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Government use of derivatives

Italian fiddle?

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A government's financial wizardry unmasked

THE plot is familiar. A big bond-market player wants to dress up its balance sheet; wizard bankers conjure up a solution using smoke and mirrors; and regulators strain to keep up with the tricks of high finance. Are these the ingredients of the latest hedge-fund fiasco?

Actually, no: it is just the ordinary struggle of a European country desperate to join the euro, according to a report from the International Securities Market Association (ISMA). Its author, Gustavo Piga, a professor and former adviser to the Italian Treasury, claims that he has uncovered a strange transaction made by an unnamed European country—one that unmistakably resembles Italy.

The deal, an interest-rate and currency swap, dates from 1997, when EU countries were under pressure to meet the Maastricht treaty's budget-deficit targets of 3%. Most swaps require each party to pay one stream of cashflow and receive another—in, say, a different currency or interest rate. This deal, unusually, made use of a negative rate of interest, apparently to defer payments on ¥200 billion ($1.7 billion) worth of government debt from 1997 into 1998. It was a bid to reduce the country's 1997 budget deficit, and so help get it into the single currency, says the report.

Both Italy and the European Commission protest that nothing was amiss. They insist that the budget deficit, heroically cut from 6.7% in 1996 to 2.7% in 1997, fell because of tough budget choices, not financial window-dressing. Eurostat, the EU statistics agency, says it approved the swap, although there is a question about whether it fully understood the terms. Professor Piga does not allege wrongdoing. He argues only that loopholes in derivatives accounting make it hard to spot dodgy deals. Mysteriously, his report vanished from ISMA's website on the day it was posted.

Accusations that EU countries fiddled their books to meet the Maastricht criteria are nothing new. France and Germany, for example, raided their big telecoms firms to cut budget deficits. Fudged figures or no, the European single currency was always a political project; the Maastricht criteria made little economic sense.

Almost all EU countries use swaps to manage their public debt. This need not be a problem. Swaps can be useful tools, allowing, for example, a European country to borrow cheaply at Japan's low interest rates, while fully hedging its exchange-rate risk. Investors, governments and taxpayers all gain. But, without greater transparency, these strategies can turn into something riskier.

Better disclosure and accounting rules for governments' derivatives dealings are sorely needed. The EU's stability and growth pact sets stringent budget limits, yet these require accounts free of financial legerdemain. In its aid packages, the IMF sternly and properly demands the same of emerging-market economies, some of which will have carefully noted the ISMA story about Italy.

And there is a danger of hidden liabilities and unseen counterparty risk. Sophisticated investors (and even the Bank of Italy, which lost a lot of money in Long-Term Capital Management) know this only too well.