Debt Management Strategy

2000-01

Canada

Debt Management Strategy

2000-01

Department of Finance Canada | Ministère des Finances Canada

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Foreword by the Minister of Finance

I am pleased to table for the first time before Parliament the *Debt Management Strategy* of the Government of Canada for fiscal year 2000-01. Previously, the *Debt Management Strategy* was released only as an annual publication of the Department of Finance Canada.

Effective management of the federal debt is important to all Canadians as the cost of servicing the debt currently takes about 26 cents of each dollar of revenue collected by the federal government, down from 33 cents when this government took office.

Fulfilling its ongoing commitment to sound financial management, the Government expects to report a balanced budget or better in 1999-2000. In addition, the Government committed in the 2000 budget to maintain balanced budgets or better in 2000-01 and 2001-02. This will mean five consecutive years of balanced budgets or surpluses, a performance not matched in the last 50 years. As a result, the debt-to-GDP ratio, a measure of the debt against the size of our economy, will continue to fall. This is important because the lower the ratio, the more manageable the public debt.

That being said, the level of debt remains significant. It is thus important to ensure that debt servicing costs are kept low and stable. Key elements of the debt strategy to that end are maintaining a prudent debt structure and ensuring a well-functioning market for Government of Canada securities.

The *Debt Management Strategy* provides comprehensive information on the federal government's debt management strategy for the coming fiscal year. The Government's intention in tabling this document is to ensure parliamentarians, market participants and indeed all Canadians are aware of the strategy and the results it is intended to achieve.

The Honourable Paul Martin, P.C., M.P.
Minister of Finance
Ottawa, March 23, 2000

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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. (To assist readers who are unfamiliar with the technical terminology of debt management, a glossary is provided at the end of this document.)

Debt Management Objectives

The fundamental debt management objective is to provide stable, low-cost funding for the Government.

With the Government's commitment to balanced budgets or better, the current focus of debt management is to refinance maturing debt.

- The fundamental objective of debt management continues to be to provide stable, low-cost funding for the Government.
- A related important objective is to maintain a well-functioning market for Government of Canada securities.

Domestic Debt Management

Principles

- Consistent with the practice of many sovereigns, funding for the Government's domestic financial requirements is raised in the domestic market in Canadian dollars.
- In order to maintain a well-functioning domestic market and keep borrowing costs low, the Government focuses on the key aspects of transparency, liquidity and regularity. For this reason, the Government borrows in the market on a regular, pre-announced basis and builds large bond benchmarks.
- Given the key role played by federal government securities in Canada's fixed-income market, market participants are consulted extensively on the Government's debt strategy and adjustments to its domestic debt programs.

General Strategy

- The primary focus of the Government's debt management strategy is the structure of the debt, as the exposure to changes in interest rates inherent in the maturity profile of the debt stock can impact debt servicing costs. The Government structures the debt prudently to provide reasonable cost stability under a range of potential interest rate environments and a moderate level of regular financing operations. The target debt structure is not based on a particular interest rate outlook.
- Large benchmarks in Treasury bills and Government of Canada bonds are maintained to promote market liquidity.
- Bond benchmarks are built at the 2-, 5-, 10- and 30-year maturities, and a Real Return Bond benchmark is also maintained.
- The Government maintains a diversified investor base and active relations with investors and credit rating agencies.

Foreign Currency Debt Management

Principles

Borrowings in foreign currencies fund Canada's foreign exchange reserves.

- Foreign currency borrowings by the Government fund Canada's foreign exchange reserves.
- Major risks, including currency and interest rate risk, are largely immunized by investing borrowings in matching assets of high credit quality.

General Strategy

- The Government finances foreign exchange reserves through a range of programs, the use of which is determined by asset portfolio objectives, cost, maturity profile and market conditions.
- In general, there is a modest cost to holding reserves, as the yield on high quality assets is less than the cost of funding. Liabilities are managed in conjunction with the reserve assets to limit the cost of holding reserves and to maintain a prudent maturity structure to limit refinancing needs.
- The Government's foreign exchange reserves are held predominantly in US dollars, supplemented by euro- and yen-denominated reserves.

Debt Management Environment

Fiscal Outlook

Budgetary Balance

The Government is committed to a balanced budget or better based on prudent planning assumptions.

The Government's fiscal policy sets the context for debt management operations. Fulfilling its ongoing commitment to maintain sound financial management, the Government expects to report a balanced budget or better in 1999-2000. The Government will continue to follow a prudent approach to budget planning, backed by a $3-billion Contingency Reserve and economic prudence, and has committed to maintain balanced budgets or better in 2000-01 and 2001-02. This will mean five consecutive years of balanced budgets or surpluses – a performance not matched in the last 50 years.

