INSIDE DEBT

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Monday, February 22, 2010

CHART OF THE DAY

Speculators increase bets against the euro

The euro recovered from last week's nine-month low beneath $1.35. It was still down slightly on the day as investors worried about Greece's ability to get its budget deficit under control.

TODAY'S TOP NEWS

- Geithner urges independent U.S. financial watchdog
- Obama offers plan to revive U.S. healthcare push
- Yellen: U.S. economy still needs ultra-low rates
- EU, Germany deny report of Greek aid plan
- Schlumberger buying Smith Int'l in $11.3 bln deal
- Demand soft at U.S. 30-yr inflation-linked bond sale
- Fannie Mae launches $1 bln 'warehouse' lending plan

ECON WATCH

FOR TUESDAY FEBRUARY 23

ET		Indicators	Unit	Reuters	Prior
02:45	FR	HICP final mm	%	-0.2	0.3
02:45	FR	HICP final yy	%	1.2	1.0
02:45	FR	Consumer spending mm	%	-0.6	2.1
03:30	IT	Consumer confidence	ind	112.0	111.7
04:00	DE	Ifo business climate	ind	96.1	95.8
04:00	DE	Ifo current conditions	ind	91.8	91.2
04:00	DE	Ifo expectations	ind	100.5	100.6
04:00	IT	CPI final mm	%	0.1	0.2
04:00	IT	HICP final mm	%	-1.4	0.2
04:00	IT	HICP final yy	%	1.4	1.1
09:00	US	CaseShiller 20 mm	%	0.0	-0.2
09:00	US	CaseShiller 20yy	%	-3.2	-5.3
10:00	US	Consumer confidence	ind	55.0	55.9
10:00	US	Rich Fed comp. index	ind	-	-2
18:50	JP	Exports	%	38.4	12.1
18:50	JP	Imports	%	12.0	-5.5
18:50	JP	Trade balance total	bln	-108.5	545.3

MARKETS TODAY

TODAY'S TOP STORY: The Obama administration urged support for a U.S. financial consumer watchdog that is strong and independent, pushing Senate Democrats to resist compromises sought by Republicans and bank lobbyists. **For more please click here**

TREASURIES: Longer-dated U.S. Treasuries fell as relatively soft demand in an auction of 30-year inflation-protected bonds added to uncertainty over the market's ability to absorb record new issuance this week.

- The Treasury Department will sell $44 billion of two-year notes on Tuesday, $42 billion of five-year notes on Wednesday and $32 billion of seven-year notes on Thursday.
- 30-yr bond prices fell 12/32 to yield 4.73 pct, up from 4.71 pct on Friday.
- 10-yr Treasury prices were down 5/32 yielding 3.8 pct.
- 5-yr Treasury prices rose 1/32 to yield 2.44 pct.
- 2-yr notes were up 2/32 to yield 0.88 pct.
- 2-10's part of the yield curve steepened 5 bps to 291 bps, nearing record highs.

FOREX: The dollar edged higher against the euro but fell against the yen as markets worried about fiscal strains in Europe and weighed the possibility of higher U.S. interest rates later this year.

- Euro fell 0.25 pct to $1.3599, recovering from a nine-month low of $1.3442 hit last week.
- The dollar was down 0.42 pct at 91.1 yen while euro shed 0.68 pct to 123.91 yen.
- Dollar index fell 0.13 pct to 80.535. Sterling gained 0.03 pct to $1.5479.

CORPORATES: U.S. corporate bonds spreads tightened in response to less negative sentiment across European financial markets about Greece's debt troubles.

- The CDX.IG-13 index remained unchanged at 91 bps. The IG-13 index fell earlier to 88.25, its lowest level since Jan 20.
- Wyndham Worldwide Corp sold $250 mln of senior notes.

STOCKS: U.S. stocks ended flat to slightly lower as investors held back ahead of congressional testimony by Fed Chairman Ben Bernanke, while scattered buying lifted shares of health insurers and banks.

