
EconWorld2020@Porto

Is Audit the Solution to the Sovereign Debt Dilemma?

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ABSTRACT

This paper focuses on audit as a rationalizing mechanism of sovereign debt in the case of emerging and developing economies. Firstly, the author analyzes the limits and failures of the current framework by contrasting the International Monetary Fund (IMF) inertia to the United Nations' determinism in favor of responsible and sustainable sovereign debt. Secondly, based on the agency theory contributions, the author argues that both international creditors and sovereign debtors would benefit from institutionalizing sovereign debt audit through strengthening market discipline. The author demonstrates that the IMF's position is not economically credible to the extent that it is contrary to the teachings of the signal theory. Consequently, the rejection of sovereign debt auditing would not be an optimal equilibrium of the international financial system. In conclusion, the author supports that the international community would benefit from depoliticizing the debate on the public debt of developing countries. The institutionalization of the audit as a clause in debt contracts could create a mechanism for rationalizing sovereign indebtedness. Auditing may be the solution to the dilemma of sovereign debt, by limiting adverse selection and moral hazard problems, and strengthening market discipline.

KEYWORDS sovereign debt; audit; market discipline; agency theory; signal theory; transaction costs; sustainable development

JEL H63, O19, P35, Q01