The public debt burden is expected to decline over time.

Given the outlook for balanced budgets, over the next two years the stock of public debt is expected to remain unchanged at its 1998-99 level. However, this projection does not take into account the Contingency Reserve. Consistent with the Debt Repayment Plan, the Government will continue to use the Reserve to reduce the public debt in those years when it is not required. The Plan and sustained economic growth will ensure that the debt-to-GDP (gross domestic product) ratio – the level of debt in relation to the country's annual income – remains on a permanent downward track. From a peak of 71.2 per cent in 1995-96, the debt-to-GDP ratio is expected to fall to about 55 per cent by 2001-02 and to below 50 per cent in 2004-05. Lowering the debt-to-GDP ratio remains a key objective of the Government's fiscal policy.

The Debt Repayment Plan

The prudent approach to budget planning contained in the Government's Debt Repayment Plan will continue. This entails:

- continuing to use the average of private sector economic forecasts for budget planning purposes;
- continuing the practice of setting aside an annual $3-billion Contingency Reserve which, if not needed, will be used to pay down the public debt; and
- continuing to add an extra degree of economic prudence to provide further assurance against falling back into a deficit.

Financial Balance

The key budgetary measure for debt management planning is the financial balance (see the box on the next page). In general, balanced budgets can be expected to reduce market debt (see page 12 for a description of market debt) as they are normally accompanied by financial surpluses. However, the precise relationship between the budgetary balance and financial balance will vary from year to year, as it depends in part on the level of a number of non-budgetary transactions. It also depends on the timing of cash payments – cash payments may be made in one year for liabilities incurred in a different year.

The Government is projecting a financial surplus of $8.0 billion for 1999-2000, while a financial requirement of $5.0 billion is projected for 2000-01. The change from financial surplus to requirement reflects a number of factors, including public sector pension reform and several extraordinary cash payments that will also arise in 2000-01. Of note, the reforms to public sector pension plans will permanently reduce the difference between the budgetary balance and financial balance. With the ending of the special payments, a financial balance is projected for 2001-02.

A number of extraordinary cash payments and public sector pension reform will give rise to a financial requirement in 2000-01.

The primary reason the Government is forecasting a financial requirement in an environment of a balanced budget is that there will be a number of extraordinary cash payments in 2000-01, the liabilities for which were included in the budgetary balance in prior fiscal years. These include payments associated with the pay equity settlement and the Canada Health and Social Transfer cash supplement to a third-party trust.

In addition, the reform of public sector pension plans becomes effective April 1, 2000. Under this reform, government and employee contributions to the pension plans will be invested in financial markets rather than included as part of non-budgetary transactions. This will reduce the non-budgetary source of funds by at least $3.5 billion per year. As well, a number of Crown corporations, which are currently members of the public sector pension plan, will be establishing their own pension plans and will receive in cash over the next two fiscal years the accrued value of their share of the plan.

The Budgetary Balance and Financial Balance

The budgetary balance – deficit/surplus – is one measure of the Government's financial situation. It is largely presented on an accrual basis of accounting in that it includes liabilities incurred by the Government regardless of when the actual cash payment is made.

The financial balance – requirements/surplus – provides a measure of the net cash requirements needed to fund the Government's programs and debt charges during the year. The difference between the financial balance and the budgetary balance is due to a number of non-budgetary transactions that provide funds to the Government. Non-budgetary transactions convert the accrual-based concepts in the budgetary balance to cash-based financial requirements. The largest of the non-budgetary transactions are the government employee pension accounts.

Excluding foreign exchange requirements, the federal government recorded a financial surplus in each of the last three years – $1.3 billion in 1996-97, $12.7 billion in 1997-98 and $11.5 billion in 1998-99.

The net financial balance includes foreign exchange transactions, which represent all transactions in international reserves held in the Exchange Fund Account. Including these transactions, the Government recorded a net financial requirement of $6.5 billion in 1996-97, and a surplus in each of the two following years – $10.6 billion in 1997-98 and $5.8 billion in 1998-99.

Foreign Exchange Transactions

The Government ensures that it holds a prudent level of foreign exchange reserves.

The Government's net financial balance is the domestic financial balance less foreign exchange transactions.

In recent years, the Government's commitment to raise the level of international reserves, announced in the 1996 and 1998 budgets, as well as increased intervention activity in the foreign exchange market, particularly in 1998, has meant that foreign exchange transactions have become a somewhat larger, although still modest, element of debt operations. These activities have resulted in a reduction in the financial surplus. However, to the extent that they increase Canada's foreign exchange reserves, these transactions do not change the level of the net public debt. Foreign reserves are assets of the Government, thus offsetting foreign exchange liabilities.

Market Debt Impact

No additional market borrowing is expected to be required in 2000-01.

