SAVING EUROPE

Improving Your Financial Literacy of an EU Total Government Balance Sheet Framework Can Help Save Europe from Financial Ruin

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Guest Lecture for ISCTE-IUL Professor Sofia Vale

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ISCTE IUL Instituto Universitário de Lisboa

ISCTE Business School INSTITUTO UNIVERSITÁRIO DE LISBOA

IPPS ISCTE Public & Nonprofit Education

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Highlights from Day One (1 of 5): Discovered Systemic Misconceptions

- Governments do not have balance sheets (“it’s illegal”).
- Governments do not have a Net Worth.
- You cannot subtract a stock (balance sheet net debts) from a flow (GDP).
- Statistics provide information comparable to audited government financial statements.

Highlights from Day One (2 of 5): CEPS Task Force Report Overview Metrics: Breaking Silos to Create Extraordinary Value

- **Task Force Members**: 48
- **Length of time to produce report:** 3 years, 10 months
- **# of countries represented:** 20
- **Multi-disciplinary professional sectors represented:** 16 (Accountants, auditors, business executives, central bankers, development bankers, economists, historians, investors, finance ministries, media, NGO executives, political advisors, rating agencies, regulators, statisticians, treasury officials)
- **Task Force Report Pages:** 47

URGENT

RESEARCH REPORT

Thinking ahead for Europe

No. 2019/10, March 2019

Beyond Public Debt

The Hidden Rapid Erosion of EU Government Balance Sheets is a Financial Threat to Society

How to stop it

Authors: Jorge Núñez Ferrer and Roberto Musmeci

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CEPS Task Force Report: "Beyond Public Debt: The Hidden Rapid Erosion of EU Government Balance Sheets is a Financial Threat to Society. How to stop it."

- Overview: https://www.ceps.eu/publications/beyond-public-debt
- Preview Video: https://youtu.be/S2-IckvU1c0
- Commentary: https://www.ceps.eu/publications/beyond-public-debt-commentary
- Task Force Report: https://www.ceps.eu/system/files/Beyond%20Public%20Debt_0.pdf

How to Stop It

- There is no quick fix.
- There is a deep lack of *trust* in the Eurozone due to the track-records of member states.
- Public expenditures are not all "investments" nor do they all have a positive impact on the economy, which can be seen in the Citizens' Wealth losses despite the large net liability increases.
- Broad brush austerity has not been "the" answer, but the one available due to the lack of transparency and responsible public financial management.
- Adequate public financial management and public accounting standards can lead to value creation, and a fiscal space capable of reducing the burden for the motors of the economy.
- Reforms are not only essential for the EU, but also crucial for the single member states. These reforms are a national priority.

Highlights from Day One (3 of 5): Portugal Key Metrics

- Citizens' Wealth (2015): **-€11,359** per citizen
- Total Government Net Debts (Burden) (2015): **€30,100** per citizen
- Citizens' Wealth – simplified (2017): **-€1,517** per citizen
- Change in Citizens' Wealth – simplified (2000-2017): **-€8,823** per citizen

Highlights from Day One (4 of 5): Benefits of Citizens' Wealth Ratio

Citizens' Wealth:

1. Provides insights into total economy results from government decisions. Governments claim success for GDP growth but should be offset by total government net debts (burden) placed on its citizens.
2. Brings together accounting and economic information to provide new insight (breaking silos).
3. Provides comparisons over time.
4. Provides comparisons to projections.
5. Provides comparisons among countries.
6. Uses the Total Government Balance Sheet.
7. Keeps focus on government performance and avoids distractions.

Total Government Net Debts ("Burden"):

1. Measures and reports the currently hidden 70% of the assets and liabilities under government stewardship.
2. Potential to improve return on assets generating more revenue without taxation.
3. Potential to reduce the hidden future liabilities resulting from government decisions.
4. Potential to reduce the impact of recurring economic downcycles.
5. Increase key stakeholder (voters, investors, etc.) trust and confidence in governments.

Highlights from Day One (5 of 5): Citizens' Wealth Formulas

- **Using Total Government Balance Sheet:** Total economy GDP per citizen less Total Government Net Debts per citizen or plus Government Net Worth per citizen.
- **Simplified:** Total economy GDP per citizen less Government Net Financial Debt (Government Financial Debt less Government Financial Assets) per citizen.

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Since 2002, there has been a massive destruction of the EU Bottom 5 worst performing government balance sheets <u>hidden from the public</u> with minimal economic growth.

