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# DEBT MANAGEMENT STRATEGY

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1998-99



Department of Finance  
Canada

Ministère des Finances  
Canada

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## *Foreword by the Minister of Finance*

On February 24, 1998, the government announced a fiscal victory for all Canadians – the elimination of the federal deficit. Perhaps more importantly, it also announced that for the first time in nearly 50 years, the budget would also be balanced for the two years after that – in 1998-99 and 1999-2000.

Indeed, if Canada used the same less stringent yardstick as other countries to measure its deficits – financial requirements, or the amount of new money borrowed from the market – then we could have declared victory even earlier: a year earlier, in fact. In 1996-97 we were the only G-7 country to record a surplus in financial requirements. And we will do so again and again, year after year.

What this means is that the age of chronic deficits is over and that the age of debt reduction has begun.

The government is committed to reducing the debt burden. By concentrating on a balanced approach, we will ensure a growing economy that will result in a persistent lessening of the debt-to-GDP ratio. Moreover, the government has outlined a Debt Repayment Plan that will bring down the absolute level of the federal debt. This plan includes the continued use of two-year fiscal forecasts and prudent planning assumptions, the maintenance of an annual \$3 billion Contingency Reserve and the application of that reserve to the debt when it is not required for other uses. Lastly, the government will continue to maintain a prudent debt structure – one designed to protect the fiscal plan against unexpected changes in the economic and financial landscape.

As the government continues to run financial surpluses, market debt will be reduced. Market debt programs will be adjusted gradually, in consultation with market participants, and initiatives will continue to be undertaken to ensure the integrity of the market. The government's objective is to maintain a liquid and well-functioning market for Government of Canada securities.

This document shares with Canadians how that challenge will be met successfully. I hope that this new publication – arising from the dawn of a new fiscal age – will contribute to a broader and better understanding of the government's plans to reduce and manage Canada's debt.

The Honourable Paul Martin, P.C., M.P.  
Minister of Finance  
March 30, 1998

### *Overview*

The *Debt Management Strategy* is a new annual publication of the Department of Finance. It provides information on the federal government's debt management strategy for the coming fiscal year.

The government's intention in issuing the *Debt Management Strategy* is to ensure the strategy remains transparent and well understood.

The government will also continue to publish the *Debt Management Report* shortly after the release of the Public Accounts in the fall. Its focus will be to report on the federal government's debt operations over the previous fiscal year, and to provide detailed information on the government's outstanding debt.

## *Debt Management Framework*

This section outlines the federal government's objectives in managing the federal debt and the key principles underlying the pursuit of these objectives.

### **Debt Management Objectives**

*The fundamental objective is to raise stable, low-cost funding for the government.*

- The fundamental debt management objective is to raise stable, low-cost funding for the government.
- A key strategic objective is the maintenance of a well-functioning market for Government of Canada securities.

### **Domestic Debt Management**

#### ***Principles***

*All funding required for the government's operations is raised in the domestic market.*

- Funding required for the government's operations is raised in the domestic market and in all major maturities.
- The government borrows on a regular, preannounced basis. Debt management decisions are independent of the government's outlook for domestic interest rates.
- The government focuses on liquidity, transparency, regularity and market integrity in its efforts to maintain a well-functioning market.

#### ***General Strategy***

- The debt stock is structured prudently to ensure reasonable cost stability under a range of potential interest rate environments.
- The government maintains a broad investor base and active relations with investors and credit rating agencies.
- Adjustments to the domestic debt programs are made gradually, following consultation with market participants.

### **Foreign Currency Debt Management**

#### ***Principles***

*Foreign currency debt is issued to raise foreign exchange reserves.*

- The government borrows in foreign currencies, mainly in U.S. dollars, as required to fund Canada's foreign exchange reserves.

#### ***General Strategy***

- The government raises foreign exchange reserves through a range of sources and investors. The liabilities are managed in conjunction with the assets to limit the cost of carrying reserves, and to maintain a prudent maturity structure.

