Debt Management Strategy

2005–2006

Canada

Debt Management Strategy

2005–2006

Department of Finance Canada
Ministère des Finances Canada

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Foreword by the Minister of Finance

I am pleased to table before Parliament the Government of Canada's *Debt Management Strategy* for fiscal year 2005–06. This document provides comprehensive information on the Government's debt strategy and objectives for the coming fiscal year.

Over the past eight years, Canada has pursued a balanced approach to fiscal management that has combined debt reduction, targeted spending in areas that represent the priorities of Canadians, and efforts to reduce the tax burden on both individuals and businesses. This balanced approach has been the cornerstone of Canada's fiscal policy and has been the source of our success at a time when many of our G-7 counterparts continue to face difficult fiscal circumstances.

This balanced approach has provided significant benefits for Canadians. Our most recent federal budget, which was tabled on February 23, 2005, forecasts that Canada will record its eighth consecutive balanced budget or better—a record that is unmatched in our nation's history. Since 1997–98, the budgetary surpluses have reduced our federal debt by more than $61 billion. As a result, the federal debt-to-GDP (gross domestic product) ratio is projected to decline to 38.8 per cent in 2004–05, down from 68.4 per cent in 1995–96. This reduction in the federal debt burden has led to lower interest charges of more than $3 billion annually, savings that have already been invested in the priorities of Canadians, such as health care, education and the environment, as well as significant reductions in both corporate and personal tax rates.

Nevertheless, federal debt charges continue to consume just under 18 cents out of every revenue dollar received by the federal government. In order to provide the funding necessary to meet the priorities of Canadians, while preparing for the demographic and social challenges caused by an aging population, the Government must continue to maintain its focus on debt reduction and prudent fiscal planning.

Canadians continue to enjoy one of the highest standards of living in the world, and the Government is committed to maintaining our nation's prosperity. By continuing to use a balanced approach that combines targeted spending, debt reduction and prudent management of our debt, and tax relief, we will redouble our efforts to ensure that Canada continues to enjoy a strong economy, both now and in the future.

The Honourable Ralph Goodale, P.C., M.P.
Minister of Finance
Ottawa, March 21, 2005

Purpose of This Publication

The *Debt Management Strategy* is an annual publication of the Department of Finance Canada that provides information on the Government of Canada's objectives and strategies for managing the outstanding stock of market debt and financial assets within the context of the fiscal environment.

The Department publishes a companion document, the *Debt Management Report*, which reports on the Government's debt operations over the previous fiscal year and provides detailed information on outstanding debt. This publication is available shortly after the release of the Public Accounts each year.

Focus of the Federal Debt Strategy

The debt strategy focuses on the management of the marketable debt and liquid financial assets of the Government of Canada.

As of March 31, 2004, the Government had $440.2 billion of market debt composed of marketable bonds, Treasury bills, retail debt, foreign currency debt, Canada Pension Plan bonds, and obligations related to capital leases, and $61.7 billion of liquid financial assets composed of domestic cash balances and foreign exchange assets.

	(C$ billions)
Market Debt	
Payable in Canadian currency	
Marketable bonds	278.8
(fixed-rate bonds with 2-, 5-, 10- and 30-year maturities and real return bonds with 30-year maturities)	
Treasury bills	113.4
(zero-coupon securities with 3-, 6- and 12-month maturities)	
Retail debt	21.3
(Canada Savings Bonds and Canada Premium Bonds)	
Canada Pension Plan bonds	3.4
Obligations related to capital leases	2.8
Payable in foreign currency	
Marketable bonds	12.9
(fixed-rate bonds issued in US dollars and in other currencies)	
Canada bills	3.4
(zero-coupon securities with 1- to 9-month maturities)	
Foreign currency notes	4.3
(Canada notes and Euro Medium-Term Notes)	
Liquid Financial Assets	
Cash	20.5
Foreign exchange reserves	41.2

Source: *Public Accounts of Canada.*

Highlights of the 2005–2006 Debt Strategy

- The Government will continue to target a gradual reduction in the fixed-rate share of the debt from two-thirds in 2002–03 to 60 per cent in 2007–08 to achieve savings on public debt charges while retaining a prudent debt structure.
- In moving to the new debt structure, the maintenance of a well-functioning market in Government of Canada securities is an important objective of the debt strategy.
- Thus, the change in the debt structure will continue to be made gradually through increases in the Treasury bill program and reductions in the bond program:
  - The outstanding amount of Treasury bills will increase from about $130 billion at the end of 2004–05 to approximately $140 billion by the end of 2005–06.
  - The total amount of marketable bonds issued in 2005–06 will be about $33 billion, roughly $3 billion lower than in 2004–05. Net marketable bond issuance (net of buybacks) of about $23 billion will be about $1 billion lower than in 2004–05. The Government intends to forego the auction of a 2-year fungible bond in the fourth quarter of 2005–06 to facilitate a reduction in gross bond issuance in the coming year.
  - The bond buyback program has helped to smooth the transition from the larger bond programs of the 1990s to the smaller programs expected in the future. While the bond buyback program is needed to continue to support a portion of gross bond issuance over the next few years, the requirement for a transition mechanism to a sustainable, lower level of bond issuance is diminishing. In addition, it is appropriate to reduce the buyback program as the bond stock becomes concentrated in fewer liquid issues. The Government will begin in 2005–06 to reduce the size of the bond buyback program. The planned amount of bond buybacks is in the order of $9 billion to $10 billion, roughly $1.5 billion less than in 2004–05.
  - The stock of marketable domestic bonds will decrease from an estimated $243 billion at the end of 2004–05 to about $235 billion due to maturities and continued cash management buyback operations.
- Annual bond issuance is expected to stabilize in the range of $30 billion to $35 billion once the 60-per-cent fixed-rate target has been reached. Annual issuance of this size will put into question the viability of the scope and structure of the current bond program. In 2005–06, the Government will consult with market participants on potential changes to the structure of the bond program to help ensure that a well-functioning market for Government of Canada securities is maintained in future years.