An obsessive focus on debt and cash deficit framework is enabling financial ruin in the EU Bottom 5, which includes France, Greece, Italy, Portugal, and Spain.

Improving Your Financial Literacy of Total Government Balance Sheets Provides a Framework to Reverse the Financial Destruction and Save Europe from Financial Ruin

Total Assets − Total Debts = Total Government Net Debts ("Burden")

Total Government Net Debts ("Burden")
is also known as Net Worth or Net Liabilities or
Taxpayer's Equity or Net Position

With the Obsessive Focus on Debt and Cash Deficit, Almost 3/4 (€16 Trillion) of EU Bottom 5 Government Assets and Debts are Hidden from Public Management

(31 December 2017; €, trillions)

SN	Balance Sheet Item	Amount	% of Total Assets and Debts Combined
1.	Financial Assets	€ 1.6	7%
2.	Non-Financial Assets	€ 3.8	17%
3.	Total Assets	€ 5.4	24%
4.	Financial Debts	€ 6.2	28%
5.	Non-Financial Debts	€ 10.7	48%
6.	Total Debts	€ 16.9	76%
7.	Total Government Net Debts	**(11.5)**	100%

Note: Balance sheet financial information based on KCPFM research and government financial statement, EC AMECO, Eurostat, and IMF sources.

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These Indicators Provide a Framework to Improve Your Financial Literacy of an EU Total Government Balance Sheet

- Compare EU Bottom 5 with EU Top 23 and EU 28
- Changes over time, especially from 2002 to 2017
- Per Citizen
- Formulaic relationships with balance sheet line items, GDP, and population
- As a percentage of gross domestic product (GDP)

Total Government Balance Sheets - 2002 and 2017: EU 28, EU Bottom 5*, EU Top 23

(€, Trillions)

	EU 28 Total	EU Bottom 5*	EU Top 23
	2017	**2017**	**2017**
Financial Assets	€ 4.9	€ 1.6	€ 3.3
Non-Financial Assets	€ 11.1	€ 3.8	€ 7.3
Total Assets	€ 16.0	€ 5.4	€ 10.6
Financial Debts	€ 12.7	€ 6.2	€ 6.5
Non-Financial Debts	€ 18.3	€ 10.7	€ 7.6
Total Debts	€ 31.0	€ 16.9	€ 14.1
Total Government Net Debts	**(15.0)**	**(11.5)**	**(3.5)**
	2002	**2002**	**2002**
Financial Assets	€ 2.2	€ 0.8	€ 1.4
Non-Financial Assets	€ 8.3	€ 3.3	€ 5.0
Total Assets	€ 10.5	€ 4.1	€ 6.4
Financial Debts	€ 6.1	€ 3.0	€ 3.1
Non-Financial Debts	€ 10.0	€ 5.6	€ 4.4
Total Debts	€ 16.1	€ 8.6	€ 7.5
Total Government Net Debts	**(5.6)**	**(4.5)**	**(1.1)**

*EU Bottom 5 includes France, Greece, Italy, Portugal, and Spain.

Note: Balance sheet financial information based on KCPFM research and government financial statement, EC AMECO, Eurostat, and IMF sources.

Government Balance Sheet Indicators - Change Per Citizen from 2002 to 2017: EU Bottom 5 vs. EU Top 23