## Debt Management Environment

### Changing Debt Structure

*Federal debt management is entering a new era of financial surpluses and a declining stock of market debt.*

*The last four years have seen significant changes in the composition of the debt.*

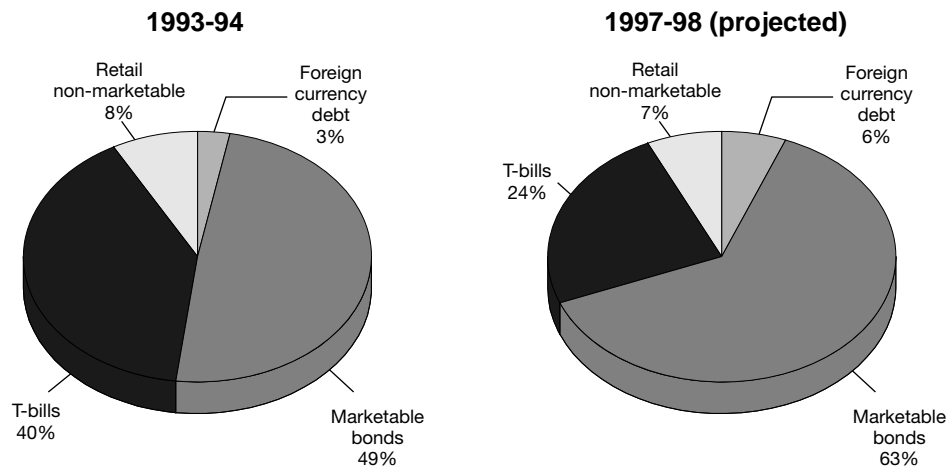
With the elimination of the deficit this fiscal year and the commitment to balanced budgets for the next two years, debt management has entered a new era. The 1998 budget outlook for financial requirements (excluding foreign exchange transactions) in 1997-98 is a surplus of \$12 billion. It is expected that domestic market debt will fall by this amount. This is a dramatic change in the debt management environment from four years ago.

- As recently as 1993-94, the federal government recorded a financial requirement (excluding foreign exchange transactions) of \$30 billion and had net domestic borrowings of \$26 billion (i.e. the stock of domestic market debt increased by \$26 billion).

The composition of market debt has also changed significantly over the past four years (see charts below) due to the decision to increase the portion of the gross debt in fixed-rate form from 55 per cent to 65 per cent in order to protect the government from the fiscal effects of unexpected increases in interest rates. Reaching this objective was made easier by the dramatic turnaround in the federal government's fiscal situation.

- The stock of marketable bonds has increased from \$203 billion (49 per cent of market debt) at the end of 1993-94 to \$294 billion (63 per cent of market debt) at the end of 1997-98.
- The Treasury bill stock has declined from \$166 billion (40 per cent of market debt) at March 31, 1994 to \$113 billion (24 per cent of market debt) at March 31, 1998.

**Composition of Market Debt**  
(% of total market debt at fiscal year-end)



## Fiscal Outlook: Implications

*The budget outlook is for a balanced budget in the coming years.*

On February 24, 1998, the Minister of Finance announced a balanced budget in 1997-98, and the government's commitment to balanced budgets in 1998-99 and 1999-2000.

The Minister also announced the government's commitment to lower the overall burden of public debt. This will be done through a two-track strategy: the government will continue to follow policies that will pay off in better economic growth, and it will bring down the absolute level of debt through a Debt Repayment Plan. The Plan is based on three key elements:

*The overall level of federal debt may fall.*

- as before, two-year fiscal plans based on prudent economic planning assumptions; the current plan commits to balanced budgets in 1998-99 and 1999-2000;
- the inclusion in the fiscal plan of a Contingency Reserve of \$3 billion in each year; and
- the use of the Contingency Reserve, when it is not needed, to pay down the public debt.

*Financial surpluses will give rise to reductions in the market debt stock and a need for gradual restructuring of market debt programs.*

The 1998 budget also projects financial surpluses of \$6 billion in 1998-99 and \$9 billion in 1999-2000. The financial balance provides a measure of the cash requirement to fund the government's programs and debt charges – a financial requirement represents a positive cash requirement whereas a financial surplus represents a negative cash requirement. The cash requirement is funded with market debt. Market debt includes marketable bonds, Treasury bills, retail non-marketable debt (primarily Canada Savings Bonds) and foreign-currency-denominated bonds and bills.