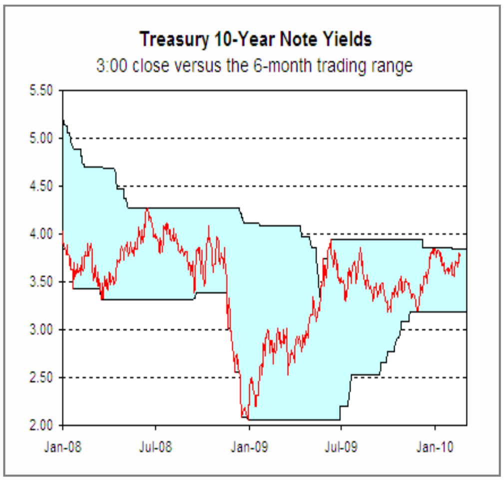
- Dow fell 0.18 pct to 10,383.53, S&P was down 0.1 pct to 1,108.02 and Nasdaq shed 0.08 pct to 2,242.03.
- Schlumberger shares tumbled 3.65 pct to $61.57 while Smith International rose 8.81 pct to $41.02.
- S&P energy index dropped 1.32 pct, while shares of Chevron Corp shed 1.47 pct to $72.96.
- The Morgan Stanley healthcare payor index rose 1.67 pct.
- S&P financial index rose 1.1 pct. KBW bank index jumped 2.89 pct.

C & E: Oil rose slightly to over $80 a barrel as a French refiner strike and tensions over Iran's nuclear program outweighed gains in the dollar.

- U.S. crude prices was up 0.44 pct to $80.2, after hitting $80.51 earlier.
- Gold fell 0.32 pct to $1,113.9 an ounce.
- Reuters-Jefferies index shed 0.37 pct at 276.78.

- For MARKET SNAPSHOT click here
- For NEXT UP click here
- For DEEP DIVE click here

MARKET SNAPSHOT as of 3:00 pm EST



REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.160	O/N	0.190
2-Week	0.200	2-Week	0.210
1-Month	0.200	1-Month	0.230
3-Month	0.250	3-Month	0.300
AGENCY REPOS		i-REPO℠ INDEX	
O/N	0.180	10:00 AM	0.120
2-Week	0.200	3:00 PM	0.128
1-Month	0.220		
3-Month	0.250		

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

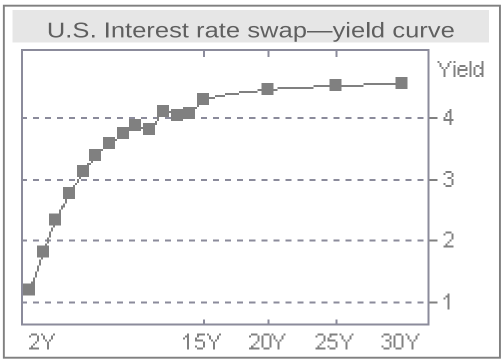
	BID	ASK	BID	ASK
O/N	0.140	0.150	-	-
1-Month	0.180	0.280	0.134	0.144
3-Month	0.220	0.400	0.157	0.167
6-Month	0.250	0.450	0.188	0.198
12-Month	0.600	1.000	0.345	0.355

TREASURIES <5> <500>

	BID	ASK	YIELD	CHANGE
1-Mo Bill	0.065	0.03	0.066	-0.011
3-Mo Bill	0.090	0.080	0.091	-0.019
6-Mo Bill	0.180	0.170	0.183	-0.012
1-Year	0.338	0.325	0.343	-0.025
2-Year	99.961	99.992	0.896	0.063
3-Year	99.680	99.719	1.486	0.066
5-Year	99.070	99.109	2.451	0.020
7-Year	99.328	99.375	3.234	-0.047
10-Year	98.563	98.625	3.799	-0.156
30-Year	98.313	98.391	4.731	-0.352

IR SWAPS <19901>

	SPREAD		RATE	
2-Year	26.25	30.25	1.15	1.17
3-Year	31.75	35.75	1.80	1.81
5-Year	31.25	35.25	2.76	2.76
7-Year	12.50	16.50	3.35	3.35
10-Year	7.50	11.50	3.87	3.86
30-Year	-16.25	-12.25	4.57	4.54