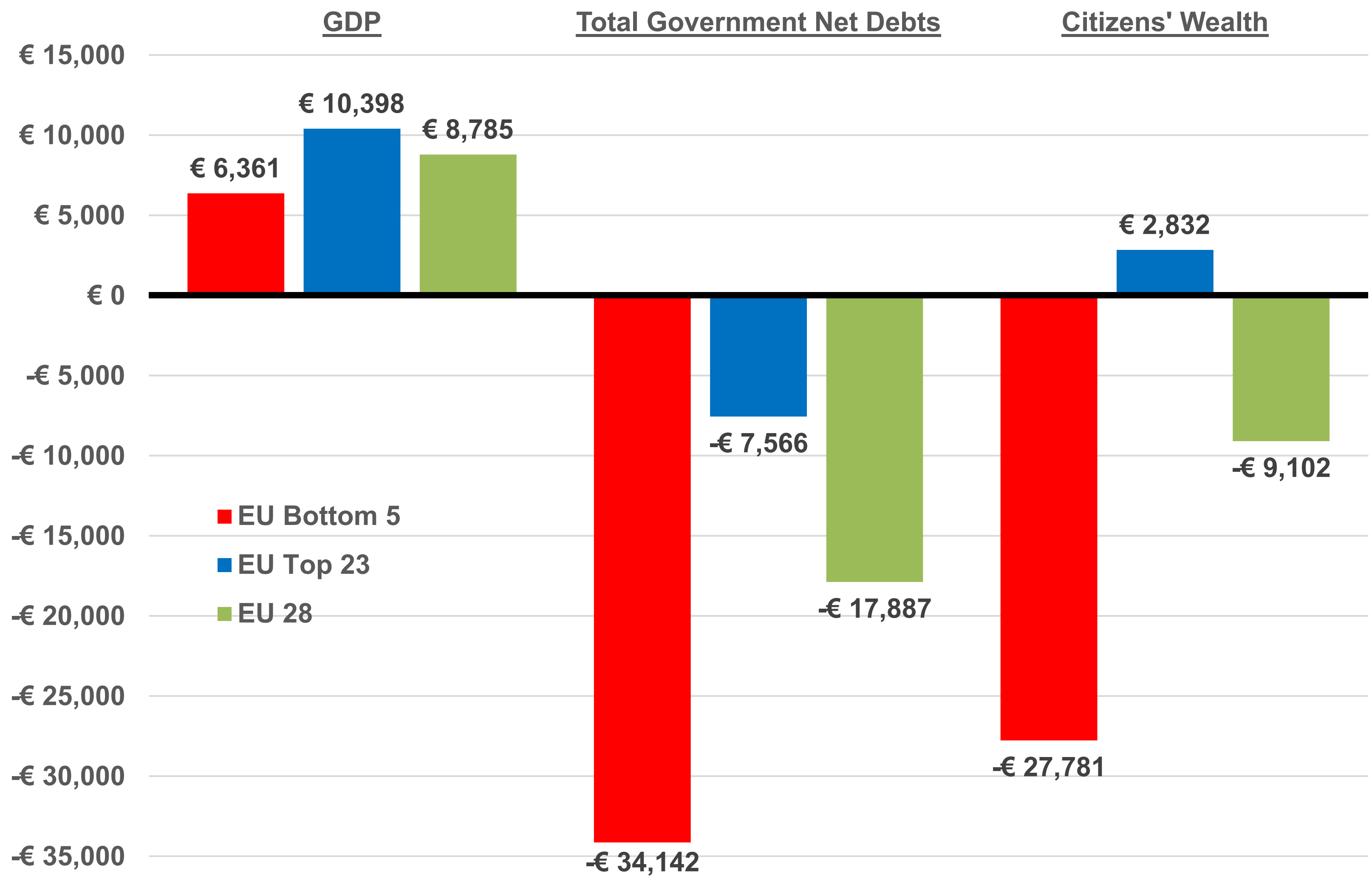
(Per Citizen Data)

		Change from 2002 to 2017	
		EU Bottom 5	**EU Top 23**
1.	GDP	€ 6,361	€ 10,398
2.	GDP (ex-Inflation)	€ 1,087	€ 5,794
3.	Government Debt	€ 15,558	€ 10,411
4.	Government Net Debt	€ 11,797	€ 4,560
5.	Total Government Net Debts	-€ 34,142	-€ 7,566
6.	Citizens' Wealth (Simplified)	-€ 5,436	€ 5,838
7.	Citizens' Wealth (Total Gov't Balance Sheet)	-€ 27,781	€ 2,832
8.	Fiscal Multiplier (Simplified)	54% (46%)	228% (0%)
9.	Fiscal Multiplier (Total Gov't Balance Sheet)	19% (81%)	137% (0%)
10.	ROA	-10%	-5%

Note: Balance sheet financial information based on KCPFM research and government financial statement, EC AMECO, Eurostat, and IMF sources. Fiscal Multiplier is change in GDP over change in net debt or net liabilities.

Important to Your Financial Literacy to Understand the Difference Between the Citizens' Wealth of the EU Bottom 5, EU Top 23, and EU 28

(Change per Citizen from 2002 to 2017)



Note: Balance sheet financial information based on KCPFM research and government financial statement, EC AMECO, Eurostat, and IMF sources.