Ongoing financial surpluses mean that there will be a significant, ongoing decline in market debt. As a result, market debt programs will need to be gradually restructured. In this context, priority will be given to the maintenance of a liquid and well-functioning Government of Canada securities market, as well as ensuring the integrity of the market.

The difference between the financial surplus and a balanced budget reflects a number of accrual adjustments made to expenditures and revenues in the calculation of the budgetary balance. These accrual adjustments do not affect the financial balance because they do not require immediate cash payments. The largest of these accrual adjustments relates to the government's liabilities for public sector pensions. The accumulation of these accrual adjustments comprises the other portion of the debt – this portion is commonly referred to as non-market debt.

*Pension reform may lead to additional market borrowing.*

Non-market debt will continue to increase over time, reflecting higher public service pension plan liabilities. The government has indicated its intention to consider reform of the public service pension plans. The reform may involve the replacement of some of the government's internal funding with market funding and, as a result, would reduce the pace of the reduction in market debt.

### Government of Canada Securities Market

*A well-functioning Government of Canada securities market is important to all market participants.*

A well-functioning Government of Canada securities market provides low-cost financing for the government. It is also of general benefit to the domestic capital market where federal securities are key investments, as well as pricing and hedging tools.

The Government of Canada securities market is one of the most liquid and efficient sovereign markets in the world, featuring tight bid-offer spreads, large transactions volumes, and high turnover ratios. While marketable debt is expected to decline over time, the government's priority will be to ensure that the Government of Canada securities market continues to be highly attractive to investors.

A number of recent developments, including growing levels of concentration and the declining supply of new debt, are creating challenges for the management of the Government of Canada securities market. This is reflected by the occurrence of infrequent, but highly undesirable "squeezes"<sup>1</sup>. Squeezes reduce the incentive for dealers and investors to participate actively in the Government of Canada securities market. If steps are not taken, this could lead to reduced participation which would raise the cost of federal government borrowing. This, in turn, would affect other market participants who rely on a liquid and efficient Government of Canada securities market.

*The government is responsible for the functioning of the primary market.*

It is clearly in the public interest to ensure that integrity of the Government of Canada securities market is maintained. In this regard, the government distinguishes between the primary market (auctions), where it bears responsibility, and the secondary market, where the responsibility for maintaining a well-functioning market is shared by all market participants. The government is proposing changes to the auction rules designed to prevent squeezes from occurring at auctions, and the Investment Dealers Association is developing a Code of Conduct. Details on the initiatives underway to enhance market integrity are detailed in a later section of this report.

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<sup>1</sup> A squeeze occurs when one or more market participants gain control of the stock of a security and use the controlling position to manipulate prices.



## *1998-99 Debt Management Strategy*

### **Maintaining a prudent debt structure**

*With a still-large debt stock, maintaining a prudent debt structure remains a priority.*

While the elimination of the deficit represents a major achievement, the level of debt remains significant and must come down. Canada's debt stock is exposed to interest rate changes originating in Canada and around the world. Interest rate shocks can significantly affect the level of annual debt charges, as the portion of debt that is rolling over must be issued at the new prevailing market interest rates. Some \$200 billion of the federal market debt will be maturing or repriced over the 1998-99 fiscal year. The continued success of the government in achieving low interest rates should prove beneficial to Canada in this respect.

Nonetheless, a prudent debt structure is essential in protecting the government's fiscal position from unexpected increases in interest rates, as well as moderating refinancing risk. A prudent debt structure is one that provides reasonable cost stability under a range of economic scenarios. Such a structure also maintains investor and credit rating agency confidence.

*The fixed target is being slightly increased in 1998-99 for prudent financial management reasons.*

In 1995, the government set a target for the fixed-rate share of the debt<sup>2</sup> of 65 per cent – it was achieved in 1997-98. This means that a 100-basis-point increase in interest rates would now raise public debt charges by \$1 billion in the first year; in the mid-1990s, the first year impact of a 100-basis-point increase was estimated at about \$1.8 billion.

