AUDIT: an essential tool to prove the origins and causes of the current "debt" crises in the United States and Europe

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1. The origins and the essence of the current financial crisis

The recent debt crisis in the United States of America, as well as some new findings about the current economic problems in European countries, threw open the encroachment of the instrument of public debt and its use in benefit of banking financial system.

First of all, it's necessary to enlighten the fact that public debt hasn't any kind of inherent evil. Actually, it should be an important instrument of financing state programmes, which is in the basis of the allowance for the governments to contract debts; obviously, under certain limits and conditions. The loans should serve to get funds that, in association with those raised through taxes, would be destined to the country to carry out its role in benefit of its people.

Although, many studies, audits and inquiries have already unveiled that instead of contributing to advances in public policies, significant amounts registered as public debt do not correspond to money collected through loans to the country. Besides that, the largest part of sovereign debt is being used to pay interests and amortizations of previous debt whose counterpart is not publicly known.

The essential problem, as it can be easily detected, is that the instrument of public indebtedness is being converted in a means for a kind of embezzlement of public resources. Because of the lack of transparency in these processes and the great amount of privileges - both in legal and financial areas with many ramifications – we can say this scheme works like a *debt system* and function in benefit of a restricted part of the financial markets.

The "Debt-System" is a very profitable business. The financial private system is a complex of agents with a series of privileges in legal, political, financial and economic aspects. These agents are large corporations leaded by banks and powerful rating agencies.

In the United States of America, this system operated, recently, to rescue banks from the imminent risk of bankruptcy. The dimension of this rescue was unveiled in July 21st, by Senator Bernie Sander[ii], who showed up the result of the audit realized by the Government Accountability Office[iii]. This report proved that the Federal Reserve Bank (FED) spent about US$ 16 trillion dollars with the bail-out, directly transferred to banks and large corporations under interest rates near zero, between December 2007 and June 2010.

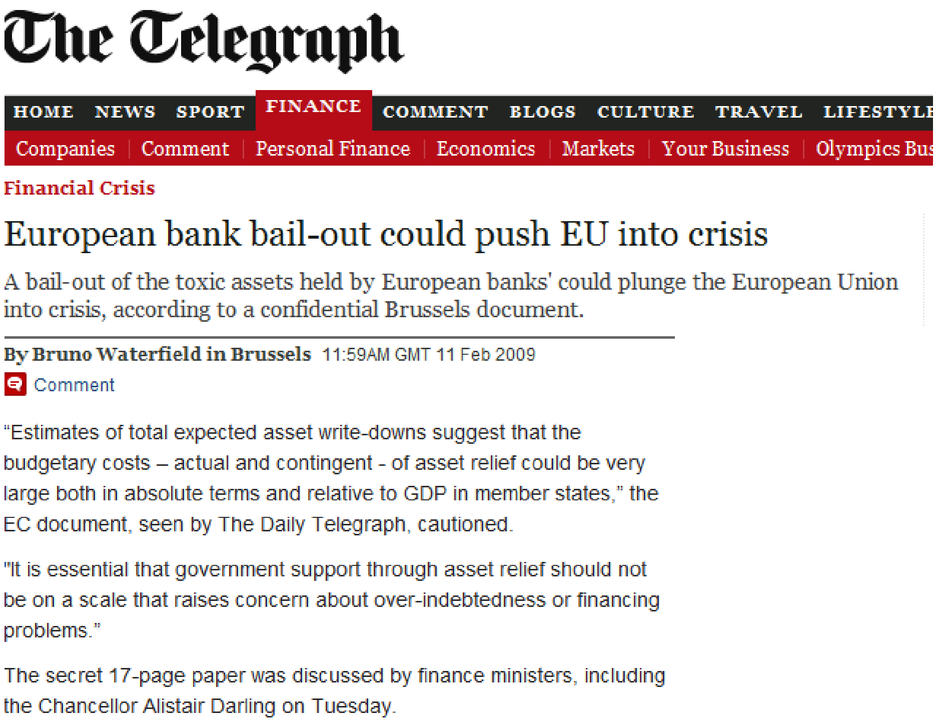
The revelation of this governmental audit report can be one of the most relevant examples of the privilege of the financial sector: the crisis of this sector was the first step towards the current "sovereign" debt crisis not only in the United States, but also in many European countries. The sum given by the FED to bail-out institutions is higher than the global amount of public debt in USA (currently estimated in US$ 14.5 trillion dollars) and than the GNP (US$ 14.3 trillion in 2010).