- To enhance bidding and participation in domestic debt operations:
  - Reflecting market participants' preferences, the timing of bond auctions will be advanced from 12:30 p.m. to 12:00 p.m. to allow these auctions and associated buyback operations to take place earlier in the day. Also, the time between bond auctions and cash buybacks will be reduced from 30 minutes to 20 minutes beginning in April. The offering deadline for bond buybacks will be advanced from 1:00 p.m. to 12:20 p.m.
  - The Government will continue to work in the fiscal year to further reduce turnaround times for auctions and buyback operations.
- The Government will be actively working with market participants and securities regulators in 2005–06 to increase the level of transparency of secondary market trading information for Government of Canada securities, both for institutional and retail investors.

Funds Management Framework

Government of Canada funds management encompasses a wide range of activities related to the issuance of debt and the management of liquid financial assets by the Government. Prudent and effective funds management is a key element of achieving the Government's objective of fiscal sustainability. Management of debt and assets follows key principles. There are also specific objectives and principles guiding management of domestic debt and cash, and management of foreign reserves.

Key Principles

- Governance: Ensure that debt and asset management activities are conducted in line with clearly established operational and risk guidelines and that risk monitoring and oversight are independent of treasury management operations.
- Transparency: Disclose information on the management and performance in a timely manner so as to ensure public understanding and accountability.
- Leading practices: Operational frameworks and practices should be in line with leading practices of other comparable sovereigns. Regular evaluations should be conducted of the effectiveness of the governance framework, policy initiatives and operations.

Domestic Debt and Cash Management

Objectives

The fundamental objective of domestic debt and cash management is to provide stable, low-cost funding to meet the financial obligations and liquidity needs of the Government of Canada. Key strategic objectives, pursued over a medium-term horizon, are to maintain a prudent debt structure, maintain and enhance a well-functioning market for Government of Canada securities, and maintain a diversified investor base.

Principles

In pursuit of these objectives, the Government of Canada manages its activities according to a set of principles.

- Prudence: Manage the structure of the debt to protect the Government's fiscal position from unexpected increases in interest rates and to limit refinancing needs. Manage the Receiver General cash position to ensure that adequate liquidity is maintained at reasonable cost and risk to the Government.
- Cost-effectiveness: Borrow using a variety of instruments and a range of maturities, and maintain a diversified investor base.

- Maintaining a well-functioning market: Emphasize transparency, liquidity and regularity in the design and implementation of domestic debt programs in order to maintain a well-functioning domestic market. Work with market participants and regulators to enhance the integrity and attractiveness to investors of the market for Government of Canada securities.
- Consultations: Seek input from market participants on major adjustments to the federal debt and cash management programs.

Foreign Reserves Management

Objectives

The fundamental objective of foreign reserves management is to provide a source of funds to help promote orderly conditions for the Canadian dollar in the foreign exchange market, and to provide general foreign currency liquidity for the Government.

The key strategic objectives of foreign reserves management are to maintain a high standard of liquidity, preserve capital value, and optimize return subject to liquidity and prudence objectives.

Principles

In pursuit of these objectives, the Government of Canada manages its foreign exchange reserves according to a set of principles.

- Prudence: Manage borrowing and investment activities to limit exposure to risk and protect the value of the Government's reserve assets.
- Cost-effectiveness: The carrying cost of reserves, taking into account the return on assets and the cost of liabilities, should be kept as low as possible.

Debt Management Environment

Fiscal Outlook

Budgetary Balance

The Government's fiscal policy sets the context for debt management operations. The Government recorded budgetary surpluses over the previous seven fiscal years and reduced the federal debt (accumulated deficit) by $61.4 billion. As announced in the February 2005 budget, the Government is committed to maintaining balanced budgets or better for 2004–05 and for each of the next five fiscal years.

Contingency Reserve and Debt Reduction

The Government of Canada sets aside an annual Contingency Reserve of $3 billion to cover risks arising from unforeseen circumstances.

Combined with forecast economic growth, the federal debt-to-GDP ratio—the level of debt in relation to the country's annual income—remains on a downward track. On an accrual basis, the federal debt (accumulated deficit) as a percentage of the economy is projected to fall to 38.8 per cent in 2004–05, down from its peak of 68.4 per cent in 1995–96. With the commitment to balanced budgets in each of the next five fiscal years, it is forecast to decline to about 30.6 per cent in 2009–10.

In terms of international debt burden comparisons, taking into account the accounting methods of various sovereigns, the debt burden of Canada's total government sector has declined the fastest among Group of Seven (G-7) countries since the mid-1990s. Between 1995 and 2004, Canada's net financial liabilities as a percentage of GDP (akin to the debt-to-GDP ratio) are estimated to have been reduced by 38.2 percentage points. Consequently, Canada's total government debt burden moved from being the second highest among the G-7 countries to the lowest in 2004. According to the OECD, Canada's debt burden is expected to decline further in both 2005 and 2006, while the debt burdens of the other G-7 countries, with the exception of Italy, will increase.

Financial Requirement/Source

The key budgetary measure for debt management planning is the financial requirement/source rather than the budgetary balance (see box below). The budgetary balance is presented on a full accrual basis, recognizing revenues and expenses when they are incurred. In contrast, the financial requirement/source is a cash flow measurement that represents actual cash transactions related to current- and prior-year budgetary items, as well as the cash implications of non-budgetary transactions, such as changes in financial or non-financial assets or liabilities.

Measuring the Government's Fiscal Position: Budgetary Balance and Financial Requirement/Source

The budgetary balance and financial requirement/source measures used in the *Debt Management Strategy* are based on the Public Accounts accounting framework. The Public Accounts provide information to Parliament on the Government's financial activities, as required under the Financial Administration Act. The measures are provided on a fiscal-year basis ending March 31.