Sharing the Increase in Total Government Net Debts Per Citizen of the EU Bottom 5 Governments Since 2002 with the EU Top 23 Citizens Reverses the Positive Increase of Citizens’ Wealth in the EU Top 23 to a Negative Citizens’ Wealth by a Reduction of €11,934

	Citizens' Wealth (Total Gov't Balance Sheet)		
Net GDP	**2002**	**2017**	**Change**
EU Top 23	€ 17,345	€ 20,177	€ 2,832
EU Bottom 5	(€ 2,643)	(€ 30,424)	(€ 27,781)
EU 28 Total	€ 9,882	€ 780	(€ 9,102)
EU Top 23 Loss From Combination			**(€ 11,934)**

*EU Bottom 5 includes France, Greece, Italy, Portugal, and Spain.

Note: Balance sheet financial information based on KCPFM research and government financial statement, EC AMECO, Eurostat, and IMF sources.

Money in the Bin: Impact of Mismanagement of Bottom 5 EU Government Balance Sheets on the Total EU 28 - Value Created and Destroyed: 2002 – 2017 Change

EU 28 Liabilities increase:
€14.9 trillion
(€8.3T for EU Bottom 5
€ 6.6T for EU Top 23)

EU 28 Value change

EU 28 Result:
<u>49 cents per € created</u>
<u>51 cents per € destroyed</u>
Net GDP: (€4.6T)

EU Top 23 value change

EU Bottom 5 value change

EU Bottom 5 Result:
19 cents per € created
81 cents per € destroyed
Net GDP: (€5.5T)

EU Top 23 Result:
137 cents per € created
0 cents per € destroyed
Net GDP: €898 billion

EU, EU Bottom 5, EU Top 23 Government Balance Sheets: 2002 and 2017

(Percent of GDP except GDP in €, trillions)

	EU Total	EU Bottom 5	EU Top 23
	2017	**2017**	**2017**
Financial Assets	32%	29%	33%
Non-Financial Assets	72%	69%	74%
Total Assets	104%	98%	107%
Financial Debts	82%	113%	66%
Non-Financial Debts	119%	195%	77%
Total Debts	201%	307%	142%
Total Government Net Debts	**-97%**	**-209%**	**-35%**
GDP	€ 15.4	€ 5.5	€ 9.9
Population	512,500,000	195,300,000	317,200,000
	2002	**2002**	**2002**
Financial Assets	21%	20%	22%
Non-Financial Assets	80%	83%	79%
Total Assets	101%	103%	101%
Financial Debts	59%	75%	48%
Non-Financial Debts	96%	140%	69%
Total Debts	155%	215%	117%
Total Government Net Debts	**-54%**	**-113%**	**-17%**
GDP	€ 10.4	€ 4.0	€ 6.4
Population	489,100,000	181,600,000	307,500,000

Note: Balance sheet financial information based on KCPFM research and government financial statement, EC AMECO, Eurostat, and IMF sources.

The Population of the EU Bottom 5 is Only 38% of the Total EU, but Accounts for 77% of the Total Government Net Debts ("Burden"), Imposing Over Five Times the "Burden" on Their Citizens

	Population		Total Government Net Debts ("Burden")		Per Citizen Total Gov't Net Debts ("Burden")
	Amount	**% of EU Total**	**Amount**	**% of EU Total**	
			(€, Trillions)		
EU Top 23	317,200,000	62%	€ 3.5	23%	€ 11,034
EU Bottom 5	195,300,000	**38%**	€ 11.5	**77%**	€ 58,884
EU Total	512,500,000	100%	€ 15.0	100%	€ 29,268
EU Bottom 5 / EU Top 23					**5.3X**

*EU Bottom 5 includes France, Greece, Italy, Portugal, and Spain.

Note: Balance sheet financial information based on KCPFM research and government financial statement, EC AMECO, Eurostat, and IMF sources.

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Summary: Understanding the Destruction of EU Bottom 5 Government Balance Sheets since 2002 by the Numbers

1. EU Bottom 5 governments have added a massive burden of €34,142 in net debts (total assets less total debts) for every man, woman, and child. At year end 2017, each citizen is now burdened with €58,786 in government net debts.
2. By comparison, GDP increased only €6,361 per citizen (1.7% annually) and adjusted for inflation has almost insignificantly grown by €1,087 per citizen since 2002.
3. Citizens' Wealth has decreased in the EU Bottom 5 by €27,781 and increased in the EU Top 23 by €2,832.
4. For every one euro addition in government net debts ("burden"), citizens saw only 19 cents increase in GDP, which means citizens suffered 81 cents in value destruction for each one euro addition in total government net debts.
5. Total government net debts as % of GDP have deteriorated by almost double to 209% from 113%.