The audit of this operation must persist, because it can be related to the conversion of huge private debts into public debt. The main receivers of the sum given by the FED specified on the report are summarized below:

Citigroup: **$2.5 trillion** ($2,500,000,000,000)
Morgan Stanley: **$2.04 trillion** ($2,040,000,000,000)
Merrill Lynch: **$1.949 trillion** ($1,949,000,000,000)
Bank of America: **$1.344 trillion** ($1,344,000,000,000)
Barclays PLC (United Kingdom): **$868 billion** ($868,000,000,000)
Bear Sterns: **$853 billion** ($853,000,000,000)
Goldman Sachs: **$814 billion** ($814,000,000,000)
Royal Bank of Scotland (UK): **$541 billion** ($541,000,000,000)
JP Morgan Chase: **$391 billion** ($391,000,000,000)
Deutsche Bank (Germany): **$354 billion** ($354,000,000,000)
UBS (Switzerland): **$287 billion** ($287,000,000,000)
Credit Suisse (Switzerland): **$262 billion** ($262,000,000,000)
Lehman Brothers: **$183 billion** ($183,000,000,000)
Bank of Scotland (United Kingdom): **$181 billion** ($181,000,000,000)
BNP Paribas (France): **$175 billion** ($175,000,000,000)

These amounts show the privilege of the financial sector which, aside from the huge FED loan funds, also received other significant amounts from the National Treasury, either directly or by other bail-out plans that consumed a great part of the resources collected from tax payers. Meanwhile, these same tax payers are dealing with the growth of unemployment, restrictions to health programs and cuts in other benefits of social security that altogether reshape the social structure and lead the society to a worse social condition; an inequality deeper than decades ago. This paradox explains the reason why manifestations like "occupy wall street" are getting so strong.

The same situation can be attested in Europe, where many countries deal with serious "debt" crises and social manifestations of millions of citizens in the streets. It's important to recall that back in 2008, there wasn't such a "debt" crisis, but instead, a crisis located in the largest bank sector. At that time, the authorities decided to bail-out those institutions, even knowing the serious risks this choice could represent for the budget and "over-indebtness" of all countries, as shown by a February 2009 news:



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Financial Crisis

European bank bail-out could push EU into crisis

A bail-out of the toxic assets held by European banks' could plunge the European Union into crisis, according to a confidential Brussels document.

By Bruno Waterfield in Brussels 11:59AM GMT 11 Feb 2009

Comment

"Estimates of total expected asset write-downs suggest that the budgetary costs – actual and contingent - of asset relief could be very large both in absolute terms and relative to GDP in member states," the EC document, seen by The Daily Telegraph, cautioned.

"It is essential that government support through asset relief should not be on a scale that raises concern about over-indebtedness or financing problems."

The secret 17-page paper was discussed by finance ministers, including the Chancellor Alistair Darling on Tuesday.

Despite of the awareness of the risk of economic ruin, grounded in some secret documents, atmosphere of fear and emergency summits, European Union took the countries to a series of bank bail-out operations, in order to rescue financial institutions. Since the countries didn't have the funds to carry out this operation, it was promoted in the form of issuing large amounts of sovereign bonds.

It's important to spotlight that the fundaments for this decision was the "secret 17-page paper", which must be unveiled by a complete **audit** of this process.

The origin of the financial crisis is related to the lack of regulation in this sector. Some existing controls under the SEC[iv] - that since the 1929 crisis was assigned to control the "quality and authenticity" of papers trade in the financial market – were revoked or simply disrespected and bypassed by the main financial institutions.

The lack of regulation opened space to the discharge of an immeasurable amount of assets – such as derivatives and other kinds of financial products that can be considered as simple bets – without any real value or support. The so-called "toxic assets" loaded the financial market with "garbage".

The amount of these "toxic" papers was so expressive that some financial institutions specially designed to receive such assets - the "bad banks" - were created to relieve the banks of part of this "garbage", as noticed by the Financial Times:


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Germany plans individual 'bad banks'

By Bertrand Benoit in Berlin and James Wilson in Frankfurt

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The toxic assets of troubled German banks will be spun off into separate "bad banks" under a new government plan, the Financial Times has learnt.