EQUITIES

	INDEX	CHANGE
DJIA	10408.85	6.50
NASDAQ	2246.64	2.77
S&P 500	1110.56	1.39

OIL

	PRICE	CHANGE
NYMEX	80.2	0.4
BRENT	78.2	0.0

EURODOLLAR FUTURES

	CLOSE	CHANGE
Mar-10	99.723	0.008
Jun-10	99.600	0.015
Sep-10	99.385	0.045
Dec-10	99.050	0.060

FUTURES

	PRICE	CHANGE
CBOT 5 yr	116.06	0.09
CBOT 10 yr	117.23	0.05
CBOT 30 yr	116.66	-0.13

CURRENCIES

	BID	ASK
Euro	1.3607	1.3610
Sterling	1.5489	1.5494
JP Yen	91.15	91.18
Swiss Franc	1.0756	1.0758
Can Dollar	1.0415	1.0420
Mexico	12.7998	12.8088

FED FUNDS

Open	0.1400
High	0.1500
Low	0.0900

NYFR℠ - 10AM

1m	0.2175
3m	0.2506

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	0.875	12/01/2012	7	6.5	0.97
3-Year	1.375	09/01/2013	14	12	1.63
5-Year	2.875	09/02/2015	28.5	28	2.74
7-Year	5.125	18/10/2016	19.5	19	3.43
10-Year	-	-	-	-	-
30-Year	6.625	15/11/2030	37	31	5.11

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	15/12/2011	4	0	0.95
3-Year	1.75	22/02/2013	20.5	20	1.68
5-Year	2.625	20/11/2014	16	15	2.61
7-Year	5.25	15/09/2016	16.75	16	3.4
10-Year	3.75	27/03/2019	20.5	19.5	4
30-Year	6.25	15/07/2032	37	32	5.11

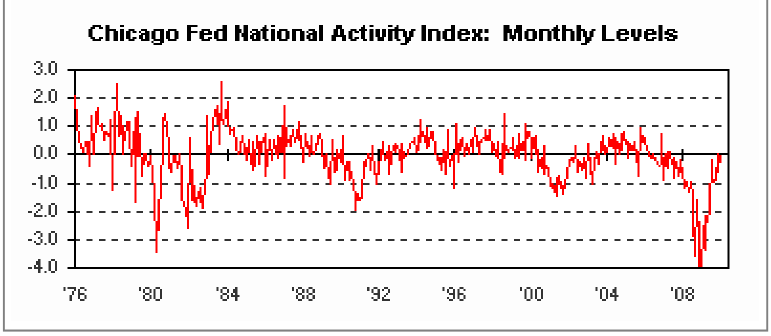
Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	5.0	105.0170	105.0370	2.756
FHLMC	5.0	105.0170	105.0370	2.756

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	5.5	105.0570	105.0770	3.091
FHLMC	5.5	105.1470	105.1670	2.926
GNMA	5.5	105.1760	105.1960	3.576

Wrightson ICAP℠ Chart of the Day



TODAY'S TOP NEWS

Geithner urges independent U.S. financial watchdog

The Obama administration urged support for a U.S. financial consumer watchdog that is strong and independent, pushing Senate Democrats to resist compromises sought by Republicans and bank lobbyists.

Geithner said the administration is still fighting "to consolidate the fragmented authority of seven separate agencies into a single, independent and accountable CFPA."

Geithner's remarks came in a statement marking the implementation of tough new rules for the credit card industry, signed into law last year by President Barack Obama as his first victory in a push to tighten financial oversight.

After the worst banking and capital market crisis since the 1930s, Obama in mid-2009 also proposed creating the CFPA. The House of Representatives endorsed a pared-back version of the idea in December as part of a sweeping financial reform bill.

However, in recent weeks the CFPA has become the main obstacle to a bipartisan Senate deal on financial reform.

