Guidelines for public debt management

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Introduction

The Italian public debt is comprised 95% by liabilities of the Central Government, with the remaining quota attributable to Local governments, whose autonomy mandates that they manage their own portion of the debt. About 88% of the Central government debt is represented by negotiable financial instruments – Government bonds – and is managed by the Direction II of the Department of the Treasury of the Ministry of Economy and Finance.

The present document illustrates the guidelines for the management of said quota of the debt, carried out essentially through the issuance of Government securities.

With regard to the investor base, the dynamic observed over the past few years in the distribution of bond holders by geographical area and by category illustrates how the public interest to invest in Government bonds has grown: the demand from investors abroad has continually increased, with the relative quota of possession growing from 22% in 1997 to 49% in 2003; the quota of Government bonds held by Italian families has diminished between 1997 and today, from 40% to 17%, signaling an ever greater recourse to investment by way of financial intermediaries.

Objectives of public debt management

The criteria that inspire the issuance policy aim to satisfy the financing needs of the State at the most favorable economic conditions in the medium and long-term, while limiting the exposure to various types of risk at prudential levels.

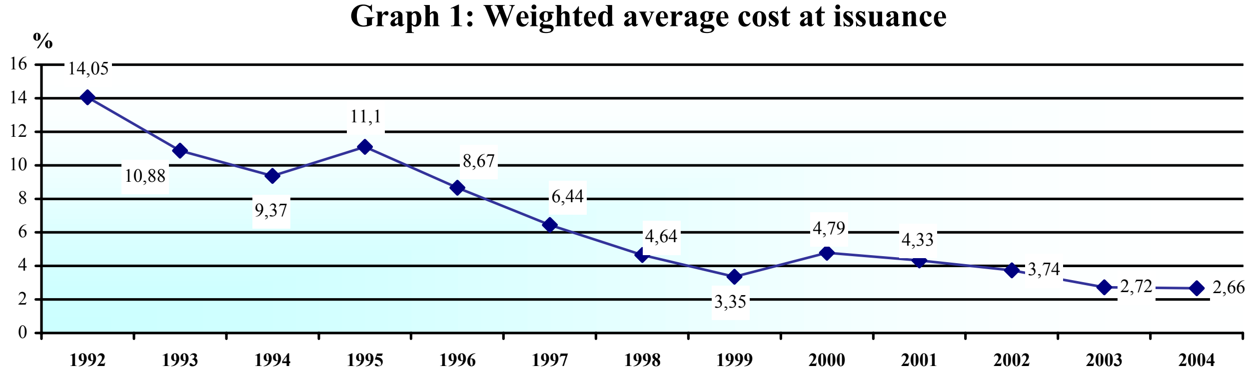
Debt management policy in 2004

The strategy carried out in 2004, in line with the policy undertaken in the past few years, focused on a careful management of various sources of risk, namely interest rate, refinancing, and “inflation” risks – and on the pursuit of a greater efficacy in the placement of Government bonds.

Structure of public debt and reduction of risk.

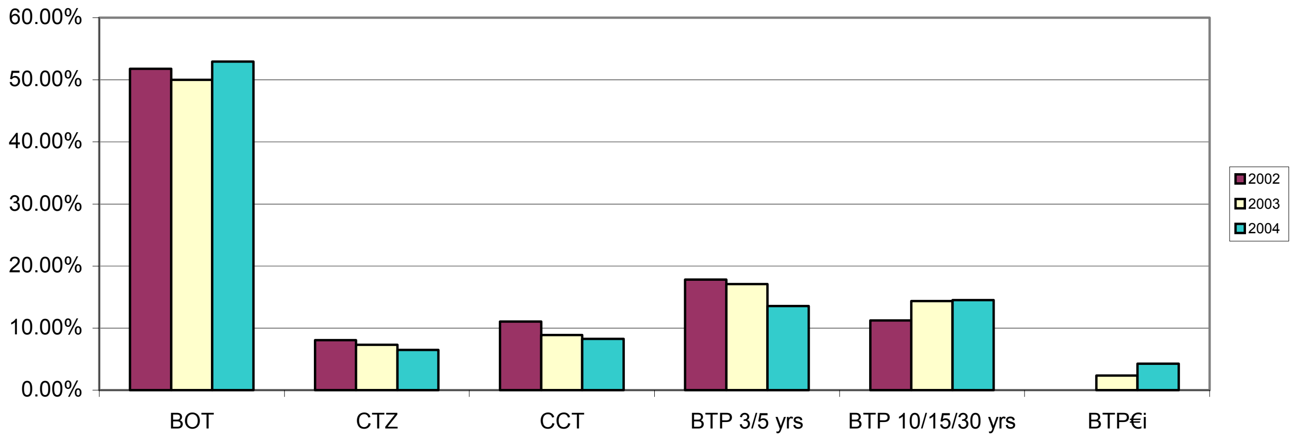
Taking advantage of the descending trend of interest rates, it was possible to obtain a progressive reduction of the total debt interest expenditure of the General Government sector, which went from 6.5% of the GDP in 2001, to 5.3% in 2003 and in 2004. Contributing significantly to such reduction was the Government bond component, whose marginal cost at issuance, has continually decreased, reaching 2.66% in 2004, as compared to the corresponding value of 2.72% for the preceding year (see Graph 1).