A total of $16.4 billion in market debt was retired in 1997-98 and 1998-99. Additional market debt retirement is projected for 1999-2000, bringing total debt retirement over this three-year period to around $20 billion. While market debt is generally on a downward track, it is expected to remain largely unchanged in 2000-01 due to the public sector pension reform and extraordinary cash payments. The projected financial requirement of $5 billion in 2000-01 is expected to be met without additional borrowing. Strong financial results in 1999-2000 have allowed the Government to position itself to meet the large expenditures in 2000-01 by increasing domestic cash balances. If necessary, the Government can draw on the existing amount of $4 billion in non-lapsing borrowing authority.

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 debt, in the form of a borrowing authority bill.

Currently, available borrowing authority is limited to a $4-billion non-lapsing contingency under the 1996-97 Borrowing Authority Act.

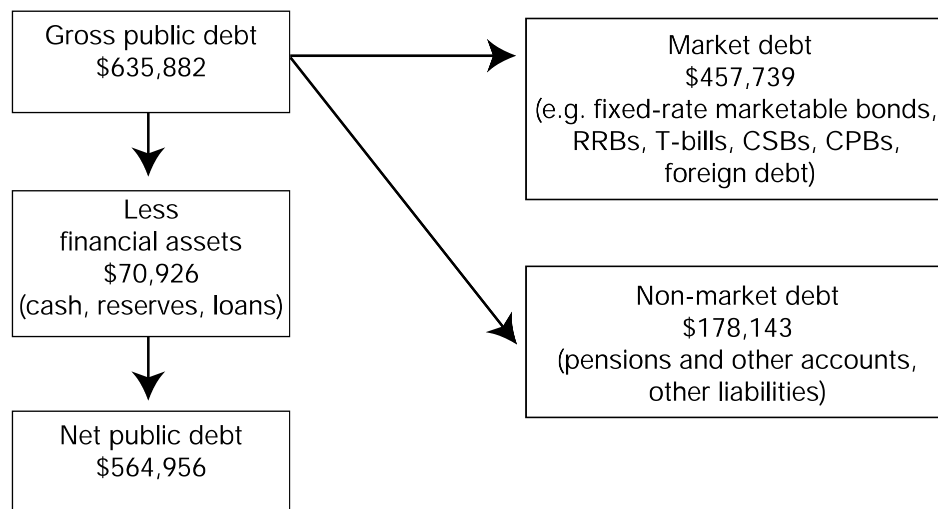
Debt Structure and Holdings

Debt management operations focus primarily on market debt, which is only one component of the total public debt. The other component – non-market debt – is taken into account in debt strategy planning, but is not actively managed. Non-market debt includes federal public sector pension liabilities and the Government's current liabilities.

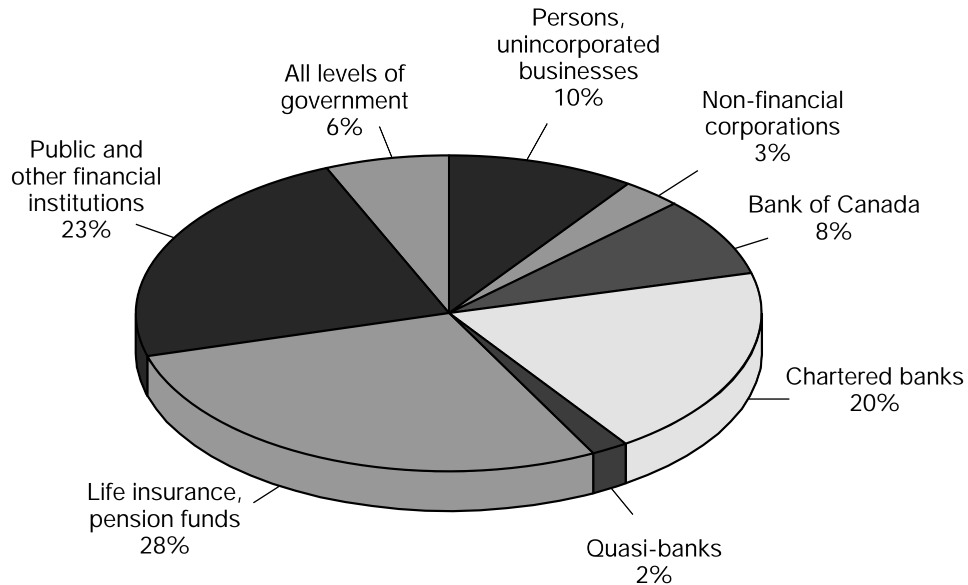
The federal government's market debt consists mainly of fixed-rate marketable bonds, Real Return Bonds (RRBs), Treasury bills (T-bills), retail non-marketable debt (Canada Savings Bonds [CSBs] and Canada Premium Bonds [CPBs]) and foreign currency denominated debt. The composition of the federal government's market debt has remained relatively stable in recent years, following a period of significant change in the mid-1990's, when the share of market debt held in short-term instruments (e.g. T-bills) declined and the share held in longer-term instruments (e.g. fixed-rate marketable bonds) increased.