EU Bottom 5 includes France, Greece, Italy, Portugal, and Spain.

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Examples of the Consequences of the Destruction of EU Bottom 5 Government Balance Sheets

- Dilapidated government infrastructure including: bridges, buildings, and roads.
- Large increases in opaque government debts such as the current value of government employee legally contractual pension obligations.
- Government assets sold to private investors who have earned above risk adjusted market returns (e.g. sale-and-leasebacks and concessions).
- Recurring explosion of hidden government liability guarantees (e.g. indemnification on assets sold).
- Value destruction not value creation in government expenditures (e.g. day one asset impairment and penalty interest on overdue payables).
- Very little economic growth relative to the burden of increasing net debts for citizens.

EU Bottom 5 includes France, Greece, Italy, Portugal, and Spain.

Characteristics of Recent Sovereign Debt Exchanges Through 2012

A new world in sovereign bond investing after Greek debt exchange loss that is 4x larger than all other debt exchanges combined and 81% of total loss.

Issuer	Transaction Year	Original claims, $ billions	Present Value loss	Dollars lost, $ billions	Losses as % of total	Participation rate	
Greece	2012	271.3	77%	208.9	81%	97%	*(a)*
Argentina	2005	60.6	73%	44.2	17.1%	76%	*(a)*
Seychelles	2010	0.3	56%	0.2	0.1%	84%	
Cote d'Ivoire	2010	2.9	55%	1.6	0.6%	99%	
Dominica	2004	0.1	54%	0.1	0.0%	72%	
Ecuador	2000	6.7	38%	2.5	1.0%	98%	
Moldova	2002	0.0	37%	0.0	0.0%	100%	
Grenada	2005	0.2	34%	0.1	0.0%	97%	
Belize	2007	0.5	24%	0.1	0.0%	98%	
Ukraine	2000	1.6	18%	0.3	0.1%	97%	
Pakistan	1999	0.6	15%	0.1	0.0%	99%	
Uruguay	2003	3.1	10%	0.3	0.1%	93%	
Dominican Rep.	2005	1.1	5%	0.1	0.0%	94%	
Subtotal		**77.9**	**64%**	**49.6**			
Total		**349.2**	**74%**	**258.5**			

Source: Kopf "Sovereign Debt Restructuring: Lessons from History" - page 158
Note: (a) PV Loss and Dollars Lost are IB consensus. Table does not include Venezuela 2017 default on approximately $65 billion and Puerto Rico on approximately $70 billion.

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600 Years of History Teaches Us that Governments Managing with a Proper Balance Sheet have an Important Role in the Financial Rise and Fall of Nations

Professor Jacob Soll, author of “The Reckoning: Financial Accountability and the Rise and Fall of Nations”, conclusions from studying the past 600 years of European government finance and accounting:

1. Good accounting and good financial management of government finances go hand in hand with the financial rise and fall of nations.
2. Government financial declines are preceded by denial of government balance sheet destruction.
3. With only rare exceptions, good management of a government’s balance sheet requires a major financial crisis.
4. European and US greatest financial administrators (Jacques Necker, Jean-Baptiste Colbert, William Pitt, and Alexander Hamilton) knew the importance of managing a government balance sheet and double entry accounting.

Euro Area Government Bond Collective Action Clauses (CACs): Consequence is Financial Ruin for Investors

- Since 2013, the EC has mandated investor hostile collective actions clauses (CACs) in all euro area government bonds.
- Each new issue of government bonds contains the updated CACs.
- As currently written, in certain circumstances 51% of the bond holders can agree to change the terms of the bonds and substantially reduce the bond obligation value.
- The changes can include reducing the amount due at maturity, cutting the interest rate, and extending the maturity.
- And, as currently written, government affiliated bondholders are not prohibited from voting.
- **<u>By 2020</u>, most euro area government bonds will contain the updated CACs and offer a legal option to reduce government debt.**
- On 4 December 2018, Euro zone finance ministers led by Mario Centeno announced an agreement to include single limb CACs by 2022.