Senate Banking Committee Chairman Christopher Dodd, a Democrat, is working closely with Republican Senator Bob Corker, a committee member, on crafting an agreement they hope will win broad support. Its release is expected within days.

Fed's Yellen: U.S. economy still needs ultra-low rates

The U.S. economy still needs extraordinarily low interest rates, as inflation is "undesirably low" and growth will likely be sluggish for several years, a top Federal Reserve offical said.

San Francisco Federal Reserve Bank President Janet Yellen told the University of San Diego's business school that the U.S. economy will likely grow at a pace of about 3.5 percent this year and 4.5 percent next year.

Unemployment, currently at an "unacceptably high" rate of 9.7 percent, will likely only decline to 9.25 percent this year and 8 percent by the end of next year, she said.

Yellen said the increase in the discount rate reflected a return to more normal financial conditions, since banks are now better able to tap private markets for borrowing.

When the time does come for monetary tightening, raising the interest rate the Fed pays on reserves will take a "lead role," she said.

Only after economic conditions improve and monetary tightening underway will the Fed possibly sell some of the assets that currently bloat its balance sheet, she said.

Schlumberger buying Smith Int'l in $11.3 bln deal

Schlumberger Ltd agreed to buy Smith International in a $11.34 billion all-stock deal that will boost the oilfield services leader's revenue to double that of its nearest rival.

The deal, still subject to shareholder and regulatory approval, values Smith Stock at $45.84, a 37.5 percent premium over Thursday's closing price, according to a joint statement by the companies on Sunday.

After the deal, Schlumberger would boast revenue double that of nearest rival Halliburton Co, which had 2009 revenues of $14.7 billion. Schlumberger said it expects the acquisition to add to earnings per share in 2012. The company also expects to realize pretax synergies after costs of about $160 million in 2011 and about $320 million in 2012.

Under the terms of the deal, Smith shareholders will receive 0.6966 shares of Schlumberger for each Smith share. On closing, Smith shareholders will hold about 12.8 percent of Schlumberger's outstanding shares.

Obama offers plan to revive U.S. healthcare push

President Barack Obama tried to rejuvenate his stalled U.S. healthcare overhaul with a plan to make insurance coverage more affordable and to bolster government authority to regulate premium hikes.

Obama will push the proposal at a bipartisan White House healthcare summit on Thursday in a last-ditch bid to break an impasse in the U.S. Congress and rally support for a sweeping overhaul that would tighten regulations on insurers and expand coverage to tens of millions of Americans.

"We view this as the opening bid for the health meeting," said Dan Pfeiffer, White House communications director. "Hopefully this will move the process forward."

The White House said Obama's plan would make it easier to bypass Republicans if necessary and ram legislation through in a process requiring a simple majority in the 100-member Senate rather than the 60 votes needed to clear procedural hurdles.

The new proposal, based on the Senate bill, would cost $950 billion over 10 years -- up from the Senate bill's $871 billion price tag -- and reduce the deficit by about $100 billion over the same period, White House officials estimated.

EU, Germany deny report of Greek aid plan

The EU and Germany denied a report of a 20-25 billion-euro aid plan for Greece, and Athens pledged again to take new steps if needed to keep tough deficit-cutting plans on target.

The European Commission and Germany's finance ministry dismissed a report in German weekly Der Spiegel on Saturday that the finance ministry had sketched out a plan for aid from euro zone states worth 20-25 billion euros ($27-$33.7 billion).

In Berlin, a finance ministry spokesman told a news conference Germany had not made a decision on aid and expected Greece to be able to refinance in April.

Greece's central bank governor meanwhile said the country was prepared to take extra fiscal steps to make sure it meets its deficit-cutting targets though he said financial markets were over-reacting to the country's financial woes.

Der Spiegel had reported that "initial considerations" by the German finance ministry were for financial aid for Greece to be calculated according to the proportion of capital each country holds in the ECB.

In another Der Spiegel report, Greek Prime Minister George Papandreou told Germany he was not seeking aid, and criticized the EU Commission for failing to ensure member states adhered to the EU's Stability and Growth Pact that limits budget deficits.