Instead of setting up a national "bad bank", the German government wants banks to set up individual vehicles to hold their illiquid assets.

It is very important to know that the institutions which issued the "toxic" papers are the leading ones of the financial world: they are the ones who have the "credibility" to have their papers accepted and traded in the financial market. They were at risk of default, but only very few of these important institutions went broken - Lehman Brothers, for example. Soon, many measures came to bail-out and save them from bankruptcy.

The nations have had different destines. As predictable, the bail-out plan took the euro zone to a great crisis: an economic depression in a dimension that has not been seen since the World War II.

Despite of all the information about the European crisis in the media, expressing the problem of public debt, very few is published about its origins – located especially in the bank crisis, and not at massive public expenses, as it is common to hear.

For a deeper analysis, it is also necessary to understand the mechanisms utilized by the financial system, the “creativity” of the financial markets and its products like the *derivatives* and other unbacked assets that allow investors “to profit off changes in the prices of stocks, indices, commodities and other underlying assets”[v].

Derivatives have spread within financial markets and were transferred to mutual funds, pension funds, sovereign funds, and all kinds of investments throughout the world. As many bets got frustrated, the great volume of insurance policies started being used, driving banks to serious financial crises. It’s needed to inform that, at that time, “the average securities firm was leveraged 27 to 1, i.e. they had borrowed 27 times their capital”[vi].

Several different solutions are being built as a workaround for this situation, like the mentioned *bad banks*. In Ireland, the National Asset Management Agency (NAMA), created in 2009 as an attempt to bail-out the financial system, nationalizing private debts in exchange of public bonds (on which the banks themselves develop all kind of speculation), what represents a “socialization” of the losses of banks that brutally affects taxpayers’ lives[vii].

Regardless of all consequences for the economies and immense social costs of the measures adopted by governments to rescue the financial sector, these same institutions do not accept any restriction imposed by legislation, so that the financial transactions continue to be unregulated. Differently from other assets, which suffer many legal constraints, derivatives have almost no control and no transaction costs. Banks and other corporations are still allowed to recklessly issue new assets and speculate on them.

2. The misuse of the public debt

In order to help banks to substitute part of the big bubble of “toxic assets”, the nations either issued currency (like in the USA, as unveiled by the audit realized by the Government Accountability Office which proved US$ 16 trillion were given by FED to the banks), or created public debt by issuing public bonds, among other instruments.

A significant part or the “sovereign bonds” of these countries did not represent real “public debt”, or bond issuing to obtain resources to the country, but simply *the misuse of the debt mechanism to guarantee funds to financial institutions*.

Furthermore, the de-regulation of the financial market is permitting the use of sovereign debt bonds as if they were cards or chips of a casino, used in gamblers’ bets and games. One of the main privileges of the financial sector is the possibility to move anywhere, especially to tax havens, under bank secrecy, and negotiate sovereign bond in any secondary market, globally, and in many times even without the knowledge of the country who had issued those bonds in the first time. And this is not new; it has been a great difficulty for the Latin American countries since the 70´s, when the international banks used to sell parts of the debt-contracts in secondary market.

For how long will the society be held responsible for the losses of such irresponsible and immoral operations, which are taking money from essential services like Health, Education, Social Security etc., provoking the loss of thousands of jobs and, at the same time, addressing large profits to financial sector?

Moreover, can the result of these operations be considered as “public debt”? The economy books explain that public debt is an instrument that can be used to finance state needs and complete the necessary funds for the state competences in benefit of the society. The bonds issued to bail-out banks without any criteria couldn’t be considered as “public” debt, but should be treated as a separated loan to be paid by banks, not by the entire society.

Financial institutions bailed out since the 2008 crisis bought Treasury bonds with the money borrowed by government, transferred liquidity – because of the low interest rates imposed by governments – for speculative branches (through *hedge funds,* unregulated forms of investment) that intend to earn more money by “investing” on public debt issuing more and more derivatives, whose problems were mentioned before.

Despite of that, governments still help financial institutions, affording the social reforms imposed by neoliberal policies. The obvious perception is that countries are exchanging democracy for banks profits, as a result of a political system in which decision-making does not pass by public deliberation, but by negotiation tables among "technocrats" that pretend not to do politics.

