# EUROPE - Italy rebuts swap contract claims.

By JAMES BLITZ.
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The Italian Treasury firmly rebutted allegations yesterday that it had structured a complicated swaps contract with the aim of deflating its 1997 budget deficit figure and qualifying for the single European currency.

In a formal statement, the Treasury said that swap contracts - in which a bond issuer can trade his obligation to make payments in one currency rather than another - were a regular method of "improving management of public debt".

Privately, meanwhile, Treasury officials sought to explain why Italy had undertaken a swap contract highlighted over the weekend by a report for the International Securities Market Association.

On May 15 1995 the Italian government issued a bond for Y200bn. At the time, after the dramatic 1992 devaluation of the lira, the Italian Treasury was gradually seeking to regain credibility in international markets, and did so by issuing bonds in a range of currencies.

When the Y200bn bond was issued, the yen-lira exchange rate was at L19.3. By December 1996, however, the yen had depreciated by 30 per cent to a level of L13.4 to the yen. The Treasury then sought to lock in its currency gains over this period.

Treasury officials say they could have undertaken to start buying back the Y200bn bond issue, but given its sheer size, this was unrealistic. They therefore decided to undertake a cross-currency swap in which the Treasury could convert its yen liabilities into lira.

The Treasury faced a serious technical problem, however. Under European Union statistical rules pertaining at the time, the debt of all EU countries could only be reported in the original currency in which the bonds had been issued, in this case yen.

Any swap contract agreed by the Treasury in order to close its foreign exchange risk would thus be irrelevant when it came to calculating the overall debt figure.

This was highly pertinent to how the swap agreement had to be structured.

The Italian Treasury could have simply closed the swap transaction when the Y200bn bond matured in September 1998, realising all its exchange rate gains at that date. But a strong appreciation of the yen during the course of 1997 might have left Italy's official debt looking higher at the end of that year than it did at the end of 1996. This could have seriously undermined the country's bid to enter the eurozone.

The Treasury therefore needed to keep the formal calculation of its debt consistent by realising their exchange rate gain during the lifetime of the bond. Both the exchange rate and the interest rate of the swap contract were structured to allow this.

Treasury officials say the 30 per cent foreign exchange gain from the Y200bn bond was highly unusual. They dismissed any notion that this could be a regular phenomenon in debt management as absurd.

Nor, say officials, could the swap be judged as a way of "window dressing" the deficit figure. If window dressing had taken place, Italy would have seen its deficit and debt shoot up after it had successfully entered the single currency. The fact remains that Italy's deficit and debt have both been on a steadily downward path since 1996. For regional reports, www.ft.com/europe .

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