Debt Management Strategy

2004–2005

Canada

Debt Management Strategy

2004–2005

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 2004–05. This document provides comprehensive information on the Government's debt strategy and objectives for the coming fiscal year.

Canada's commitment to prudent financial management has been the foundation of Canada's recent economic and policy success, and enabled us to weather a number of unexpected shocks in 2003. The Government recently presented its seventh consecutive balanced budget, and Canada is the only Group of Seven (G-7) country expected to post a balanced budget in 2004. According to the Organisation for Economic Co-operation and Development (OECD), Canada's debt burden is also expected to be the lowest in the G-7 in 2004.

The benefits of this disciplined approach are many. Ongoing federal surpluses have enabled us to reduce our federal debt by more than $52 billion since the budget was balanced in 1997–98. As a result, the federal debt-to-GDP (gross domestic product) ratio fell from 68 per cent in 1995–96 to 44 per cent in 2002–03. This reduction in the federal debt burden has led to lower interest charges of $3 billion each year, savings that can be invested in the priorities of Canadians.

In spite of such hard-earned progress, however, interest charges remain our largest single budget expense, accounting for 21 cents of every revenue dollar received by the Government in 2002–03. Given the looming challenge of an aging population, our debt reduction efforts must continue. For this reason, Budget 2004 sets an objective of reducing the federal debt-to-GDP ratio to 25 per cent within 10 years.

It is only through sound fiscal management that Canada can foster a higher standard of living and a better quality of life today and for generations to come. This government remains determined to take the necessary steps to ensure long-term prosperity for all Canadians.

The Honourable Ralph Goodale, P.C., M.P.
Minister of Finance
Ottawa, March 30, 2004

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 Government 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, 2003, the Government had $439.8 billion of market debt composed of bonds, Treasury bills, retail debt, foreign currency debt, and Canada Pension Plan bonds, and $65.5 billion of liquid financial assets composed of domestic cash balances and foreign exchange assets.

	(C$ billions)
Market Debt	
Payable in Canadian currency	
Marketable bonds	288.2
(fixed-rate bonds with 2-, 5-, 10- and 30-year maturities and real return bonds with 30-year maturities)	
Treasury bills	104.4
(zero-coupon securities with 3-, 6- and 12-month maturities)	
Retail debt	22.6
(Canada Savings Bonds and Canada Premium Bonds)	
Canada Pension Plan bonds	3.4
Payable in foreign currency	
Marketable bonds	14.0
(fixed-rate bonds issued in US dollars and in other currencies)	
Canada bills	2.6
(zero-coupon securities with 1- to 9-month maturities)	
Foreign currency notes	4.5
(Canada notes and Euro Medium-Term Notes)	
Liquid Financial Assets	
Cash	16.5
Foreign exchange reserves	49.0

Highlights of the 2004–2005 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 size of the Treasury bill program will increase from $110 billion-$115 billion at the end of 2003–04 to approximately $130 billion by the end of 2004–05.
  - The total amount of marketable bonds issued in 2004–05 will be about $36 billion, moderately lower than in 2003–04. Net bond issuance of about $25 billion will also be moderately lower than in 2003–04.
  - The planned amount of bond buybacks is in the order of $11 billion, similar to 2003–04.
  - The bond stock will decrease from $257 billion to about $241 billion due to maturities and continued cash management buyback operations.
- The Government reviewed the real return bond program and the pilot switch buyback program in 2003–04 and is announcing that:
  - Real return bonds will remain a part of the Government's debt program, with issuance in 2004–05 equal to or marginally higher than in previous years.
  - The switch buyback program will be maintained as an ongoing debt management tool.
- To enhance bidding and participation in domestic debt operations:
  - Beginning April 1, 2004, as supported by market participants, results for auctions and buybacks will be released in advance of the current fixed turnaround times on a "best efforts basis" (i.e. when ready). Turnaround times for auctions and buybacks are expected to decline to about 5 and 10 minutes respectively. Release times will vary from operation to operation, subject to a maximum turnaround time for auctions and buybacks of 10 and 15 minutes respectively. The Government will continue to take steps in the fiscal year to streamline these operations to further reduce turnaround times.
  - Morning operation times for both Treasury bill auctions and cash management buybacks introduced in June 2003 will be maintained.

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. Due to the nature and breadth of funds management activities, separate objectives have been established for domestic debt and cash management, and foreign reserves.

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 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.

Domestic Debt and Cash Management Principles

In pursuit of these objectives, the Government of Canada manages its activities according to a set of key 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 to the Government.
- Cost-effectiveness: Borrow using a variety of instruments, a range of maturities and a diversified investor base to be cost-effective.
- 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.
- Best practices: Ensure that the operational framework and practices are in line with the best practices of other comparable sovereign borrowers and the private sector.