3. The necessity of an audit – methods, transparency, citizen monitoring and the role of international institutions

The instrument of "public debt" is being used now in Europe as it has been used in Latin America since the 70's. The experiences of debt audit – official audit in Ecuador[viii] and citizen initiative in Brazil[ix] – have proved that in the last 40 years the only beneficiary of the commercial external debt were the large international banks. Instead of being an instrument to finance state activities, this kind of debt in bonds was a mechanism to transfer public resources to the private financial sector.

The debt-audit also proved that the financial crisis we had in 1982 in Latin America were provoked by the same international private creditors, who raised the interest rates on a unilateral way, from 5 to 20.5% a year. That crisis opened the opportunity for an intense interference of IMF in our economies with fiscal adjustment plans – just like it's happening now in Europe – that cost at least 2 decades of heavy social sacrifice (that we call *lost decades*) in order to guarantee benefits for the financial sector.

It's very important that European countries – which are not under dictatorships as we were in the 80's in Latin America – organize official audit commissions, like Ecuador did in 2007. It is also essential that civil society starts citizen debt audits, like our organization in Brazil – to research documents, encourage popular investigations, studies, social mobilization and elucidation about this debt process as soon as possible.

A debt-audit is an opportunity to have documents and proofs of the real nature of the so called "public" debt. The results of the audit can encourage concrete actions in all fields: popular, parliamentarian, legal and any other policies.

3.1 The Greek case and the audit experiences in Ecuador and Brazil

The misuse of the instrument of public debt must be unmasked. In Greece, for instance, the handling of country risk by rating agencies – degrading the country's classification just few days before the expiry of some obligations – forced the government to sign agreements with IMF and European Union, what shows a little example of how the mechanism work. Mounted the framework, international institutions and great corporations may invade the country imposing their interests – which includes the social rights dismantling, the protection of financial institutions and the sale of state apparatuses, mainly by privatizing the profitable public companies.

This pressure mechanism of the "Troika" ("market", IMF and European Central Bank) against countries - that have to "negotiate" alone - leads to a big inequality between the parties, which represents a clear illegitimacy. The IMF is a specialized agency of the UN, as well as the ILO and FAO, and thus "*should act in close collaboration with UN agencies and other specialized institutions, to achieve the objectives of the UN Charter and the Universal Declaration of Human Rights*" [x]. However, over time, the IMF moved away from its initial goals, and now evidently defends the financial market. Therefore, is expected that UN, through the UNCTAD, repudiate this behavior of IMF.

But the most serious is the mode this sale-of-state process happens. Public bonds are utilized to capitalize the private businesses, pushing further down the national economies. On account of the deregulation of financial sector, the bonds can be sold in secondary markets, wherever it works.

It's important to remember that the lower the price, the greater the yield, what is an interesting attraction for speculators. In Greece, for example, it was calculated that the bonds were being sold in secondary markets for 60% of its face value. Applying an interest rate of 7%, the effective remuneration would be 11,67%, as explained in the table below:

	Face Value	Market price	Interest rate	Interest	Yield
Exemplo	€1.000	60% = €600	7%	€70	11,67%

When a bond-holder sells its bonds with the so called "haircut", the one who buys these bonds makes a lot of money. As the market-price goes down, the highest goes the yield, which is a complete attraction for speculation. So, if someone "suffers" a haircut by selling bellow the nominal-value, the one who is buying will have an extra-gain over the enlarged yield of the bonds. Considering the two parts of this operation in secondary market can easily do their attached business, these actions can be characterized as "market manipulation" and "abuse" against Greece.

This situation leads to the urgency of an audit that should be integral, what means that the audit must take care not only of the data and accountability of each bond issue, but also look at all aspects and circumstances that involve the country and take them to deep indebtness, for example:

1. What is the amount of sovereign debt has been issued to bail-out failed banks?
2. What is the responsibility of European Central Bank and European Commission to the countries indebtness process evolution?
3. What is the responsibility of the rating agencies for downgrading sovereign bonds, causing the elevation of interest rates?
4. What is the responsibility of IMF and EU on their impositions to some governments to implement reforms against the people, benefiting the Banks?
5. What is the responsibility of the Banks for:
    a. impulsing more and more new loans, turning it exaggerated?
    b. speculating sovereign bonds, in order to make the interest rates go up continuously to force an intervention from IMF?
    c. playing with derivatives, "*Credit Default Swaps*" and other "toxic" papers?
6. What is the origin of the registered sovereign debt? Did the country receive this amount of money? Where did it go to? Who got the benefit of these loans? For which purpose?
7. Which private debts were transformed into public debts? What is the impact of these private debts to the budget?