Graph 1: Weighted average cost at issuance



With regards to debt issuance, graph 2 highlights the gradual reduction, over the course of the past three years, of the gross issues of CTZ and CCT in favor of the BTP sector.

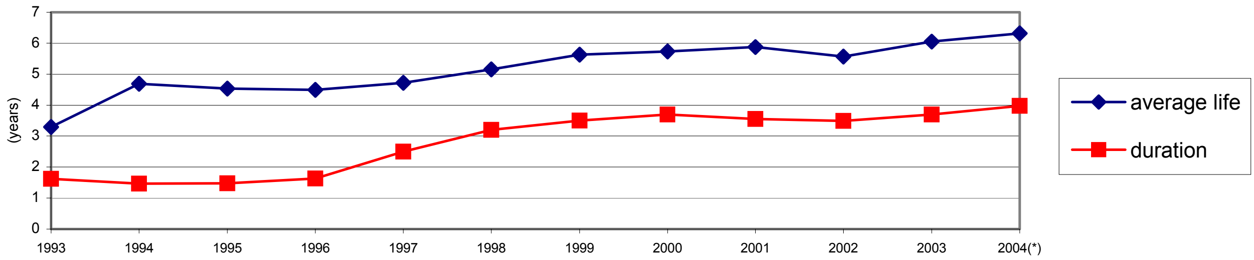
Graph 2: Evolution of gross debt issuance
(as a percentage of total domestic issuance)
2002 - 2004



This sector has seen a re-balancing in the issues: the reduction of the medium-term offering (3 and 5 years), moving from 17.8% of the total issues in 2002 to 13.5% in 2004, was accompanied by an increase in the offering of bonds with maturities greater than ten years, which in the same period moved from 11.26% to 14.5%. The gross issues of BOT were substantially the same.

With the objective to progressively reduce the sensitivity of the borrowing costs to nominal interest rate variations, the strategy followed (see graph 5) brought about an ulterior lengthening of the debt duration, which went from 3.49 years at the end of 2002 to about 4 years as of 30 November 2004. In terms of the Average Refixing Period, another measure of the debt sensitivity to interest rates, there was a shift from 4.98 years (end 2002) to 5.65 years at the end of November 2004. The average life of the debt was increased from 5.56 years, recorded at the end of 2002 to 6.32 years as of 30 November 2004.