Foreign Reserves Management Objective

The objective of foreign reserves management is to maintain foreign currency liquidity, including funds needed to promote orderly conditions for the Canadian dollar in foreign exchange markets.

Foreign Reserves Management Principles

In pursuit of this objective, the Government of Canada manages its foreign exchange reserves according to a set of key principles.

- Prudence: Maintain an appropriate level of reserves invested in high-quality highly liquid assets. Manage reserves within a framework that matches foreign liabilities to reserve assets to immunize currency and interest rate risk, and that controls credit risk through diversification.
- Cost-effectiveness: Minimize the cost of carrying reserves (i.e. the difference between interest paid on foreign currency liabilities and the interest earned on reserve assets).
- Consultations: Seek input from market participants on major adjustments to the foreign reserves management program.
- Best practices: Ensure that the operational framework and practices are in line with the best practices of other comparable sovereign borrowers and the private sector.

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 six fiscal years and reduced the federal debt (accumulated deficit) by $52.3 billion. As announced in the March 2004 budget, the Government is committed to maintaining balanced budgets or better for 2003–04 and for each of the next two 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 and variations in budget planning. The Contingency Reserve, if not needed, will be used to reduce federal debt.

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 42 per cent in 2003–04, down from its peak of 68.4 per cent in 1995–96. With the commitment to balanced budgets in each of the next two fiscal years, it is forecast to decline to about 38 per cent in 2005–06.

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 G-7 countries since the mid-1990s. Between 1995 and 2003, Canada's net financial liabilities as a percentage of GDP (akin to the debt-to-GDP ratio) declined by 34.3 percentage points. Consequently, Canada's total government debt burden moved from being the second highest among the G-7 countries to the second lowest in 2003. According to the OECD, Canada's debt burden is expected to be the lowest in the G-7 in 2004.

Financial Requirement/Source

The key budgetary measure for debt management planning is the financial requirement/source rather than the budgetary balance (see box on following page). 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.

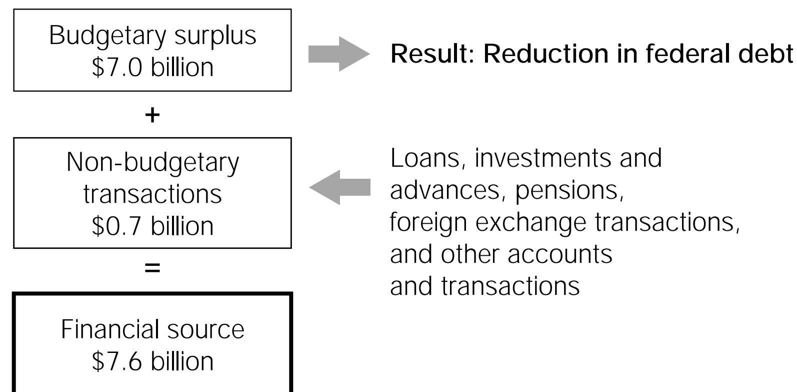
The budgetary balance—deficit or surplus—is one measure of the Government's financial situation. Consistent with the recommendations of the Auditor General of Canada, the Government moved to full accrual accounting in 2002–03. The move enhances transparency and decision making by providing a more complete 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 2002–03 fiscal year, the last year for which audited Public Accounts financial statements are available.

Figure 1
Financial Source at March 31, 2003



Note: Numbers do not add up due to rounding.

Source: *Annual Financial Report of the Government of Canada* (fiscal year 2002–03), Department of Finance.

Net Financial Requirement/Source Outlook

For 2003–04 the Government expects a financial source of $2.0 billion from non-budgetary transactions. The Government expects a financial requirement of $4.5 billion in 2004–05. 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 2002–03 fiscal year.

Figure 2
Total Public Debt as of March 31, 2003
(in billions of dollars)

Market debt
$439.8
← Fixed-coupon marketable bonds, Treasury bills, retail debt, real return bonds, foreign debt and CPP bonds

+

Non-market debt
$260.4
← Pensions and other accounts, other liabilities

=

Gross debt
$700.1

-

Financial assets
$135.3
← Cash, foreign exchange reserves, loans, investments and advances