The chart below illustrates the relationships between the components of public debt.

Total Public Debt as at January 31, 2000
(in millions of dollars)



Distribution of Domestic Holdings of Government of Canada Market Debt[1]



Source: Statistics Canada, *National Balance Sheet Accounts – 1998.*

[1] Includes investment dealers, mutual funds, fire and casualty insurance companies, sales, finance and consumer loan companies, accident and sickness branches of life insurance companies, other private financial institutions (not included elsewhere), federal public financial institutions, and provincial financial institutions.

A wide range of institutional and retail investors hold federal government debt. Non-resident holdings of Government of Canada debt have been declining in the last few years, decreasing from a peak of 28 per cent of total market debt in 1993 to around 23 per cent today. The decline was notable in 1999 in the prevailing financial surplus environment.

2000-01 Debt Management Strategy

Raise Stable, Low-Cost Financing

Maintaining a Prudent Debt Structure

While the Government's fiscal position has improved considerably in recent years with the elimination of the deficit, the stock of outstanding debt remains large. Moreover, 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 $248 billion in federal market debt will be maturing or repriced over the 2000-01 fiscal year.

Determining the Debt Structure Target

Given the large stock of outstanding debt, the Government's debt strategy aims to strike a balance between keeping debt service costs low and stable over time, while ensuring that a well-functioning market for Government of Canada securities is maintained. A prudent debt structure is maintained to limit exposure to unexpected changes in interest rates and ongoing refinancing requirements, which serves to maintain investor and credit rating agency confidence.

The Government has put in place a prudent debt structure by altering the term structure of its debt, specifically by issuing more long-term debt and less short-term debt. While there are a number of indicators that can be used to assess the debt structure, the Government's chosen target is the share of interest-bearing debt issued at fixed rates (i.e. maturing or repricing beyond one year). Thus, greater stability of debt servicing costs has been achieved over the past several years by increasing the share issued at fixed rates from about 50 per cent in 1992-93 to about two-thirds in 1998-99, where it currently stands, bringing the term structure of the debt in line with other major sovereign borrowers.

The debt structure target is reviewed annually. For 2000-01, the target fixed-rate share of the debt will be maintained at two-thirds.

As part of debt strategy planning, the debt structure target is reviewed annually to assess its ongoing suitability given changes in the fiscal and economic environment, and to ensure that it remains consistent with the best practices of other sovereign borrowers. For 2000-01, the target fixed-rate share of the debt will remain at two-thirds. A discussion of the costs and benefits of the target debt structure is provided in the box on the next page.

Implications of the Target Debt Rate Structure

One benefit of increasing the fixed-rate share of the debt to two-thirds is that it ensures that the debt stock is less sensitive to changes in interest rates. A 100-basis-point increase in interest rates would now raise public debt charges by $0.9 billion in the first year; in the mid-1990s, when 57 per cent of the debt was at fixed rates, the first-year impact of a 100-basis-point increase in interest rates was estimated at about $1.8 billion.

The long-term costs of maintaining a prudent debt structure are impossible to predict, since interest rates will change significantly over time due to both internal and external developments. Using current interest rates, maintaining a higher fixed-rate share of debt gives rise to increased debt service costs for the Government since short-term funds are currently cheaper than long-term funds. By way of illustration, debt servicing costs would differ by $110 million next year with a 5-percentage-point difference in the debt structure. In other words, given the forecast for interest rates contained in the budget and the current maturity profile of various types of government debt, the cost of a 5-per-cent higher fixed stock (72 per cent) would be $110 million more next fiscal year than the two-thirds target structure, while a 5-per-cent lower fixed stock (62 per cent) would result in a reduction of debt costs of $110 million over the next fiscal year.

Under a worst-case scenario of significantly higher interest rates that continue for some time, debt service costs under the current structure would be less affected than under a higher floating-rate structure. In order to limit the potential impact of such a scenario on the fiscal plan, the Government has adopted a more prudent structure, similar to that maintained by other comparable sovereigns.

The Government continuously improves the quality of its debt strategy modelling and uses a variety of planning tools. Among them is sophisticated cost sensitivity analysis of the target debt structure, which demonstrates that there are particular benefits to a two-thirds fixed-rate target debt structure. The analysis of a wide distribution of future interest rate scenarios indicates that, under the two-thirds structure, unexpected changes in interest rates over a five-year horizon should not disrupt the fiscal plan. Specifically, the analysis indicates that the two-thirds fixed-rate structure is highly likely to limit the fiscal impact of interest rate shocks to less than the $3-billion Contingency Reserve.