When we have this information all clear, we can tell what part of sovereign debt is illegal, supported in many legal aspects, like:

- Co-responsibility of creditors and international financial institutions
- Asymmetry between parts
- Violation of general principles: Reasonability, *Rebus sic Stantibus*
- Right to Development
- Right of Sovereignty
- Violation to Human Rights

Other legal studies are necessary to match, in the country legal structure, the prohibition for procedures like “market manipulation” and “abuse”, because it´s evident that some countries – like Greece - are assuming abusive interest rates, as shown on the examples above.

<u>Every legal system includes the notion of the Abuse of Rights</u>. In general, the main characteristics that define an abusive act are connected to the case when the act produces damage, harm or injury; when there´s excessive prejudice to a part; when there´s evidence of the intention to produce prejudice or to obtain excessive benefits; when the act is against the social and economic rights; when the act doesn´t obey the reasonability cast in terms of social interests, among others.

During the Ecuadorian Debt Audit, besides applying the country legislation, the audit commission – CAIC - also searched for principles of International Public Right, International Pacts, like the International Pact of Civil and Political Rights and the International Pact of Economic, Social and Cultural Rights. We found out that most of the negotiations of Ecuadorian external debt had violated those treatises.

The CAIC also utilized some <u>General Principles of Law</u> that can also be useful for Greece, like:

- Enrichment without cause
- Principle “*contractus qui habent tractum successivium et dependientium de futuro rebus sic stantibus*”, which determines that an obligation can be revised and become

not eligible if the circumstances have substantially changed (interest rates, for example);

- Usury, known as the illegal practice of charging excessive, unreasonably high, and often illegal interest rates on loans.
- Anatocism
- Vicious in origin
- Good Faith (like in the United nations Convention)
- Equity (The laws do not deal with other forms of abuse such as financial abuse)
- Solidarity and Cooperation (also part of UN Convention)
- Public Policy

Besides that, the CAIC deepened the studies about the doctrines of Odious Debt and Illegitimate Debt that can also be applied to other countries, because there are many subjects to be investigated, as Eric Toussaint[xi] resumed:

> *The Greek public debt made the headlines when the country's leaders accepted the austerity measures demanded by the IMF and the European Union, sparking very significant social struggles throughout 2010. But where does this Greek debt come from? As regards the debt incurred by the* ***private sector****, the increase has been recent: the first surge came about with the integration of Greece into the eurozone in 2001. A second debt explosion was triggered in 2007 when financial aid granted to banks by the US Federal Reserve, European governments and the European Central Bank was recycled by bankers towards Greece and other countries like Spain and Portugal. As regards* ***public debt****, the increase stretches over a longer period. In addition to the debt inherited from the dictatorship of the colonels, borrowing since the 1990s has served to fill the void created in public finances by lower taxation on companies and high incomes. Furthermore, for decades, many loans have financed the purchasing of military equipment, mainly from France, Germany and the United States. And one must not forget the colossal debt incurred by the public authorities for the organization of the Olympic Games in 2004. The spiraling of public debt was further fueled by bribes from major transnationals to obtain contracts, Siemens being an emblematic example.*

This is why the legitimacy and legality of Greece's debts should be the subject of rigorous scrutiny, following the example of Ecuador's comprehensive audit commission of public debts in 2007-2008. Debts defined as illegitimate, odious or illegal would be declared null and void and Greece could refuse to repay, while demanding that those who contracted these debts be brought to justice. Some encouraging signs from Greece indicate that the re-challenging of debt has become a central issue and the demand for an audit commission is gaining ground.