Graph 3: Average life and duration of public debt

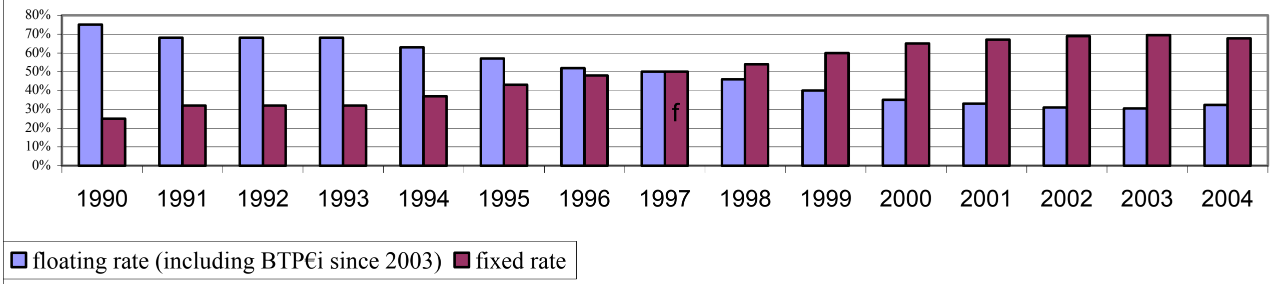


(*) data up till the 30th of November 2004

Therefore, the impact on the interest expenditure connected to an unexpected increase in interest rates[1] was reduced even further, given that the growth in interest expenditure as a percentage of GDP, due to a one percentage point increase of the entire yield curve would be of 0.21% in 2005, 0.40% in 2006, 0.50% in 2007 and 0.58% in 2008. In fact, the same estimates carried out one year ago showed slightly higher values: 0.23% in the first year, 0.41% in the second year, 0.51% in the third year, and 0.58% in the fourth year.

With the change in the debt structure that these last few years have witnessed, the quota of fixed-rate bonds with respect to total bonds was recorded at slightly less than 70% (see graph 6).

Graph 4: Domestic Debt Composition
Evolution of the fixed and floating rate quota



In September of 2003, the Treasury set in motion the program of BTPs indexed to inflation (BTP€i). The placement program, which began with five-year bonds (BTP€i 2008), was developed further with the issuance of a ten-year maturity bond (BTP€i 2014), in the month of February, and a thirty-year maturity bond (BTP€i 2035), in the month of October. Over the course of the year, reopenings of the indexed bonds were conducted, through both syndicated placements and auctions,

[1] Note that forecasts of interest expense contained in the official documents are based on the forward rates for the same issuance strategy. These estimates, therefore, already include a growing interest-rate trend.

furnishing liquidity to the single instruments on the basis of market needs. The table below illustrates the development of the issuance program of indexed bonds from 2003 to today.

Program of issuance of BTP€i indexed to inflation for 2003 - 2004

Bond	Tranche	Placement date	BEI at issuance (bps)	Annual real yield	Amount Issued
BTP €i 5 yrs	I	10/09/03	187,0	1,694	7.000.000.000
	II	22/10/03	197,0	1,670	3.150.000.000
	III	30/03/04	197,5	1,071	3.250.000.000
BTP €i 10 yrs	I	11/02/04	213,0	2,264	5.000.000.000
	II	21/04/04	220,0	2,215	3.500.000.000
	III	28/09/04	226,5	1,8	2.000.000.000
BTP €i 30 yrs	I	20/10/04	243,3	2,378	4.000.000.000
Total Issued					**27.900.000.000**

The decision by the Treasury to issue inflation-linked securities is also based on cost evaluations. In fact, real bonds, thanks to their protection against unexpected increases in the price level, allow the debt manager to save on the inflation risk premium, embedded in nominal bond's yields. On average, this premium is estimated to be about 10 basis points in the 5–10 year period and 20 basis points in the long-end of the curve.

The premium, growing more than proportionally with respect to duration, determines a lesser slope of the real curve with respect to the nominal curve. This profile allows to prolong the average life of the debt at lower costs to those that would otherwise be borne with the issuance of nominal bonds.

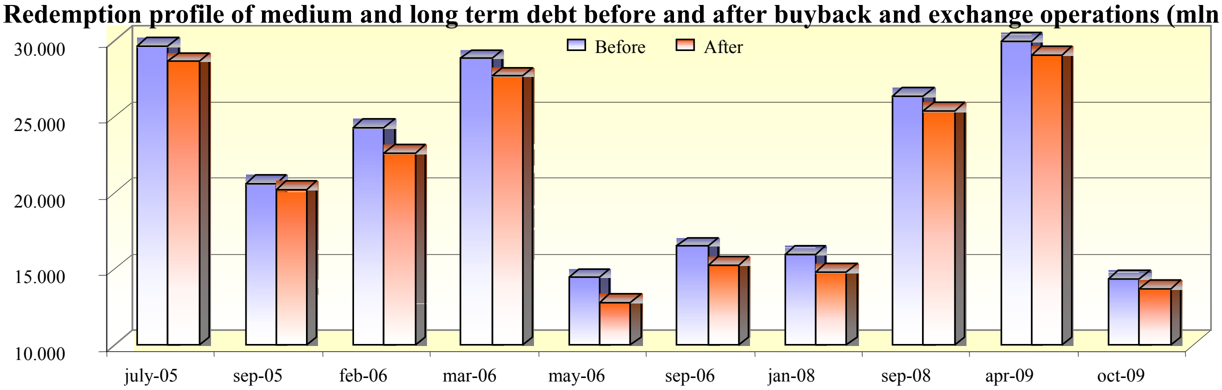
A further benefit derived from the implementation of the price indexed program was the enlargement of the investor base, both in terms of new entities not before present and in terms of geographic distribution. It should be underlined how the demand for these instruments does not substitute that of nominal bonds of the same duration, given that they generate new transactions not before possible and they allow for a greater diversification of the portfolio.