A further benefit of maintaining the fixed debt structure at two-thirds is that it ensures that regular access to markets via Treasury bills is kept at a reasonable level. In 1995, when the fixed-rate share of the debt was at 55 per cent, the Government was required to refinance, on average, $8 billion per week in maturing Treasury bills. Today, the Government only needs to refinance $4 billion per week. At the same time, the one-third share of floating-rate debt helps to keep debt servicing costs low, provided short-term rates remain lower than long-term rates.

Maintaining a Diversified Investor Base

A diversified investor base is maintained to ensure funding costs are kept low.

Maintaining a diversified investor base is also an important factor in ensuring that funding costs are kept low. The federal government pursues diversification of its investor base through the maintenance of a liquid and transparent domestic wholesale debt program and internationally through the use of a broad array of sources of funds. In addition, Canada Investment and Savings, the Government's retail debt agency, contributes to the maintenance of a diversified investor base by offering savings products designed to suit the needs of a large number of individual Canadians.

Maintaining a well-functioning Government of Canada securities market remains a high priority for the federal government.

Maintain and Enhance a Well-Functioning Market

Maintaining a well-functioning Government of Canada securities market, by focusing on the key aspects of liquidity, transparency and regularity, remains a high priority for the federal government in the general environment of declining market debt. A well-functioning Government of Canada securities market provides low-cost financing for the Government by promoting broader participation in the market. It is also of general benefit to the domestic capital market, where benchmark federal securities are key investments; because they are actively traded, these securities act as pricing and hedging tools in the fixed-income market.

The Government will continue to maintain the principles of liquidity, transparency and regularity in its debt programs.

The federal government actively pursues initiatives designed to ensure that the quality and integrity of the Government of Canada securities market is maintained, and that the market continues to be one of the most liquid and efficient sovereign markets in the world, featuring tight bid-offer spreads, large transaction volumes and high turnover ratios.

The federal government pursued a number of initiatives in 1999-2000, including:

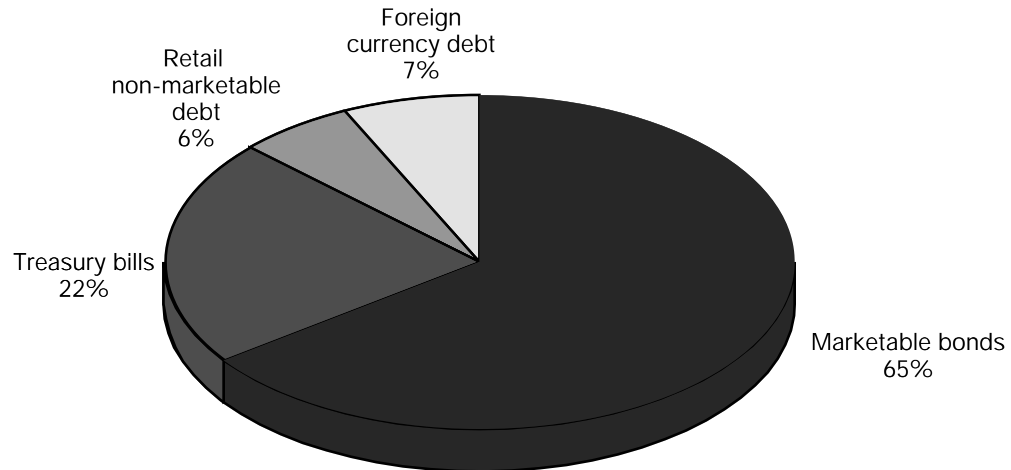
- reviewing the structure of the Treasury bill program to ensure it continues to function well;
- continuing the pilot buyback program to support the maintenance of a liquid new bond issue market;
- changing the Financial Administration Act to modernize the federal government's risk and debt management capabilities; and
- supporting the development of improved secondary market price transparency.

2000-01 Debt Program Initiatives

Outlook for Market Debt

Over the next few years, the composition of market debt is expected to remain largely unchanged. In 2000-01, debt programs will operate at approximately the same levels as in 1999-2000.

Forecast Composition of Market Debt
March 31, 2000[2]



[2] Excluding bonds issued to the CPP.

Domestic Debt Programs

To help maintain liquidity in the Government of Canada securities market, the target benchmark sizes for key 5-, 10- and 30-year bonds will be increased.

In 2000-01, bond and Treasury bill programs are expected to operate at levels similar to those in 1999-2000. No restructuring of domestic debt programs is anticipated in the near term.