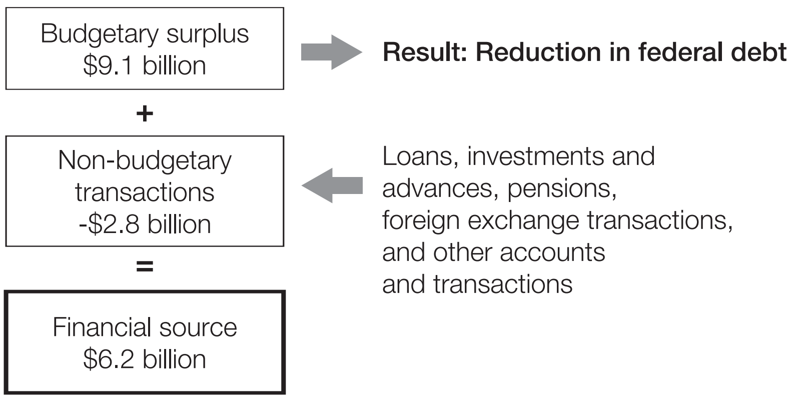
The budgetary balance—deficit or surplus—is one measure of the Government's financial situation. Consistent with the recommendations of the Auditor General of Canada, the Government moved to full accrual accounting in 2002–03. The move enhances transparency and decision making by providing a more complete accounting of government activities than under the previous modified accrual accounting framework. Under the full accrual basis of accounting, revenues and expenses are recorded when they are incurred, regardless of when the actual cash flows occur. For more information on accrual accounting, see Annex 6 of *The Budget Plan 2003*, available on the Department of Finance Web site at www.fin.gc.ca.

The financial requirement/source provides a measure of the net cash position of the Government. In contrast, the budgetary balance also includes obligations incurred by the Government during the course of the year for which the cash transaction does not take place until future years. In general terms, the difference between the financial requirement/source and the budgetary balance is timing (i.e. when funds for budgetary items are committed and the actual cash transaction occurs).

The financial requirement/source includes the cash outlays related to current- and prior-year budget commitments. It also includes transactions in loans, investments and advances, federal employees' pension accounts, other specified purpose accounts, foreign exchange activities, and changes in other financial assets, liabilities and non-financial assets. These activities are included as part of non-budgetary transactions. The financial requirement/source corresponds closely to the unified budget balance measure used in the United States.

Figure 1 presents the various elements of the Government's budgetary framework for the 2003–04 fiscal year, the last year for which audited Public Accounts financial statements are available.

Figure 1
Financial Source at March 31, 2004



Note: Numbers do not add due to rounding.
Source: *Public Accounts of Canada.*

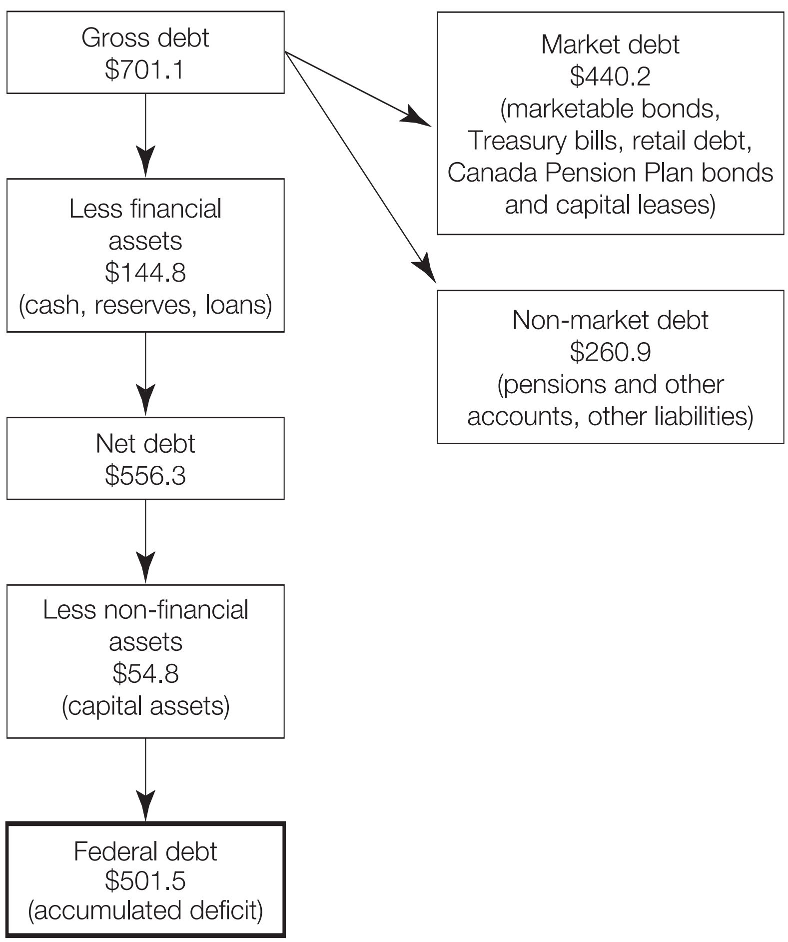
Net Financial Requirement/Source Outlook

With a balanced budget and a requirement of $2.7 billion in non-budgetary transactions, a financial requirement of $2.7 billion is estimated in 2004–05. The Government also expects a financial requirement of $5.3 billion in 2005–06. This is due to the transfer of Canada Pension Plan (CPP) operating balances, currently held by the Government, to the CPP Investment Board, as well as requirements from loans, investments and advances, and capital assets. The CPP funds transfer involves switching non-market debt to market debt, which engenders a cash requirement but does not have any effect on the federal debt.

Debt Composition

Debt management operations focus on the Government of Canada's market debt, which is only one component of the Government's gross debt. The other component of the gross debt, non-market debt, is taken into account in debt strategy planning but is not subject to debt management strategy initiatives. Non-market debt includes federal public sector pension liabilities and the Government's accrued liabilities. Debt strategy planning also focuses on the management of the Government's financial assets. Figure 2 illustrates the relationships between the components of the public debt for the 2003–04 fiscal year.