When we start to investigate the public debt of any country, the first step to take is to know the origin of this debt. In Ecuadorian debt audit (CAIC) and also during the parliamentarian investigations in Brazil[xii] (CPI), only when we went deep on documents and data we could prove, for example the explicit practice of anatocism, for its evidence on the transformation of interest into capital. That happened during the Brady Plan – the same plan was adopted for many countries in Latin America. This plan transformed the previous debt in new sovereign bonds. The previous debt had a part of capital and a large part of interests that had been accumulated because they got just so high that our countries couldn´t pay them. Some of the new bonds issued under the Brady plan were the unequivocal transformation of the accumulated interests into capital and were called Interest-bond.

The Brady plan took place in the early 90´s and all kinds of media and even some people from academy believed that the Brady plan was a good step, because it was widely presented as a plan that would bring our countries back from insolvency to the market operations. Besides that, it was said that the transformation was "giving" our countries a discount. In fact, one of the new bonds issued under the Brady plan was called "Discount Bond". Only when we did the audit in Ecuador and the investigations in Brazilian parliament and had access to the contracts we could see the reality was totally different from the propaganda.

The documents proved that there was a "Debt System" under a continuous refinancing of previous debt; a mechanism of creating new debt to pay previous debt in a way that the new debt was always much bigger than the previous one, besides the huge payments of capital, interests, commissions, fees, taxes, costs, and all kind of extra bills. The audit also proved that the negotiations were made abroad and in many occasions – like in the Brady plan

- the money registered as debt on the contracts and bond issues never arrived into our countries, because the exchange of the previous debt into the new bonds was made by the creditors themselves, in the Luxemburg stock market, with no registration in the SEC - Securities and Exchange Commission in United States of America – besides the law and jurisdiction were the North American. The interest rates, costs and clauses of the contracts were completely illegal and abusive. Resuming, the audit proved a complete misinformation about the real mean of the Brady plan for our countries. And this was possible by reaching the documents of the negotiations: contracts, records of meetings, writings, proceedings and all registers of each operation, besides the statistics and data available.

This is only one of the examples of how we proved the anatocism and the illegality of the process. The main conclusion of the 30 years audited in Ecuador and 39 years investigated in Brazil is that the "Debt System" benefited only the large international banks, and did not serve as a mechanism to finance our countries, as the economic theory defines public debt. The instrument of public debt has been usurped by the "market". Our job is to reveal the true, by reaching the documents and proves that can unmask the many lies that have being told about our countries public debt. We can **not** keep paying illegal debt with our jobs and our lives. We must be encouraged to organize commissions to realize debt audit urgently, everywhere, and unmask this "debt system".

4. Conclusion

The current financial crisis threw open the usurpation of the instrument of public debt, used as a mechanism of transferring public resources to cover a problem of the private financial system, sunk in doubtful operations of unbacked derivatives. The social cost of this crisis is getting huge, especially to Greece. The experience of debt audit in Ecuador proved the value of this tool to explain truth about indebtedness process, and proved it can help to achieve effective results. The initiative of a citizen debt audit in Brazil also is showing the importance of this work for a historical approach of the debt process, a wider understanding about the recent facts related to the debt crisis, keeping the matter of public debt in the agenda of the national and international debates. The necessity of achieving a complete debt audit in countries submitted to the recent crisis provoked by a problem located in the financial market is essential to guarantee a decision-making towards justice and dignity for all society.

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[ii] http://www.unelected.org/audit-of-the-federal-reserve-reveals-16-trillion-in-secret-bailouts

[iii] http://www.gao.gov/products/GAO-11-696

[iv] SEC - Securities and Exchange Comission in United States of America

[v] http://www.contracts-for-difference.com/compare/derivatives.html

[vi] http://www.contracts-for-difference.com/Banking-crisis.html.

[vii] http://www.marxist.com/irelands-crisis-death-agony-of-fianna-fail.htm

[viii] Commission of Debt Audi – CAIC created by Decree 472/2007

[ix] Citizen Debt Audit www.divida-auditoriacidada.org.br

[x] Eric Toussaint e Hugo Ruiz Diaz - El Banco Mundial, el FMI, la ONU y las reivindicaciones del Tercer Mundo - Perspectiva histórica- http://www.rebelion.org/docs/9409.pdf

xi www.cadtm.org - Greece: the very symbol of illegitimate debt, by Eric Toussaint

[xii] Commission created in Brazilian Parliament toinvestigate the Public Debt, the payment of interests and its impacts on the society – Câmara dos Deputados Federais, from August 2009 to May 2010 – CPI da Dívida Pública