To maintain transparency and regularity in its debt operations, the Government will continue to borrow in the domestic market on a regular, pre-announced basis. This approach ensures market awareness of future debt operations, attracts a wide range of investors and promotes liquidity. In 2000-01, the Government will continue to hold regularly scheduled quarterly auctions of 2-, 5- and 10-year bonds, and semi-annual auctions for the 30-year bonds. Quarterly auctions of Real Return Bonds will also be held.

To help maintain liquidity in the Government of Canada securities market, the target benchmark sizes for 5-, 10- and 30-year bonds will be increased from $7-$10 billion to $9-$12 billion. (The target for 2-year bonds will be maintained at $7-$10 billion.) This change balances market participants' desire for larger benchmarks with the Government's ability to manage large cash flows at maturity. (A list of outstanding Government of Canada bonds, including maturity dates, can be found in the Debt Management Report – 1998-99, which is available on the Department of Finance Canada Web site at www.fin.gc.ca.)

Bond Buyback Program

To enhance the liquidity of Government of Canada securities, a pilot bond buyback program was implemented in 1998-99. The program allows the Government to buy back existing, less liquid bonds, financed through the issuance of new bonds, thus supporting a liquid new bond issue market.

The pilot bond buyback program will be implemented on an ongoing basis in 2000-01.

An evaluation of the pilot program, which included feedback from market participants, indicates that the program has been successful in meeting its objectives and has been generally helpful to the market. As a result, the Government is implementing the bond buyback program on an ongoing basis in 2000-01. The current reverse auction system on a cash settlement basis will be maintained, with bond buybacks expected to continue to occur on the same day as regular auctions. Buyback transactions used for liquidity maintenance purposes will be announced with the quarterly bond auction.

The size of the buyback program and the number of transactions will depend on a number of factors, including general market conditions and the outlook for the financial balance. As long as the objective of the program remains focused on the maintenance of primary issuance, activity under the program for the next few years will remain modest. Should the program be used for other purposes, the activity level would change – in 2000-01, the use of debt buybacks for cash management purposes will be assessed (more details are provided on page 23).

Stripping and Reconstitution of Bonds

Stripping involves separating bonds into individual interest and principal payment components. Investors choose to strip securities to create new investment products that better match their objectives. Reconstitution is the exact opposite of stripping, and involves combining the stripped components to obtain the underlying security, when it has particular value relative to other securities.

The Investment Dealers Association of Canada has recommended that the Government allow bonds that have been stripped to be reconstituted above the original amount previously stripped by book-entry. The potential benefit of this activity would be to supplement the level of liquidity in current benchmark bonds. Currently, reconstitution of Government of Canada bonds is allowed only up to the amount stripped by book-entry form in The Canadian Depository for Securities Limited. The Government has conducted consultations with a number of market participants and will be reviewing this proposal in early 2000.

Market Integrity

The federal government and the Bank of Canada will continue to work closely with market participants on initiatives to enhance market integrity and transparency. The Government supports further refinements of the CanPx system for the real-time publication of inter-dealer prices.

Electronic Commerce

Electronic commerce (e-commerce) in wholesale fixed-income markets is growing rapidly internationally. In Canada, the federal government has a strong interest in wholesale market e-commerce initiatives which promote the maintenance of liquid and efficient domestic fixed-income markets. The Government and market participants in Canada are discussing proposals made by securities regulators on the regulation of alternative trading systems in the fixed-income markets, as these proposals could have a material impact on transparency and liquidity.

Foreign Debt Programs

Foreign Exchange Reserve Assets

The Government remains committed to maintaining a prudent and appropriate level of foreign exchange reserves.

Reflecting the Government's commitment to raise the level of international reserves, foreign borrowing has become a somewhat larger, although still modest, element of debt operations. In the 1996 budget, the Government indicated its intention to increase Canada's foreign exchange reserves, in response to increased flows in foreign exchange markets and to maintain a prudent level of liquid reserves in line with comparable countries. This commitment was reaffirmed in the 1998 budget. Canada's foreign exchange reserves have more than doubled from US$14.8 billion at the end of March 1995 to US$29.9 billion at the end of February 2000. With these increases, the Government has made substantial progress in ensuring that it has a prudent level of foreign exchange reserves that is in line with that of other comparable sovereigns. Further details on the management of international reserves are available in *The Exchange Fund Account Annual Report*, which is available from Public Works and Government Services Canada.

Funding Foreign Exchange Reserves

Foreign currency debt operations are driven by foreign exchange reserve needs.