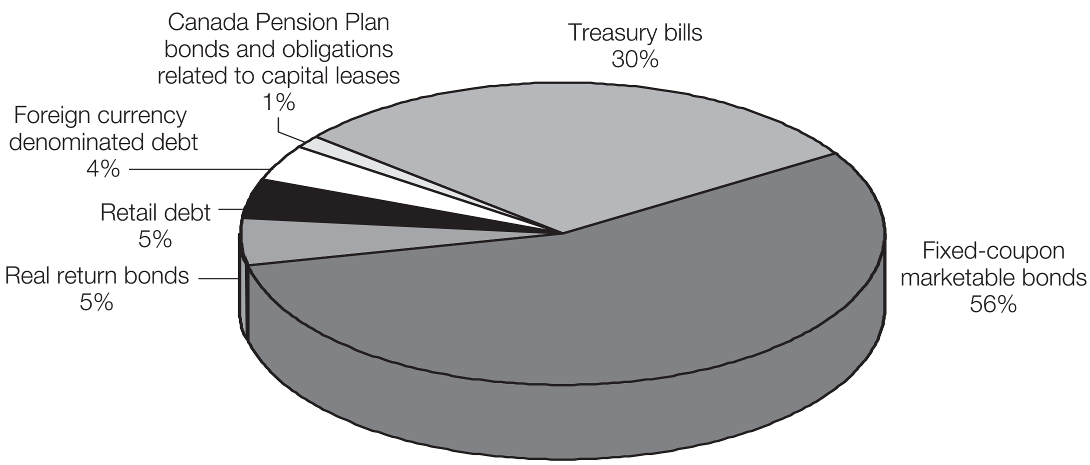
Figure 2
Total Public Debt at March 31, 2004
(in billions of dollars)



Source: *Public Accounts of Canada.*

The Government's market debt consists of fixed-coupon marketable bonds, real return bonds, Treasury bills, retail debt (Canada Savings Bonds and Canada Premium Bonds), foreign currency denominated debt, and bonds issued to the Canada Pension Plan and obligations related to capital leases. Financial assets held by the Government include operating cash balances, loans, investments and advances, and foreign exchange reserves. Non-financial assets include land, buildings and infrastructure, and vehicles. Chart 1 shows the forecast composition of the market debt at year-end 2004–05.

Chart 1
Forecast Composition of Market Debt
March 31, 2005



Note: Does not add to 100% due to rounding.
Source: Department of Finance.

Market Debt Outlook

The federal debt declined by $9.1 billion in 2003–04 and by $61.4 billion over the past seven fiscal years. Market debt, the portion of the federal debt that is funded in capital markets, declined by $2.2 billion in 2003–04 and by $38.6 billion over the past seven fiscal years. A further decline in market debt is expected in 2004–05.

Borrowing Authority

Under the Financial Administration Act, the Government has standing authority to refinance market debt maturing in a fiscal year.

Parliamentary approval must be obtained to raise new market debt, in the form of a borrowing authority bill. Once obtained, the authority to raise debt levels generally extends through the remainder of the fiscal year and lapses at the start of the next fiscal year.

Currently available borrowing authority is limited to a $4-billion non-lapsing contingency from the 1996–97 Borrowing Authority Act. The Government expects to meet forecast financial requirements in 2005–06 without seeking new borrowing authority.

2005–2006 Debt Management Strategy: Themes

Balancing Prudence and Cost: Debt Structure

One of the Government's key objectives in managing the debt is to strike the appropriate balance between low financing costs and cost stability over a medium-term horizon. In general, borrowing long-term debt is less risky, but more costly, than borrowing short-term debt. Given its sizeable level of debt, the Government maintains a prudent debt structure to protect its fiscal position from unexpected increases in interest rates and to limit annual refinancing needs. One of the main targets in this regard is the fixed-rate share of the debt—that is, the share of the debt that does not need to be refinanced within a year.

In 2005–06, the Government will continue to manage the transition by 2007–08 from two-thirds to the new 60-per-cent target, adopted in the 2003 budget, for the fixed-rate portion of the debt. The reduction in the fixed-rate share is being implemented in an orderly and transparent manner to allow the market time to adjust to the required changes in debt programs.

Updated analysis continues to support the reduction in the fixed-rate share to 60 per cent, indicating net annual cost savings could reach up to $500 million, on average, when the 60-per-cent debt structure is in place. Compared to a two-thirds debt structure, the lower fixed-rate structure will modestly increase the Government's short-term exposure to adverse movements in interest rates. However, the analysis also confirms that, over time, the additional costs of an interest rate shock would be more than offset by the savings associated with a lower fixed-rate structure.

Maintaining A Well-Functioning Market

As the sovereign and the largest borrower in the Canadian fixed-income marketplace, the Government has a major interest in sustaining a liquid and efficient market for Government of Canada securities for the purpose of providing stable low-cost funding. A liquid and efficient government securities market also provides key pricing and hedging tools for market participants, thereby contributing to the effective functioning of the broader fixed-income market.

One of the key challenges for the Government in recent years has been to maintain a liquid, well-functioning Government securities market in the face of declining borrowing requirements and reduced issuance. The Government has taken steps to adjust its bond program to maintain participation at auctions and liquidity in the secondary market, principally by concentrating issuance of large benchmark sizes in four key maturity sectors (2, 5, 10 and 30 years) and by introducing a bond buyback program.

The bond buyback program has played a key role in smoothing the transition from the larger bond programs of the 1990s to the smaller programs expected in the future. Gross bond issuance of the Government of Canada peaked at $54 billion in 1996–97; the 2004–05 program is expected to be slightly less than $36 billion. A further reduction in bond issuance to around $33 billion is planned in 2005–06 and, based on continued balanced budgets, annual gross bond issuance is expected to stabilize in the range of $30 billion to $35 billion once the 60-per-cent fixed-rate target has been reached in 2007–08. (Detailed information on the 2005–06 programs is contained in the following section, entitled "2005–2006 Debt Strategy: Program Details.")