Demand soft at U.S. 30-yr inflation-linked bond sale

The U.S. government's $8 billion auction of 30-year inflation-protected bonds produced mixed results, which may cast a cloud over the rest of this week's record $126 billion worth of debt offerings.

Since this is the first 30-year TIPS offering in nearly a decade, relevant comparisons were hard to come by.

But analysts said yields were well above expectations, based on trade in the when-issued market just before the sale.

The 30-year TIPS drew bids worth 2.45 times the amount on offer. Foreign central banks and large institutional investors took 42 percent of the sale, according to the indirect bidders category. Direct bidders took about 6 percent.

Financial markets are watching bond auctions closely given a burgeoning U.S. budget deficit brought on by a costly financial sector bailout and efforts to stimulate the economy.

TODAY'S TOP NEWS

Fannie Mae launches $1 bln 'warehouse' lending plan

Fannie Mae said it is launching a $1 billion program to boost money available to small- and mid-sized lenders.
The program would provide credit lines for 10 to 12 lenders in 2010, a spokeswoman said.
Since the onset of the credit crunch, big banks have reined in and tightened requirements for credit to smaller lenders, hindering the availability of mortgages needed to stabilize U.S. housing, brokers said. The so-called "warehouse lending" is used to make loans that are earmarked for later sale.
Fannie Mae did not name lenders who will receive credit lines, saying it has only just finalized the funding plan.
The agency will fund the credit lines through Natty Mac, a warehouse company owned by Guggenheim Partners, LLC.
Fannie Mae and rival Freddie Mac have been operating under government control after rising losses from delinquent loans jeopardized their ability to provide money to the housing market. With private capital for mortgages largely frozen, the companies have become even more important to the health of housing.

Distressed loans in CMBS may top $60 bln this year

The amount of distressed loans in commercial mortgage-backed securities may more than double to at least $60 billion by year-end, creating a logjam that could hinder the U.S. economic recovery, Credit Suisse said. The rise in troubled loans in the $700 billion CMBS market accelerated to $2.7 billion a month last quarter, compared with about $1.4 billion a month in the first three months of 2009, Credit Suisse analysts said in a report.
A buildup of loans either 90 days delinquent, in foreclosure or bank-owned is overwhelming companies charged with fixing mortgages that are souring due to the economic malaise or as investors hold back on credit, the report said. Loans delinquent at least two months have increased more than ten-fold since the end of 2008, to 5 percent, it said.
Given current capacities of "special servicers," it would take 5.5 years to resolve just the current $28.8 billion in loans, the analysts said. This means a substantially longer recovery period than in past crises, they added.

Euro Libor off lows as liquidity seen declining

Euro interbank lending rates held just above record lows as a market poll showed traders anticipated the amount of longer-term liquidity in the financial system could drop sharply in the second half of the year.
That would mean the amount of longer-term financing in the system could quickly fall when 442 billion euros of one-year money matures at the end of June.
Excess liquidity in the euro zone banking system remained around 185 billion euros. The ECB's estimate of funding requirements is around 580 billion euros.
But with nearly half a trillion euros of 1-year money due to mature at the end of June, the ECB is expected to take additional steps to ease the transition to shorter-dated money and many expect the central bank's weekly operations to remain full-allotment at least until the second half of the year.
Benchmark euro Libor rates fixed at 0.60625 percent, after beginning to rise off record lows last week.
Equivalent dollar rates edged up to 0.25219 percent.

Dubai drops preferred status, sees "equitable" deal

Dubai dropped plans to seek preferred creditor status in the restructuring of state-owned Dubai World, a reversal which removed a key stumbling block in talks with lenders.
It said the restructuring of some $22 billion in debt would be "equal" for all creditors. A source said Dubai World will likely not repay a $980 million Islamic bond linked to its property unit Nakheel and due in May.
"That is a concession from the government," a source familiar with the matter said. "We haven't let go of our want but we will continue to fund on an unsecured basis," the source said, adding: "We're not going to do this forever."
The company has been negotiating with an unofficial seven-member coordinating committee of banks from the UAE, Britain and Japan, which combined have about two thirds of total exposure to the conglomerate.
Moody's estimated the local banks' exposure to Dubai World to be around $15 billion.