Buyback and exchange transactions

Within the realm of public debt management, of particular relevance are exchange and buy-back transactions aimed principally at the progressive reduction of the refinancing risk, through an optimal remodulation of the future redemption profile. In the course of 2004 a new telematic trading system was inaugurated and two exchange transactions were carried out (with an “exchange” of bonds for about 2.7 billion euro). The new system, which is in addition to (and not in substitution of) the existing auction procedure, made it possible to obtain a greater flexibility in the choice of bonds and in the execution of the transactions. The buy-back activity, realized both by drawing on the cash availability of the Sinking Fund (Fondo ammortamento) and on that of the Treasury Cash Account (conto disponibilità), represented an effective instrument for debt stock reduction. In particular, the Treasury successfully conducted two auctions with which about 8.2 billion euro worth of nominal capital were bought back.

In 2005 these activities will still aim at the management of refinancing risk and for providing support for the liquidity of the bonds by adopting in each case the operational technicalities deemed most appropriate.

Redemption profile of medium and long term debt before and after buyback and exchange operations (mln €)



Efficacy in the placement of Government bonds of the domestic program

The auction system, for its regularity and transparency features, is the main issuance mechanism for domestic Government bonds. For the issuance of new asset classes (BTP€i) or of new benchmarks on the long-end of the yield curve (maturities greater than ten years), the syndicated placement system was used, in order to obtain a greater efficacy in terms of pricing, breadth of distribution – by type of investor and on a geographical basis – and the subsequent performance of the bond in the secondary market.

The reorganization of the auctions’ calendar, begun in 2003 with the reduction of the number of CTZ placements (and consequently the increase of the average quantities offered per auction), was carried on in 2004 given the single month auction of the 3-yrs BTPs.

Issuance Program for 2005

Over the course of 2005 the debt management policy will continue to be inspired by those principles that drove the strategy followed over the last few years and, in particular, in the last two years. The issuance policy, furthermore, will guarantee the liquidity of the single instruments, a condition necessary for keep on broadening the investor base.

Program of issuance for domestic bonds

The placement for domestic bonds will be carried out principally through auctions, according to the plan shown in the table below. The announcement dates of auctions and settlement of the Government bond issuance program of 2005 are indicated in the calendar available at the following link:http://www.dt.tesoro.it/ENGLISH-VE/Public-Deb/Italian-Go/Auctions-C/Auctions-C/Auctions-C/Auction-Calendars-2005.pdf

Auction calendar
(with reference to issuance date)

	First half of the month	Second half of the month
Cash Management Bills – 3 mth BOT	Issuance tailored to meet cash needs	
6 mth BOT		X
12 mth BOT	X	
24 mth CTZ		X
3 yr BTP		X
5 yr BTP	X	
10 yr BTP		X
15 and 30 year BTP	The 2 bonds will be issued during the month according to market demand	
7 year CCT		X
BTP €i		The offer will be established based on market demand

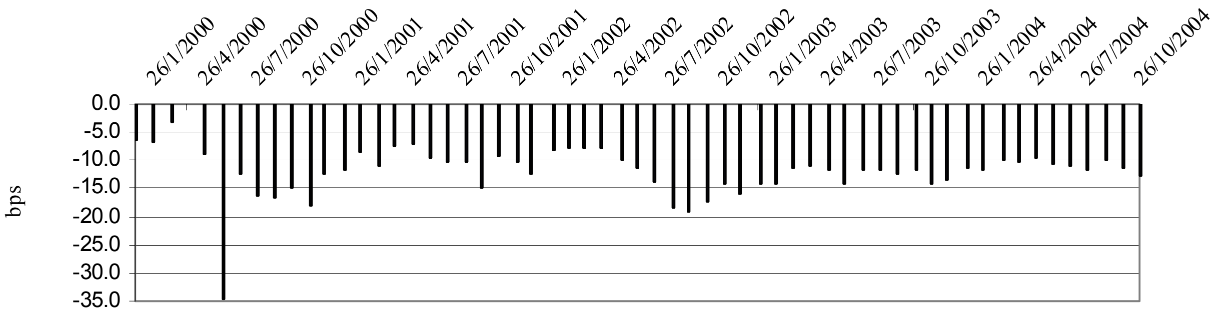
Nominal bonds

BOT: The 12 months' BOT will continue to be offered with regularity in the middle of the month, modifying the amounts offered according to demand and cash needs.