The Government has access to a wide range of sources to fund its foreign exchange reserves. These sources include a short-term US-dollar discount note 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 been a particularly cost-effective alternative to foreign currency denominated bond issues, and have been actively used in recent years. Swap activity involves the exchange of contractual obligations (e.g. the exchange of a principal amount of currency and periodic interest payments, and a commitment to re-exchange the principal amount at maturity), and thus exposes the Government to the risk of counterparty default. The Government manages the counterparty credit exposure associated with cross-currency swaps in a prudent manner.

Foreign exchange liabilities have grown significantly in recent years, in particular during 1998-99, a period of extensive foreign exchange intervention and important commitments to the International Monetary Fund. As a result, foreign exchange liabilities grew to exceed foreign currency assets in the Exchange Fund Account. Purchases of US dollars in foreign exchange markets, as one of the funding sources of the Government for its foreign exchange reserves, are being used to reduce the mismatch between foreign currency liabilities and assets. The Government plans to continue to bring foreign currency liabilities more in line with foreign currency assets in a gradual and prudent manner over time.

The Government was less active in public foreign markets last year than in previous years, as purchases of US dollars and cross-currency swaps of domestic obligations served as the primary sources of funding. These sources were supplemented by one large US dollar global bond issue, which was executed in response to favourable market opportunities.

Table 1

Sources and Requirements of Foreign Exchange Reserves, April 1 – December 31, 1999

	(billions of US dollars)
Sources of reserves:	
Purchases of US dollars	3.8
Cross-currency swaps	2.8
Public market borrowings	2.0
Total sources	8.6
Foreign exchange reserve requirements:	
Net maturing debt	(3.9)
Net foreign exchange debt charges	(0.2)
Government requirements and other	(0.7)
Requirements	(4.8)
Increase in foreign exchange reserves	3.8

Purchases of foreign exchange and the use of cross-currency swaps to fund reserves will be continued.

In 2000-01, as in previous years, the 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-denominated debt maturity structure.

Management of the Government's Cash Balances

The Government manages its cash balances in order to ensure that it has sufficient cash on hand to meet its daily operational requirements, which can at times be volatile and difficult to forecast. Thus, substantial cash balances are often held.

Cash Management Framework

The Department of Finance and the Bank of Canada are consulting with market participants on changes to the cash management system framework. Currently, cash balances are invested as term deposits with direct participants in the Large Value Transfer System. Deposits are placed with the institutions through an auction process in order to earn competitive market rates of return. Changes under consideration include broadening access to bidding for balances, and introducing a credit framework to govern the investment process. The Department of Finance and the Bank of Canada are preparing a public discussion paper on this initiative.

Bond Buybacks for Cash Management

Buybacks will be assessed for cash management purposes begining in 2000 -01.

In 2000-01, an expansion of the existing bond buyback program to include cash management will be assessed. In contrast to the buyback program for liquidity maintenance purposes, this would involve buying back maturing bonds. These bond buybacks would help in smoothing the Government's debt repayment schedule, allowing greater control over cash balances and ongoing borrowing requirements. These potential operations will be discussed with market participants during the year.

2000-01 Federal Debt Programs

Plans for market debt programs are based on the 2000 budget outlook.

The federal debt management strategy for each debt program is presented below. The strategy is based on the 2000 budget outlook for financial surpluses (excluding foreign exchange transactions): the forecast is for a surplus of $8 billion for 1999-2000 and a financial requirement of $5 billion for 2000-01.

The plan has been developed in consultation with market participants. The federal government will continue to consult with market participants in fiscal year 2000-01 on potential adjustments in order to maintain a well-functioning market in the changing debt management environment.

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

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

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

Fixed-Rate Marketable Bonds

The planned level of issuance for the fixed-rate marketable bond program in 2000-01 will be similar to that of 1999-2000.

Fixed-rate marketable Government of Canada bonds are issued in Canadian dollars and pay interest semi-annually. In 2000-01, about $34 billion in bonds will be maturing.

Taking into account buyback operations and foreign funding activity, it is planned that gross issuance under the 2000-01 bond program will total about $45 billion, which is similar to the 1999-2000 level.

Real Return Bonds (RRBs)

The target for Real Return Bonds will be maintained.

As in 1999-2000, the federal government plans to issue up to $2 billion in RRBs in 2000-01. In 1999-2000, $1.25 billion in RRBs were issued.

The Treasury bill program is expected to operate at levels similar to those in 1999-2000.

Treasury Bills

The Treasury bill stock varies over the year largely as a result of changes in the Government's funding and cash needs. In 2000-01, based on the fiscal plan in the budget, the stock at year-end is expected to total about $100 billion, similar to the 1999-2000 level.

Retail Debt

Retail debt is an important part of the Government's debt program.

Canada Investment and Savings (CI&S) contributes to the diversification of the investor base. The objective of the retail debt program is to provide cost-effective funding for the Government and to encourage Canadians to invest in Canada.