NEXT UP

Auctions, data and yet more auctions

U.S. housing and consumer confidence data will figure on bond traders' radar screens but their main focus will be this week's record wave of bond auctions.
Analysts will scrutinize house price data to see if it shows less weakness, as expected, and consumer confidence to see if forecasts of a slight dip prove correct.
However, this week's record $126 billion in bond supply is the biggest weight on the Treasury market and mixed results on Monday have done little to calm nerves.
Tuesday's $44 billion auction of two-year notes might be the safest bet but five- and seven-year offerings later in the week might suffer more from uncertainty over the burgeoning national debt. This week marks the first slate of bond auctions since the Federal Reserve raised its emergency lending rate last week.
Though policymakers have made great efforts to say this was not a sign they planned to tighten overall monetary policy anytime soon, it injected a new sense of uncertainty into the market.
If Monday's auction of 30-year Treasury Inflation Protected Securities is any guide, the rest of this week's auctions could be turbulent.

ECB to allot 35 bln euros in March six-mth tender

The European Central Bank will allot 35 billion euros ($48 billion) in its final six-month refinancing operation in March, a Reuters poll of money market traders forecast.
The poll showed forecasts for the allotment ranged from 4 billion to 100 billion euros, with a median of 35 billion.
The ECB has started to wind down its emergency lending measures as the euro zone economy has started to recover from its worst post-war recession.
Dealers expect the ECB to index the rate of the six-month operation to the main refinancing rate, as it did for the last one-year refi auction on December 16.
Around 85 percent of the ECB's outstanding liquidity to commercial banks is in long-term maturities, with some 442 billion euros in 12-month funds due for repayment at the start of July.
Twenty-two out of 31 dealers said the central bank would hold the March auction on a one-week rollover based on the ECB's main refinancing rate.
When asked if the ECB would continue the long-term auctions in the second half of 2010 at the current flat-rate, full allotment procedure, 20 of 31 dealers said they would not.

DEEP DIVE Commentary and Analysis

Red-hot U.S. bond market masks classic investor trap

By Herbert Lash

Money is still pouring into U.S. bond mutual funds after last year's record-setting $374.6 billion, a classic sign that the fixed-income market -- and the forlorn small investor -- is ripe for a bruising.

Burned by the equity market meltdown in 2008 and awarded record bond performance last year, when numerous funds posted double-digit returns, investors are staying the course and fail to see the rate trap that looms, some analysts say.

Many investors believe subdued inflation, held back by high unemployment and a gap between productivity and demand, will keep interest rates in check. U.S. consumer prices excluding food and energy fell in January for the first time since 1982.

But the once-in-a-lifetime performance of bonds in 2009 and unease over stocks has lulled investors to plow more money into fixed income in a misguided flight to perceived safety.

"These people, they're investing in bonds because they wanted yield," said Thomas Atteberry, a money manager at First Pacific Advisors Inc in Los Angeles. "The money market fund wasn't giving them anything and so they went into corporate, government, mortgage, some high-yield, that whole gamut."

High-yield "junk" bonds on average returned 41.15 percent in the 52 weeks ending Feb. 18, according Lipper, a unit of Thomson Reuters Corp. But nearly all bonds performed well last year: corporate BBB-rated funds returned an annual 27.26 percent through last week, and general bond funds had returned an annual 14.2 percent, Lipper data show.

Investors pulled $536.7 billion from zero-interest paying money market funds last year, according to the Investment Company Institute. ICI data show a record amount of fresh money flowed to U.S. bond funds in 2009, more than double than any previous year.

That massive inflow continues in 2010.

"Our thesis is they probably don't understand the interest rate risk they took by doing that," said Atteberry, who manages the $3.9 billion FPA New Income Fund.