The 3-month BOT will be subject to a greater supply discretionality , in relation to its feature of cash fine-tuning tool. In order to grant even more flexibility to the cash management, the Treasury

will issue BOTs with non-standard durations (the so-called *flexible BOT*), as already done successfully in recent years.
The 6-mth BOT issuance will be established according to flows of maturing bonds and in order that, together with the reopenings reserved for Government bond Specialists, the efficiency in the CCT market is guaranteed. The following graphs show, in fact, how the strategy followed over the course

6 mth Bot - Euribor Spread
(January 2000- November 2004)



of the last few years made it possible to contain the variance of the 6-mth BOT spread against Euribor.

CTZ: *According* to the strategy undertaken in 2003, the Treasury will continue to reduce the existing stock of 24-mth zero-coupons, while at the same time continuing to furnish liquidity to this sector, keeping in mind the interest shown by institutional investors towards this instrument.

CCT: will be offered with continuity in order to provide liquidity to the single issues.

Medium-term bonds: for 3, 5, and 10-yr bonds the issuance will continue to be characterized by extremely regular auctions.

Long-term bonds. As in the past two years, the issuance strategy for bonds with a duration greater than 10 years will be carried out by taking in consideration demand flows. So as to foster the efficiency of the primary and secondary market, the issuance on the long-end of the curve will continue to be characterized by flexibility of the amount offered. The use of syndicates will be, again for 2005, one of the options for increasing liquidity and improving investor and geographical distribution, in particular for the first tranches.

Bonds linked to inflation

The effort to provide liquidity to the sector of bonds indexed to the euro-area inflation will continue in 2005.

The bonds will be placed via both syndications (which will be used preferably for the launch of new benchmarks) and auctions. In particular, the Treasury reserves the right to auction the BTP€is, monthly according to market conditions. The auctions will take place, usually, in the second half of the month, one business day prior to the medium-long-term auction. The Ministry of Economy and Finance will announce the bonds to be issued, and the relative maximum amounts to be offered, four business days before the auction, that is, with the first announcement of the end-month auction for medium-long-term bonds.

Issuance Program of foreign currency denominated debt

Over the course of 2005, the issuance activity in foreign currency will be conducted as shown below.

1. Global benchmark program in dollars.

The Republic will continue to be an important issuer in the market of the American dollar. The issuance policy will be aimed at maintaining liquidity over the entire yield curve. All the bonds issued in the realm of the program will have benchmark duration and amount.

With regard to the program in dollars, the benchmarks of the Italian Republic are traded actively by dealers at the desks of Sovereigns, Supranationals, and Agencies and are quoted on the principal electronic platforms. The dealers in the program are: BNP Paribas, Citigroup, CSFB, Deutsche Bank, Goldman Sachs, JP Morgan Chase, Lehman Brothers, Merrill Lynch, Morgan Stanley and UBS.

2. Issuance activity in other markets.

The Republic intends furthermore to issue bonds in other international markets on the basis of investors' demand and cost opportunity. The issuance activity in currencies other than the dollar are typically carried out within the realm of the MTN program and occasionally in the Global format. Those financing operations are characterized by a more flexible approach and take in numerous currencies, including transactions in eurodollars in a non-benchmark format.

3. *Commercial Paper*

The use of Commercial papers, carried out both in the euromarket and the dollar market, represented in the course of 2004 a useful complement to the policy of cash management of the BOT program, thanks to the extreme flexibility this asset class provides, both in terms of amount to issue and duration.

In 2005 the Treasury will continue to make use of the characteristics of flexibility and diversification offered by this source of financing.

With all of this issuance activity in the international market, the Treasury aims at reaching a broader investor base and, in the course of 2005, and at keep on fostering her relations with international investors, as to improve the recognition of the Italian Republic as a sovereign issuer present in markets with strong demand flows.