In 2005–06 the Government will begin to reduce the size of the buyback program for two principal reasons. First, while the bond buyback program is needed to continue to support a portion of gross bond issuance over the next few years, the requirement for a transition mechanism to smaller sustainable bond programs is diminishing. Second, a reduction in the size of the buyback program is appropriate as the bond stock becomes concentrated in fewer old benchmark bonds which provide liquidity for market participants. The buyback program was initially designed to repurchase less liquid bonds to support new issuance of large, liquid benchmark bonds as the size of the gross bond program was reduced from its peak of $54 billion in 1996–97 to sustainable programs in the range of $30 billion to $35 billion. As the program has matured, many of these less liquid bonds have now been repurchased. As a result, the buyback program now relies on purchasing previously issued liquid benchmark bonds, and "recycles" this liquidity into new benchmark issues (i.e. the extent to which the buyback program contributes to the overall liquidity of the Government of Canada bond market has diminished). In the interest of maintaining a yield curve with a reasonable number of liquid issues, the Government will begin to reduce the buyback program.

Looking forward, annual bond issuance of $30 billion to $35 billion is expected to put into question the viability of the current bond program structure—i.e. quarterly auctions of 2-, 5- and 10-year bonds; semi-annual auctions of 30-year bonds; the present benchmark target sizes; and time periods for building benchmark bonds. In the relatively near future, the Government may need to adjust the scope of the bond program to enable maintenance of a well-functioning market for Government of Canada securities in an environment of smaller bond programs.

Accordingly, in 2005–06, the Government plans to assess potential structural changes to the bond program and to consult with market participants on this topic. (Consultations on this issue were initiated in 2004–05.) In the interim, the Government plans to accommodate a reduction in bond issuance in 2005–06 by foregoing the fungible 2-year auction in the fourth quarter of the fiscal year.

Review of the Debt Distribution Framework

In the fall of 2004, the Government initiated a review of its debt distribution framework to ensure that it has continued access to stable, low-cost funding sources over a medium-term horizon and that the Government of Canada securities market continues to function well. The framework, which includes the auction rules and surveillance of participants in the market for Government of Canada securities, was last reviewed in 1998. At that time, measures were put in place to enhance the reliability of access to funding for the Government and to ensure that the auction process would not result in undue concentration of securities or unfair competitive advantage for any particular market participants.

Since the framework was last changed, the Government has conducted auctions that have been consistently covered and well bid. However, participation has become increasingly concentrated, with the Government relying on fewer, large dealers to cover the sale of securities at auctions. The secondary market for Government securities, along with other sectors of the domestic fixed-income market, has also become increasingly concentrated. Other trends that have developed since the last review include an evolution of debt management practices of other governments, interest in direct participation at auctions by institutional and retail investors, greater price transparency and the advent of electronic trading systems.

Consultation meetings were held with market participants and other interested parties in October and November 2004 to help ascertain the current and future effectiveness of the framework and whether changes to the present distribution framework for Government of Canada securities are warranted. To allow for comments from a broad range of parties, a consultation document entitled *Review of the Government of Canada Debt Distribution Framework*[1] was released on the Bank of Canada's Web site. A summary of the comments received is available on the Bank of Canada's Web site at www.bankofcanada.ca.

The review is ongoing and is expected to be completed in 2005–06. The Government is currently assessing the feedback received during the consultations and conducting analysis of the framework. A report on the review, which may identify refinements to the distribution framework, is planned to be published later in 2005–06.

[1] See www.bankofcanada.ca/en/notices_fmd/2004/not181004_preface.

2005–2006 Debt Strategy: Program Details

Domestic Debt Programs

Modifications to debt programs in 2005–06 will continue the orderly adjustment towards the new debt structure target. In this context, the Government will focus on the maintenance of a well-functioning market over the medium-term horizon.

On April 1, 2004, the Government reduced the turnaround time for auctions and buyback operations from a fixed time to a "best efforts basis" (i.e. when ready). There has been a dramatic reduction in turnaround times, with an average for auctions of less than 3 minutes (compared to a maximum of 10 minutes) and for buyback operations of less than 7 minutes (compared to a maximum of 15 minutes).[2] Lower turnaround time has reduced the market risk for market participants, further enhancing the efficiency of the auction and buyback process. Market participants have strongly supported this change in turnaround time. The Government will continue to reduce turnaround times in 2005–06.

Fixed-Coupon Marketable Bond Program

Gross bond program issuance in 2005–06 is planned to be about $33 billion, $3 billion less than in 2004–05. Net marketable bond issuance (net of buybacks) of about $23 billion will be around $1 billion lower than in 2004–05. Taking into account bond maturities and cash management bond buyback operations during the year, the stock of bonds is expected to decline from an estimated $243 billion to about $235 billion.[3]

In 2005–06 the Government will continue to hold quarterly auctions of 2-, 5- and 10-year bonds and semi-annual auctions of 30-year bonds. However, the Government intends, absent any significant change in its fiscal outlook, to forego the auction of a fungible 2-year bond in the fourth quarter of the 2005–06 fiscal year. This measure taking place in 2005–06 is intended to facilitate a reduction in gross bond issuance in the coming year pending the larger-scale review of the bond program in the fiscal year. The 2-year auction in the third quarter of 2005–06 will be fungible (i.e. shares a common maturity date) with a large existing benchmark bond and will ensure that there is adequate liquidity in the 2-year sector of the curve for market participants. As in previous years, a quarterly calendar of auctions will be posted on the Bank of Canada Web site before the start of each quarter.

The 2-, 5-, 10- and 30-year new maturity benchmark target sizes will remain unchanged from last year (2-year bonds: $7 billion to $10 billion, 5-year bonds: $9 billion to $12 billion, 10-year bonds: $10 billion to $14 billion, and 30-year bonds: $12 billion to $15 billion). The benchmark sizes will be achieved through reopenings (where a particular bond issue is sold at several auctions) and switch buyback operations until the benchmark target size is reached.

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[2] For the period from April 1, 2004 to January 26, 2005.

[3] Regular bond buybacks do not affect the stock of bonds, as the program supports the issuance of new benchmark bonds.