Record investment flows are typical signs of market bottoms -- and peaks -- as the average investor is the last to show up for a bull market or become aware that sentiment is about to turn.

Investors added a record $309.4 billion to U.S. equity mutual funds in 2000 at the height of the tech bubble; the only outflows from stocks the past 20 years were in 2002, 2008 and 2009, years that marked deep troughs before sharp market rallies, ICI data show.

Steady consumer prices now mask a likely rise in bond rates due to rising inflation expectations -- when businesses and others try to anticipate higher prices -- and market demands for higher returns, some analyst said. If rates rise, it will crush the return of investors locked into low-yielding debt.

The benchmark U.S. Treasury note yield now trades at about 3.70 percent. A rise to its average yield over the past half century of about 6.2 percent could prove bumpy for markets and onerous for investors as prices, which move inversely to yield, drop.

Atteberry believes that the return on the 10-year U.S. Treasury note over the next five years will be about 90 basis points, or less than 1 percent. U.S. inflation may rise at a faster pace than economic growth, he said.

Short- and intermediate U.S. Treasury-based bond funds have returned less than 5 percent over the past year, but are a minor chunk of U.S. mutual fund assets.

Jane Caron, chief economic strategist at Dwight Asset Management Co in Burlington, Vermont, which oversees $68.8 billion in fixed-income assets, said she would not be surprised to see Treasuries deliver a negative return this year.

"It's potentially a tough environment for bondholders looking ahead, given our trend in where the economy is probably going and our current fiscal and monetary positions. All this points to a very negative outlook for bond prices," she said.

Caron said even if inflation and its trajectory remain subdued, interest rates are likely to rise because demand will lesson after the Federal Reserve stops buying debt in March.

"Even if inflation trends remain perfectly quiet this year, and there's no reason to be concerned about inflation, I still think you're going to see an increase in interest rates ... just for simple supply and demand reasons," she said.

For investors who must be invested in bonds, keeping their maturity short or buying floating-rate securities, are the best protection against rising rates, said Carl Kaufman, in charge of fixed income strategy at Osterweis Capital Management in San Francisco.

"A lot of high-yield companies issued a lot of floating-rate paper. That's one way you can play it," Kaufman said. "The other way you can play it is to buy shorter-duration paper, which has been the mainstay of our strategy. I'm starting to buy shorter-paper now, just to get to ready."

Equities, however, are a better inflation hedge than bonds, said Bill Hackney, chief investment officer at Atlanta Capital Management Co LLC in Atlanta, where he helps oversee $8.5 billion in assets.

Investing boils down to figuring out where inflation is going to crop up when all investment alternatives are considered, Hackney said. Natural resource stocks in emerging markets provide an inflation hedge, as does energy worldwide.

"You want to watch the energy stocks. You also want to watch those areas of the U.S. economy where we help the rest of the world deal with inflation, and that's through technology," Hackney said.

Greece not alone in exploiting EU accounting flaws

By Alex Chambers and Kirstin Ridley

Fury over Greece using derivatives that masked its debt conveniently ignores the fact that euro zone countries and EU bookkeepers have approved other deals worth billions of euros for over 10 years.

Brussels has told Greece to provide details of a 2001 derivatives deal with U.S. investment bank Goldman Sachs that helped Athens dress up its public finances by deferring interest rate payments as it entered the euro.

Goldman Sachs explained how the trades worked and that they were consistent with EU regulations in force at the time, in a statement made on its website on Sunday.

The currency swaps effectively created a 1 billion euro loan from Goldman Sachs to its client which did not show up in Greece accounts as such, a banker (not with Goldman) with an understanding of the trade said.

While previously reported in trade magazines and well-known in financial circles, the re-emergence of details on its swap was another blow for Greece, which stunned markets in October when the newly-elected socialists hiked budget deficit forecasts for 2009 to 12.7 percent of GDP, three times original estimates.

Bankers said derivatives and securitization activities were not a secret and were widely used by other euro zone members as they sought to meet the Maastrict criteria by reducing either budget deficits or debt-to-GDP ratios.