A key debt management undertaking over the last months was to review the target and assess its ongoing suitability. The government has decided to increase the target slightly – the objective will be to have 2/3 of the debt in fixed-rate instruments. This reflects the government's preference for greater prudence in its debt structure and provides increased operational flexibility.

Operationally, it is very difficult to maintain the debt at a precise fixed-rate proportion. Large maturing bond benchmarks will cause short-term variance in the fixed ratio. Rather than maintain a precise fixed-rate target, the government will manage the fixed-rate proportion of the debt around the new target.

*Further diversification of the investor base will be pursued through CI&S, the government's retail debt agency.*

A further strategy to increase cost stability has been to diversify the investor base for Government of Canada securities. By having a diversified investor base, the stock of debt is less exposed to interest rate changes caused by shifts in investor preferences. An ongoing initiative in this context is the work being done by Canada Investment and Savings (CI&S), the government's retail debt agency, to diversify the retail debt stock and broaden the retail investor base. CI&S will continue to provide individual Canadians with greater opportunity to invest in Canada. This will be accomplished by the continuing development of investment and savings products that Canadians want.

<sup>2</sup> The fixed-rate share of the debt is the percentage share of the gross debt that matures or is being repriced in more than one year.

## Maintaining and Enhancing a Well-Functioning Market

### *Debt Program Design*

*The government will maintain the principles of liquidity, transparency and regularity in its operations.*

Liquidity, transparency and regularity are the principles underlying the maintenance of a well-functioning market. The federal government is committed to maintaining these principles as the level of market debt declines.

To ensure transparency and regularity, the government will continue to borrow in the domestic market on a regular, preannounced basis. In 1998-99, the government will continue the practice of holding regularly scheduled quarterly auctions of 2-, 5- and 10-year bonds. As part of our continuing and gradual restructuring of the bond program, the frequency of issuance of 30-year bonds will be reduced to two times per year from four times per year.

*A bond buy-back program is being introduced on a pilot basis to improve primary market liquidity.*

To enhance bond market liquidity, the government plans to implement a bond buy-back program on a pilot basis in 1998-99. The purpose of this program is to buy back existing, less liquid bonds to support the maintenance of a liquid new issue market. The intent of the pilot program this year is to have no major impact on the level of bonds outstanding at year-end – thus there is the potential, later in 1998-99, for an additional bond auction to be inserted into the calendar. The government will consult with market participants on the design of the pilot program and will announce the details well in advance of its implementation.

*Gradual adjustments will be made in consultation with market participants.*

Looking further ahead, the government's plan is to adjust domestic debt programs over time in such a way that the market is not disrupted unduly. The government will be proceeding on a gradual basis, in close consultation with market participants.

### ***Enhancing Market Integrity***

*Changes to the auction rules are being proposed to improve the functioning of the primary market.*

The government is also undertaking a number of initiatives to enhance market integrity.

With respect to the primary market (auctions), the Department of Finance, in conjunction with the Bank of Canada, will be releasing very shortly a discussion paper outlining proposed changes to the auction process for Government of Canada securities. The proposals reflect comments received in response to a discussion paper issued in December 1996. They focus on changes to the auction rules, as well as an increase in the Bank of Canada's monitoring of the bond and Treasury bill markets. The proposals are designed to ensure that the auction process is competitive, transparent and fair.

*Initiatives with the private sector are underway to improve the integrity and transparency of the secondary market.*

With respect to the secondary market in Government of Canada securities, the Department of Finance and the Bank of Canada are working closely with the Investment Dealers Association (IDA), as it develops a Code of Conduct for IDA members. The Code sets a high standard of behaviour for all market participants.

The government also continues to provide support for improved secondary market price transparency. The IDA and the Inter-Dealer Brokers Association are currently in the process of developing a screen-based information system on prices and trades in the secondary market in Government of Canada securities.

*A legislative review will be undertaken.*

The government plans to review the statutory framework for federal debt management. The review will focus on the need to modernize the government's debt management authority and to clarify its capacity to address integrity concerns in the Government of Canada securities market.