A list of outstanding Government of Canada bonds, including their maturity dates, is contained in the 2003–04 *Debt Management Report*, which is available on the Department of Finance Web site at www.fin.gc.ca. The list will also be available in the forthcoming annual publication, *Summary of Government of Canada Direct Securities and Loans*, which will be posted on the Bank of Canada's Web site at www.bankofcanada.ca. Starting April 1, the Bank of Canada will update, on a monthly basis, the information on the outstanding amount of Treasury bills and marketable bonds on its Web site.

Bond Buyback Program

The Government conducts two types of bond buyback operations: regular bond buybacks and cash management bond buybacks. Regular bond buybacks permit the maintenance of a liquid new bond issue program by buying existing bonds with a remaining term to maturity from 18 months to 25 years. These buyback operations are sizeable and play a strategic role in maintaining an active new-issue bond program. The second kind of buyback operation, cash management bond buybacks, aids in the management of the Government's cash balances by repurchasing bonds maturing within the next 18 months.

Regular Bond Buyback Operations

Bond buyback operations[4] can be conducted on a cash or switch basis. Bond buyback operations on a cash basis involve the exchange of less liquid bonds for cash and are conducted shortly after auctions of similar maturity bonds. Bond buyback operations on a switch basis involve the exchange of less liquid bonds for new issue bonds on a duration-neutral basis and are conducted at other times in each quarter.

As noted earlier, in 2005–06 the Government will begin to reduce the buyback program in keeping with its reduced need as a transition mechanism. The Government plans to conduct between $9 billion and $10 billion in bond buyback operations in 2005–06, roughly $1.5 billion less than in 2004–05.

To help support participation by market participants, and reflecting feedback from market consultations, the time between bond auctions and cash buybacks will be reduced from the present 30 minutes to 20 minutes beginning April 1, 2005. Also, the timing of the bond auctions will be advanced from 12:30 p.m. to 12:00 p.m. to allow these auctions and buyback operations to take place earlier in the day. The quarterly maximum repurchase target amounts for the regular bond buyback program and the date of each operation will be announced through the quarterly bond auction calendar published by the Bank of Canada at www.bankofcanada.ca.

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[4] A document entitled *Details on Bond Buyback Operations* relating to the repurchase operations of Government of Canada marketable bonds is available on the Bank of Canada's Web site at www.bankofcanada.ca. It is a compilation of the initiatives previously announced in the Debt Management Strategy documents and other operational enhancements announced on the Bank's Web site over the years.

Cash Management Bond Buybacks (CMBBs)

The CMBB program helps manage the Government's cash requirements by reducing the high levels of cash balances needed ahead of large bond maturities. No major change is planned to CMBB operations in 2005–06.

Real Return Bonds (RRBs)

As a result of the review of the RRB program in 2003–04, the Government affirmed its commitment to the program in the 2004–05 *Debt Management Strategy.* Despite the constraints facing nominal bond issuance over the medium term, the Government will maintain RRB issuance in 2005–06 at a level similar to the $1.4 billion issued in 2004–05.

Treasury Bill Program

Based on the budget outlook and plans for attaining the 60-per-cent target for the fixed-rate portion of the debt, the stock of Treasury bills is expected to increase by around $10 billion to about $140 billion by the end of 2005–06.

Cash management bills (i.e. short-dated Treasury bills) help the Government manage its cash requirements in an efficient manner. The Government intends to continue to actively use cash management bills in 2005–06. In September 2004, the Government announced that minimum bidding requirements and maximum bidding limits would be suspended on a trial basis for a period of at least 12 months for auctions of cash management bills that are non-fungible (i.e. do not share a common maturity date) with a previously issued Treasury bill. The change, which allows participants that have either a limited or strong interest in non-fungible cash management bills to participate to the extent of their interest, has been well accepted by market participants. The trial period will continue in 2005–06.

Domestic Market Development

The Government has been actively involved in supporting the development of enhanced transparency in the Canadian fixed-income market for many years. Greater transparency (i.e. dissemination of trading information regarding prices of securities and volumes traded) for both institutional and retail investors is an important contributor to the development and maintenance of well-functioning and efficient capital markets. The experience of other countries suggests a growing global trend towards higher levels of fixed-income market transparency.

In Canada, positive developments in recent years have enabled progress towards greater transparency. These include the launch of several electronic or alternative trading systems on which fixed-income securities can be traded directly between counterparties, and the establishment of the regulatory framework for these systems. Developments in Canada and abroad suggest that, while maintaining liquidity remains an important objective, a higher level of transparency could be supported for Government of Canada securities.

The Government will be actively working with market participants and securities regulators in 2005–06 to enhance the transparency of Government of Canada securities for both institutional and retail investors.

Retail Debt Program

In September 2004 the Government published an external evaluation of the Retail Debt Program and announced that the program, commonly known as the Canada Savings Bonds Program, would be maintained. The Government also announced that options are being assessed that align the program with the evolving needs of the Government and Canadians. The interrnal review is ongoing.

Management of the Government's Cash Balances

The Government of Canada manages its cash balances to ensure that it has sufficient cash on hand to meet its operating and liquidity requirements. The cash balances are invested through auctions twice daily.

The bulk of the cash balances are invested through a morning auction. The morning auction incorporates a credit management system, using credit ratings, credit lines and collateral arrangements to manage credit risk, and a broad list of eligible counterparties to encourage more competitive bidding at the auctions.

The afternoon auction is used to invest the Government's residual cash balances. This auction is uncollateralized and is limited to Large Value Transfer System participants.

No major change is planned to the cash management framework in 2005–06.

Foreign Reserves

The Government holds foreign exchange reserve assets in the Exchange Fund Account (EFA) to provide foreign currency liquidity and to provide the funds needed to help promote orderly conditions for the Canadian dollar in the foreign exchange markets. Further details on the management of international reserves are available in the *Report on the Management of Canada's Official International Reserves,* which is available on the Department of Finance Web site at www.fin.gc.ca.

The Government's foreign currency reserves are funded through foreign currency liabilities. The foreign currency reserve assets, and liabilities financing those assets, are managed on a portfolio basis, based on many of the same principles used by other sovereigns and private sector financial institutions, including prudent risk management principles.

