demonstrate that it is controlling the financial and systemic risks is the State's annual balance sheet. The balance sheet is a table containing the State's assets and liabilities. Should assets and liabilities be reported in their historical value, the table is financially unhelpful. Only if it incorporates information on potential risks and opportunities, the State's balance sheet becomes the central informer on the financial soundness of a country.

Look for example to the Greek State balance sheet how it mirrors all big problems the national government deals with: in its assets table, tax collection inefficiency, and public property selling delays; in its liabilities table, huge public debt, and systemic risks from areas such as social security, banking or health care and local governments.

Transparency which first and foremost is an essential democratic value should be fully respected when balance sheet is drafted. Data which are intentionally complex so that they hinder, from an intellectual point of view, access to them are not transparent. Complexity and opacity in the balance sheet create doubts, lack of information or incomplete information fuel catastrophic rumors.

Dealing with uncertainty, processing to risk assessment in order to evaluate the price of an asset poses serious challenges to the auditing function. To assess fiscal sustainability of a fiscal entity it is necessary to proceed to complex investigations on the macroeconomic vulnerability of the entity and the systemic risks which surround it, while making difficult projections of future financial positions. Transparency in this case is, from an auditors point of view, the completeness and the reliability of the data provided in the balance sheet and above all the plausibility of the financial projections made on the fiscal sustainability of the country.

Predicting the future for the Supreme Audit Institutions means precisely to look deep in the State's annual balance sheet to identify not only inaccuracies but also weaknesses in the projections made.