Using the Balance Sheet Framework to Determine the Haircut Percentage on Bottom EU Government Bonds in a Single Limb Debt Restructuring

- In a single limb EU government bond restructuring, the government will need to destroy investor value and transfer investor wealth to the government, which is effectively another form of taxation.
- Once any one of the larger EU bottom 5 invoke the single limb debt restructuring, other governments will follow.
- The process will move to calculating the relative level of value destruction to impose on each country's bondholders.
- With history as a guide, when governments begin to anticipate a restructuring, the increase in debt to be defaulted upon accelerates.
- Understanding the government balance sheet (its financial position) will provide the best framework to navigate the highly complex process, which will be--by a large multiple--the largest government debt haircut in history, and, correspondingly destroy the largest amount of government bond investor money in history.
- Bloomberg (4 December 2018): Sovereign debt write downs draw closer in Franco-German Plan.

EU Governments Building Cash Buffers: Warning Bells of Pending Debt Restructuring

- Historical experience is that strategic defaulters seek to borrow to build cash buffers prior to debt restructurings as the debt has negative costs given that the expectation is to pay back only a fraction.
- Eurogroup (3 December 2018): Building buffers is needed at the current juncture.
- IMF Article IV on Euro Area (25 July 2018): High debt countries should take advantage of remaining window to rebuild buffers.
- ESM (3 December 2018): Support needed for high debt countries to build cash buffers.

Observations on Pending Sovereign Debt Defaults

- Not a question of “if” but “when” EU governments will restructure.
- Even after initial debt write downs, given that non-financial debts are twice the size of financial debts (liabilities) and dilapidated state of non-financial assets, there is a high risk of serial defaults unless governments begin to actively manage their full balance sheets.
- Europe’s required use of CACs is spreading to other sovereign issuers and may increase risk and raise yields on sovereign bonds globally.
- Once an EU Bottom 5 default occurs, there is an even greater likelihood of global debt default contagion further increasing risk and raising yields on sovereign bonds globally.
- EU Bottom 5 risk becoming similar to emerging market serial defaulters.

EU Bottom 5 Interest Rate Increase Exposure

(€, Billions)

Interest expense increase will have an accelerating impact as more debt matures and interest compounds.