As announced in the budget, the prudent and cost-effective management of the Government's foreign reserves portfolio will be enhanced by the modernization of the Currency Act. Currently, the Act sets out a legislated list of approved investments, which is no longer in keeping with modern legislative drafting practices. Such a list is inflexible and excludes instruments that are equivalent to or better in terms of risk and return than some currently eligible assets.

Modernizing the Act will improve the flexibility in managing the portfolio by allowing investment in asset classes with lower risk and potentially higher returns. It will also reduce the risk of legal issues arising from antiquated and unclear drafting of some sections of the current legislation.

Ongoing management of the EFA is governed by a strict investment policy designed to achieve the risk/return objectives of the Government. Investment activity follows comprehensive credit guidelines that restrict reserves holdings to high-quality, low-risk assets. The investment policy and guidelines are published in the annual *Report on the Management of Canada's Official International Reserves*. Under a revised legislative framework, a ministerial decision to change investment policy would be reported to Parliament and made public through the annual report.

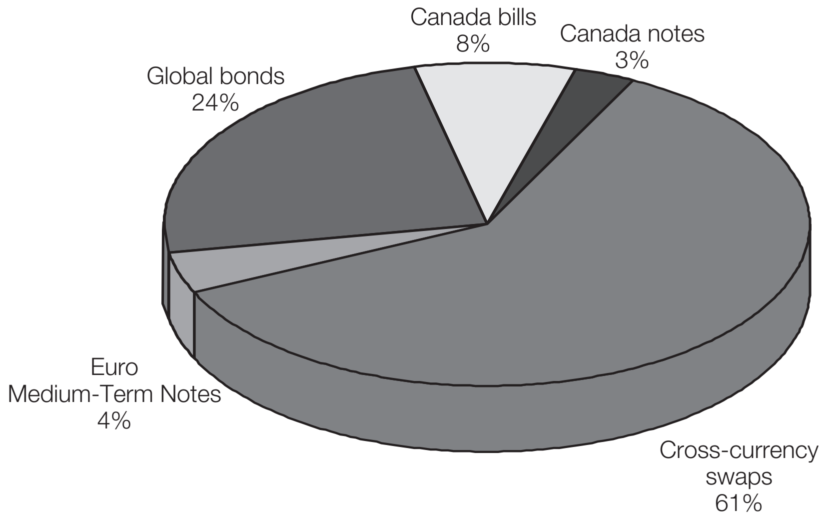
Proposed amendments to the Currency Act to make changes to the eligible investments in the EFA will be introduced shortly.

Funding Sources

The Government has access to a wide range of sources to fund its foreign currency assets. These sources include a short-term US-dollar paper program, medium-term note issuance in various markets, cross-currency swaps of domestic obligations, international bond issues, and purchases of US dollars in foreign exchange markets. Cross-currency swaps have proven to be a particularly cost-effective alternative and have been actively used in recent years.

In 2005–06 the precise mix of funding sources will depend on a number of considerations, including relative cost, market conditions and opportunities, and the desire to maintain a prudent foreign-currency-denominated debt maturity structure. It is expected that cross-currency swaps of domestic obligations will continue to be the primary source of reserve funding. Chart 2 shows the expected composition of foreign currency liabilities at March 31, 2005.

Chart 2
Forecast Composition of Foreign Currency Liabilities
March 31, 2005



Source: Department of Finance.

Risk Management

The Government has in place a comprehensive risk management framework for identifying and managing treasury risk, including market, credit, operational and legal risks related to the financing and investment of the foreign exchange reserves. Standards for risk control are high, market risks are immunized, and high standards of credit quality and portfolio diversification are followed.

The Government's risk management policies call for prudent management of treasury risks based on best practices. In recent years the Government has continued to further strengthen its risk management framework by implementing collateral management frameworks for its Receiver General morning auctions, cross-currency swap program, and US-dollar deposit program. Collateral management systems are increasingly the norm in capital markets as a way of managing risk. Under the frameworks, high-quality collateral (e.g. cash, securities) is posted to the Government when its credit exposure to financial institution counterparties exceeds specified limits.

Summary of 2005–2006 Debt Strategy Plan and Intended Results

Debt Structure

Objective: *Gradually reduce the fixed-rate share of debt from two-thirds to 60 per cent by 2007–08.*

Action for 2005–06:	Intended Result:
Continue to reduce the fixed-rate share of debt towards the 60-per-cent target.	Achieve lower debt charges, while continuing to prudently mitigate the risk to the budget framework.
Increase the size of the Treasury bill program from about $130 billion in 2004–05 to approximately $140 billion in 2005–06. Issue about $33 billion of bonds in 2005–06, about $3 billion less than in 2004–05. Due to large bond maturities and continued bond buyback operations, the bond stock is expected to decrease by some $8 billion.	Facilitate market adjustment to changes in the bond and Treasury bill programs.
Reduce the size of the buyback program, with a planned level of between $9 billion and $10 billion, roughly $1.5 billion less than in 2004–05.	Prepare for the end of the transition to sustainable bond programs and preserve liquidity in outstanding issues.
Maintain a stable maturity profile.	Limit the need to refinance a large portion of debt in any given period.

Domestic Debt Programs

Objective: *Maintain diversified sources of funding and a well-functioning market.*

Action for 2005–06:	Intended Result:
Continue regular issues of marketable bonds in four maturity sectors, Treasury bills in three maturity sectors and a long-dated inflation-linked bond.	Keep costs low and mitigate funding risk by diversifying borrowing across investor segments, instruments and maturities.
Continue to borrow on a pre-announced basis and provide timely notices of government policy decisions.	Maintain transparency and efficiency.
Maintain current new maturity benchmark target sizes for 2-, 5-, 10- and 30-year bonds.	Maintain a liquid market for on-the-run issues and building-benchmark issues.
Forego the 2-year auction in the fourth quarter of 2005–06.	Facilitate a reduction in bond issuance in 2005–06 pending a review of the bond program structure.
Consult with market participants in 2005–06 on potential changes to the structure of the bond program.	Adjust the structure of the bond program to achieve the structural target while maintaining a well-functioning government securities market.
Advance the timing of bond auctions from 12:30 p.m. to 12:00 p.m. Advance the timing of cash buybacks from 1:00 p.m. to 12:20 p.m., 10 minutes closer to the bond auction than previously.	Encourage participation by reducing market risk for participants.
Continue to work to lower turnaround times for the release of results of auctions and buybacks.	Enhance the bidding process and participation.
Update the retail debt strategy.	Ensure the evolving needs of the Government and Canadians are met.