A former public sector banker likened the process for getting derivatives approved by Eurostat in the early days as hands-on and similar to that conducted with a rating agency.

Greece like other EU sovereigns, most notably Italy, was happy

DEEP DIVE **Commentary and Analysis**

to take advantage of known loopholes in the European system of accounts 1995 (ESA 95), produced by Eurostat, which ensures the comparability of European countries' accounts

Eurostat was pushed to clear up on accounting grey areas in 2001 when the academic Gustova Piga published research that showed Italy had used derivatives to massage its statistics in 1997, and enter the single currency in the first wave.

But when in 2002 Eurostat published a new version of ESA 95 it set out in detail the very rules Greece was to use.

Sovereigns were explicitly allowed to use year-end levels on cross currency swaps, a banker said.

Because there was a big move in euro/yen, there was a large enough difference in the year-end rate and the real rate at which Greece transacted so that it was able to get 1 billion euros upfront and repay that loan over the swap's term.

The tale has also spun the spotlight back on Goldman Sachs, the Wall Street investment bank that has triggered public and political anger for paying some of the biggest bonuses in the industry despite the near-collapse of the sector in 2008.

Eurostat now says it wants to assess whether underlying exchange rates and interest rates in the deals conducted with Goldman were based on actual market rates rather than historical rates, which was a loophole sovereigns had exploited for years.

Unsurprisingly, bankers are echoing comments by Christophoros Sardelis, who was chief of Greece's debt management agency when the swaps were secured. He noted this week that rules governing swaps were only tightened later.

"Everyone did these (types of) trades. Deutsche Bank, JP Morgan, Merrill, Goldman and others. They look unfortunate now -- but are we solely to blame?" said a senior fixed income banker.

"It's easy to simply blame the bankers... but really people should also be asking about the politicians who asked us to find solutions for their problems," said a senior fixed income banker.

"No one can act surprised. Eurostat's regulations are clear. If the political will to stop this had been there, it could have happened," he said.

German Chancellor Angela Merkel led the bandwagon of politicians bashing bankers -- already suffering from a public image debacle ever since the credit crisis -- saying it would be "a disgrace" if they had been party to "falsifying Greek national statistics".

Bankers noted, however, that Germany is no stranger to off-balance sheet vehicles. KfW, the German state-guaranteed development bank borrowed 50 billion euros last year, a sum that does not appear on the state's budget.

"The reality is that it's not about a single deal. It's not about whether what was done was right or against the spirit of the regulations or not," noted a former public sector banker.

"It's the whole accounting standard you have to look at."

Another anomaly in the accounting for states' liabilities and assets was how options are treated. States writing an option can book premium as cash but the liability is not accounted until the option is exercised, a banker said.

SHIFTING LIABILITIES

It is not just derivatives. European sovereigns' game of shifting liabilities off their balance sheets once provided fruitful ground for the now tarnished securitization sector.

Italy kicked of the craze 10 years ago by selling a 4.5 billion euro securitization backed by unpaid social security payments at the Istituto Nazionale Previdenza Sociale (INPS).

The early years of the single currency was marked by a series of similar asset-backed securitizations for Italy and other states such as Portugal, Greece and Belgium.

Then in May 2005 Germany joined in, selling 8 billion euros of civil service pension rights backed by payments from former state-owned companies Deutsche Telekom, Deutsche Post and Deutsche Postbank.

Eurostat did not allow the German securitization count as part of state borrowings, a stance which has seen the flow of deals grind to a halt.

Similarly, in 2008 it stopped the use of derivatives for fiscal window dressing but revelations over public sector finances are likely to continue this year.

Italian authorities are pressing for legal action against several banks for deals involving local authorities who sold bonds worth billions of euros during the past decade.

Italian municipals were heavy users of the debt markets during much of the past decade as a squeeze on public sector financing at the state level led them to look for alternatives

The rules on Italian local authorities' borrowings encouraged them to use derivatives to smooth out the redemptions of debt. It is these derivatives, which are the centre of the legal disputes.

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