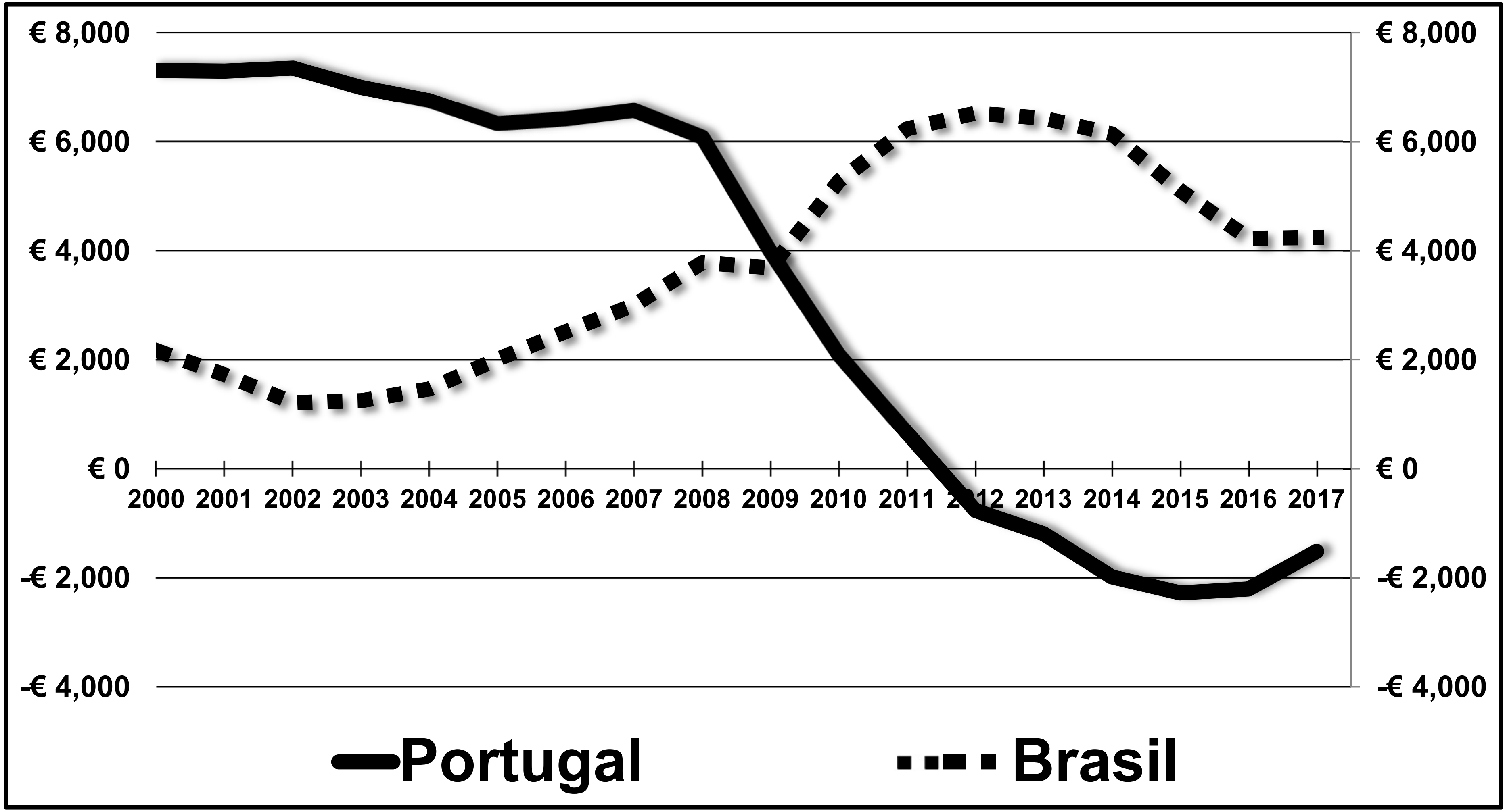
Assumptions:								
Net Debt/GDP:		55%		Government Primary Expenditures as % of GDP:				46%
Current Average Interest Rate:		3%		Projected GDP Annual Growth				2%
			Current	**2019**	**2020**	**2021**	**2022**	**2023**
Baseline Scenario (Estimated Average EU Bottom Quartile):								
GDP			€ 800	€ 816	€ 832	€ 849	€ 866	€ 883
Government Expenditures			€ 368	€ 375	€ 383	€ 391	€ 398	€ 406
Net Debt			€ 440	€ 449	€ 458	€ 467	€ 476	€ 486
Interest Expense			€ 13.2	€ 13.5	€ 13.7	€ 14.0	€ 14.3	€ 14.6
Interest Expense as % of Govt Exp.			4%	4%	4%	4%	4%	4%
Interest Rate Increase Scenarios:								
Interest Rate Increase By:		To:						
	1%	4%	€ 17.6	€ 18.0	€ 18.3	€ 18.7	€ 19.1	€ 19.4
	2%	5%	€ 22.0	€ 22.4	€ 22.9	€ 23.3	€ 23.8	€ 24.3
	3%	6%	€ 26.4	€ 26.9	€ 27.5	€ 28.0	€ 28.6	€ 29.1
	4%	7%	€ 30.8	€ 31.4	€ 32.0	€ 32.7	€ 33.3	€ 34.0
Necessary Reduction in Other Govt Exp.			1.2%	1.2%	1.2%	1.2%	1.2%	1.2%
			2.4%	2.4%	2.4%	2.4%	2.4%	2.4%
			3.6%	3.6%	3.6%	3.6%	3.6%	3.6%
			4.8%	4.8%	4.8%	4.8%	4.8%	4.8%

Showing How Quickly Government Financial Position Can Change, in Only Four Years (2013 to 2017), Greece Government Net Debt Increased from 62 Percentage Points Lower than Peer Average to a Slim Five Percentage Points Lower

	Greece	Peer Average	Greece vs. Peer Average
Debt as % of GDP			
2013	68%	113%	**-45%**
2017	103%	102%	**1%**
Change	35%	-11%	
Net Debt as % of GDP			
2013	18%	80%	**-62%**
2017	71%	76%	**-5%**
Change	**53%**	**-4%**	
Fiscal Balance			
2017 (As Reported)	0.8%		
2017 (Including Debt Accretion)	0.0%		

Notes: Peers include Ireland, Italy, Portugal, and Spain. Balance sheet debt calculated according to international accounting standards based on KCPFM research and EC AMECO (accessed 4 Dec 2018) and Eurostat (accessed 31 Oct 2018) databases.

Citizens' Wealth* (per citizen): Portugal vs. Brazil



*Simplified.

Notes: Data from IMF WEO database (April 2018) accessed 27 August 2018. Data in euros for comparative purposes.

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