Foreign Reserves

Objective: *Improve the cost-effectiveness of funding foreign reserve assets.*

Action for 2005–06:

- Modernize the Currency Act, which provides the legislative basis for the management of the foreign reserves.
- Continue to review the foreign reserves portfolio investment policy.
- Continue to use cross-currency swaps as the primary source of reserves funding.

Intended Result:

- Reduce potential for legal risk issues by modernizing the Act, and increase flexibility of investment policy.
- Improve the risk/return profile of the portfolio, with the possible inclusion of new asset classes.
- Keep the cost of carrying reserve assets low.

Glossary

accumulated deficit: Total liabilities less financial and non-financial assets.

asset liability management: A systemic investment decision-making framework that is used to concurrently manage a portfolio of assets and liabilities.

basis point: One-hundredth of a percentage point (0.01 per cent).

benchmark bond: The specific issue outstanding within each class of maturities. It is considered by the market to be the standard against which all other bonds issued in that class are evaluated.

budgetary surplus: Occurs when government annual revenues exceed annual budgetary expenses. A deficit is the shortfall between government revenues and budgetary expenses.

buyback on a cash basis: The repurchase of bonds for cash. Used to maintain the size of auctions and new issuance.

buyback on a switch basis: The exchange of outstanding bonds for new bonds in the current building benchmark.

Canada bill: A promissory note denominated in US dollars, issued for terms of up to 270 days. Canada bills are issued for foreign exchange reserve funding purposes only.

Canada note: A promissory note usually denominated in US dollars and available in book-entry form. Canada notes can be issued for terms of nine months or longer, and can be issued at a fixed or a floating rate. Canada notes are issued for foreign exchange reserve funding purposes only.

Canada Premium Bond: A non-marketable security instrument issued by the Government of Canada that is redeemable once a year on the anniversary date or during the 30 days thereafter without penalty.

Canada Savings Bond: A non-marketable security instrument issued by the Government of Canada that is redeemable on demand by the registered owner(s) and that, after the first three months, pays interest up to the end of the month prior to cashing.

Contingency Reserve: Is included in the budget projections primarily to cover risks arising from unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts and risks arising from unpredictable events. If not needed, it is used to pay down the public debt.

cross-currency swap: An agreement that exchanges one type of obligation for another involving different currencies and the exchange of the principal amounts and interest payments.

electronic trading system: An electronic system that provides real-time information about securities and enables the user to execute financial trades.

Exchange Fund Account: A fund maintained by the Government of Canada for the purpose of promoting order and stability of the Canadian dollar in the foreign exchange market. This function is fulfilled by purchasing foreign exchange (selling Canadian dollars) when there is upward pressure on the value of the Canadian dollar and selling foreign exchange (buying Canadian dollars) when there is downward pressure on the currency.

financial requirement/source: Measures the difference between cash coming in to the Government and cash going out. In the case of a financial requirement, if cash on hand is not used, it is the amount of new borrowing required from outside lenders to meet the Government's financing needs in any given year.

fixed-coupon marketable bond: A market debt instrument issued by the Government of Canada and sold via public tender. These issues have a specific maturity date and a specified interest rate. All Canadian-dollar marketable bonds pay a fixed rate of interest semi-annually and are non-callable. They are transferable and hence can be traded in the secondary market.

fixed-rate debt: The share of the gross debt that is maturing or being repriced in more than 12 months.

fungible bond: A bond that has the same financial attributes as another. Fungible bonds are interchangeable.

government securities distributor: A member of a group of investment banks and dealers through which the Government distributes Government of Canada Treasury bills and marketable bonds.

gross public debt: The total amount the Government owes. It consists of market debt in the form of outstanding securities such as Treasury bills, marketable bonds and Canada Savings Bonds, non-market debt owed mainly to the superannuation accounts for government employees, and other current liabilities.

interest-bearing debt: Consists of unmatured debt, or market debt, and the Government's liabilities to internally held accounts such as federal employees' pension plans.

market debt: For debt management purposes, market debt is defined as the portion of debt that is funded in the public markets, and consists of marketable bonds, Treasury bills, retail debt (primarily Canada Savings Bonds), foreign currency denominated bonds and bills, and bonds issued to the Canada Pension Plan.

marketable debt: Market debt that is issued by the Government of Canada and sold via public tender or syndication. These issues can be traded between investors while outstanding.

net debt: Gross debt, net of financial assets.

non-market debt: Consists of the Government's internal debt, which is, for the most part, federal public sector pension liabilities and the Government's current liabilities (such as accounts payable, accrued liabilities, interest payments and payments of matured debt).

non-marketable debt: Market debt that is not tradable and that is issued to retail investors (Canada Savings Bonds and Canada Premium Bonds).

primary market: The market in which securities are initially sold or offered.

real return bond (RRB): Government of Canada RRBs pay semi-annual interest based upon a real interest rate. Unlike standard fixed-coupon marketable bonds, interest payments on RRBs are adjusted for changes in the Consumer Price Index.

secondary market: The market in which previously issued securities are traded, as distinguished from the new issue or primary market.

sovereign market: The market for the debt issued by a government.

Treasury bill: A short-term obligation sold by public tender. Treasury bills with terms to maturity of 3, 6 or 12 months are currently auctioned on a biweekly basis.

turnover ratio: The volume of securities traded as a percentage of total securities outstanding.

yield curve: A graph based on the term structure of interest rates, plotting the yield of all bonds of the same quality with maturities ranging from the shortest to longest term available.