## *1998-99 Federal Debt Programs*

*Plans for the market debt programs are based on the 1998 budget outlook.*

The federal government uses a variety of instruments to fund its operations:

- fixed-rate marketable bonds;
- Real Return Bonds;
- Treasury bills; and
- retail debt (primarily Canada Savings Bonds).

The foreign currency borrowing program is used to fund Canada's foreign exchange reserves.

The plans for each debt program in 1998-99 are presented below. The plans are based on the 1998 budget outlook for financial surpluses (excluding foreign exchange transactions): the forecast is \$6 billion for 1998-99, and \$9 billion for 1999-2000.

The changes are consistent with the government's intention to make gradual adjustments, and to maintain a high standard of liquidity and transparency. They incorporate feedback received from market participants.

### **Fixed-Rate Marketable Bonds**

*The planned bond program for 1998-99 will be modestly lower than in 1997-98.*

Fixed-rate marketable Government of Canada bonds are issued in Canadian dollars and pay interest semi-annually. The outstanding stock of these bonds is projected to be \$285 billion at March 31, 1998, up from \$275 billion at March 31, 1997. Of the total amount outstanding, \$36 billion of bonds will be maturing in 1998-99.

#### **1998-99 Program**

*Quarterly issuance of the 2-, 5- and 10-year maturities will be maintained ...*

- Given the declining needs of the government, the fixed-rate bond program (i.e. gross issuance) is planned to be modestly lower than the \$38 billion gross program in 1997-98.
- Regular, quarterly issuance of the 2-, 5- and 10-year maturities will be maintained.
- As part of the gradual restructuring of the bond program, issuance of the 30-year bonds will be reduced to a semi-annual basis. Last year, 3-year bonds were dropped from the program.
- As a consequence of the decrease in 30-year issuance, the proportion of 2-, 5- and 10-year bonds within the total bond program will be modestly higher than in 1997-98.

*... 30-year bonds will be issued semi-annually.*

*Quarterly auction schedules will be retained.*

- For the purposes of transparency, the bond auction calendar, containing dates for each bond maturity to be auctioned, will continue to be published prior to the start of each quarter.
- To maintain liquidity, the target benchmark sizes for all maturities will be maintained at \$7-10 billion.

*The 2-year bond dating will be changed.*

- The maturity dates for the 2-year bond will be changed to June 1 and December 1 (from March 15 and September 15) to enhance the fungibility of interest payments with the 10- and 30-year bonds, smooth out the bond maturity pattern and facilitate cash management.

*The target for RRBs continues to be modest growth.*

### **Real Return Bonds (RRBs)**

The federal government plans to issue up to \$2 billion in RRBs in 1998-99. The currently planned method of distribution is quarterly single-price auctions.

*The Treasury bill stock is expected to continue to decline in 1998-99.*

### **Treasury Bills**

The Treasury bill stock at the end of 1997-98 is expected to be in the area of \$113 billion, down from \$135 billion at the end of 1996-97.

Based on the fiscal plan for 1998-99, the Treasury bill stock is expected to fall roughly 10 per cent.

### **Retail Debt**

Canada Investment and Savings (CI&S), the government's retail debt agency, plays an important part in the government's debt program, by targeting an investor base among the widest possible range of individual Canadians. Its long-term strategy is to continually develop innovative products and services that will fulfil investor needs and encourage Canadians to invest in Canada.

The retail debt plan for 1998-99 will be released directly by CI&S under separate cover.

*The target level of foreign exchange reserves has been increased.*

### **Foreign Currency Debt Programs**

The Minister of Finance announced in the 1998 budget that, reflecting increased flows and volatility in foreign exchange markets, Canada's foreign exchange reserves would continue to be increased. This will bring Canada's reserves more in line with those of comparable countries.

The reserves are funded through a variety of instruments, including Canada Bills and Canada Notes, Global and Euro bonds, Euro Medium-Term Notes and cross-currency swaps of domestic obligations. The key determinants of the relative use of these instruments will be their contribution to minimizing the cost of carrying reserves and to maintaining a balanced maturity structure.