The retail debt plan will be released later in 2000 by CI&S.

Canada Pension Plan (CPP) Bonds

CPP bonds are largely 20-year bonds issued by the Government of Canada to the CPP in the past. As new CPP contributions are now invested in the market, no new bonds will be issued under this program.

Foreign Currency Debt Programs

Foreign funding activity will be spread across a range of funding sources.

The principal source of funding for the foreign exchange reserves is expected to be purchases of US dollars. Use of cross-currency swaps of domestic obligations will also be continued. These programs are expected to be used less than in prior years. Medium-term note issuance in various markets and occasional large international bond issues may also be required.

Glossary

benchmark bond: 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.

bid: Price a buyer is ready to pay. The **bid-offer spread** is the difference between bid and offer prices.

book-entry: The form in which the majority of Government of Canada fixed-income securities are held and issued. Book-entry form consists of an electronic ledger entry at The Canadian Depository for Securities Limited (CDS). No physical bond certificate is sent to the owner of the security but is held in safekeeping at the CDS.

budgetary surplus: The amount by which government revenues exceed budgetary spending in any given year. A **deficit** is the amount by which government budgetary spending exceeds revenues in any given year.

Canada Pension Plan bond: Non-negotiable and non-transferable bond issued by the Government of Canada to the Canada Pension Plan.

Canada Premium Bond (CPB): A savings product for individual Canadians introduced by the Government of Canada in 1998. It offers a higher interest rate compared to the Canada Savings Bond and is redeemable once a year on the anniversary of the issue date or during the 30 days thereafter without penalty.

Canada Savings Bond (CSB): A savings product currently offered for sale by most Canadian financial institutions to individual Canadians. CSBs pay a competitive rate of interest which is guaranteed for one or more years. They may be cashed at any time and, after the first three months, pay interest up to the end of the month prior to encashment.

CanPx: A transparency system that provides real-time price and transaction information for key benchmark issues of Canadian government bonds and Treasury bills. Over time, the system will be expanded to include other actively traded government securities.

Contingency Reserve: The Contingency Reserve is included in the budget projections primarily to provide an extra measure of protection against adverse errors in the economic forecast. It is not a source of funding for new policy initiatives.

counterparty credit exposure: The risk the Government faces through the default of a counterparty on its contractual obligations.

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.

discount note: Short-term debt security where the yield is provided through a discounted selling price relative to the face value of the note.

Exchange Fund Account: A fund maintained by the Government of Canada for the purpose of promoting order and stability of the Canadian dollar on the foreign exchange market and for general liquidity purposes.

financial balance (excluding foreign exchange transactions): Measures the difference between the cash coming in to the Government and the cash going out. In the case of a financial requirement, it is therefore the amount of new borrowing required from outside lenders to meet the Government's financing needs in any given year.

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

fixed-rate marketable bond: 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 fixed-rate 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.

foreign exchange reserves: Stocks of foreign exchange assets (e.g. interest-earning bonds) held by sovereign states to support the value of the domestic currency. Canada's foreign exchange reserves are held in a special account called the Exchange Fund Account.

gross public debt: Total amount the Government owes. It consists of market debt in the form of outstanding securities such as Treasury bills and Canada Savings Bonds, internal debt owed mainly to the superannuation fund for government employees and other current liabilities.

inter-dealer broker: A broker who acts as an intermediary between dealers buying and selling Government of Canada securities.

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.

liquidity: Characterization of a market with good trading volumes, where trades of medium and even large sizes can be effected quickly without materially affecting the price.

market debt: The portion of debt that is funded in the public markets. It includes fixed-rate marketable bonds, Real Return Bonds, Treasury bills, retail debt (primarily Canada Savings Bonds and Canada Premium Bonds), foreign currency denominated bonds and bills, and bonds issued to the Canada Pension Plan.

medium-term notes (MTNs): MTNs are issued in various currencies outside Canada with terms to maturity generally beyond one year. MTNs are issued for foreign exchange reserve funding purposes only.

net public debt: Consists of interest-bearing debt and other liabilities, net of financial assets.

non-market debt: Includes 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 and payment of matured debt).

primary market: Market for new issues of securities.

Real Return Bond (RRB): Government of Canada RRBs pay semi-annual interest based on a real interest rate. Unlike standard fixed-rate marketable bonds, interest payments on RRBs are adjusted for changes in the consumer price index.

reverse auction: The reverse of a regular or conventional bond auction. Bidders submit an offer to sell a security rather than offers to buy the security.

secondary market: Market where securities are bought and sold after issuance.

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

transparency: Characterization of a market where debt management strategies and operations are known and well understood by market participants.

Treasury bill: 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: Volume of securities traded as a percentage of total securities outstanding.