=

Net debt
$564.8

-

Non-financial assets
$54.2

=

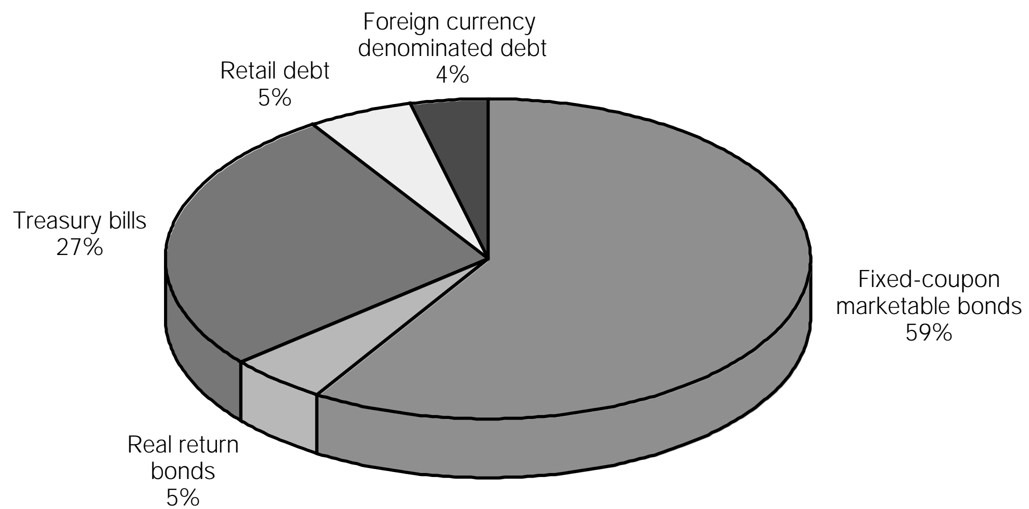
Federal debt (accumulated deficit)
$510.6

Note: Numbers may not add up due to rounding.

Source: *Annual Financial Report of the Government of Canada* (fiscal year 2002–03), Department of Finance.

The Government's market debt consists of fixed-coupon marketable bonds, real return bonds, Treasury bills, retail debt (Canada Savings Bonds, Canada Premium Bonds and Canada Investment Bonds), foreign currency denominated debt, as well as bonds issued to the Canada Pension Plan. 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 2003–04.

Chart 1
Forecast Composition of Market Debt
March 31, 2004



Note: Excludes bonds issued to the Canada Pension Plan.
Source: Department of Finance.

Market Debt Outlook

The federal debt declined by $7.0 billion in 2002–03 and by $52.3 billion over the past six fiscal years. Market debt, the portion of the federal debt that is funded in capital markets, declined by $2.5 billion in 2002–03 and by $37.1 billion over the past six fiscal years. A further decline in market debt is expected in 2003–04.

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 new borrowing authority is limited to a $4-billion non-lapsing contingency from the 1996–97 Borrowing Authority Act. Given the impact of the expected transfer of the Canada Pension Plan operating balances, the Government may seek special borrowing authority to fund the transfer through the issuance of new market debt. The need for additional borrowing authority will be considered later in 2004–05, in light of the Government's prevailing fiscal position at that time.

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. In general, borrowing long-term debt is less risky, but more costly, than borrowing short-term 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 measures of prudence 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.

As announced in the 2003 budget, the Government has adopted a new target for the fixed-rate portion of the debt: it will be reduced from two-thirds to 60 per cent by 2007–08 to lower future debt costs. The Government is in a position to reduce the target following significant improvements in Canada's economic and fiscal position in recent years. Canada now has low and stable inflation, lower foreign indebtedness and a current account surplus, all of which make interest rate surprises less likely. In addition, the reduction in the debt level has provided Canada with greater financial stability, reduced vulnerability to events happening beyond our borders, and contributed to the restoration of Canada's triple-A credit rating. The reduction in the fixed-rate share will be implemented in an orderly and transparent manner to allow the market time to adjust to the required changes in debt programs.

As in past years, a simulation model has been used to re-evaluate the debt structure target. The analysis involves considering the potential debt costs and cost variation for a large number of interest rate scenarios. The analysis supports 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 the previous two-thirds target.

Compared to a two-thirds debt structure, the lower fixed-rate structure will raise the Government's short-term exposure to adverse movements in interest rates. For example, a 100-basis-point increase in interest rates along the entire yield curve would raise federal net debt-servicing costs by $1.4 billion in the first year with a 60-per-cent fixed-rate structure, compared to $1.1 billion for the current debt structure. By comparison, the impact of the same interest rate shock was estimated at $1.8 billion in the mid-1990s.

However, the analysis also reconfirms that it is highly unlikely that the additional debt costs stemming from a severe interest rate shock would disrupt the budget plan in a given fiscal year due to the cushion built into the budgetary framework and Canada's lower debt level. 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.

The Government will continue to review the structure of the debt on an annual basis to determine whether adjustments are appropriate given the objectives of keeping costs low and maintaining market liquidity in a declining debt environment. Specifically, in 2004–05 the Government will evaluate the mix of net issuance among the four key bond maturities (2, 5, 10 and 30 years) and its impact on the average term to maturity and on costs. The potential for a better integration of debt management policies and the fiscal-planning framework will be examined to assess the utility and feasibility of setting a debt structure target that aids in the management of the overall budget balance.

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.

In developing its debt program plans, the Government conducts extensive consultations with market participants. In developing the debt management strategy for 2004–05, the Government consulted with market participants on two occasions: once on issues related to the Government's real return bond program and once on wider issues related to the debt program. The results of these consultations are incorporated in the following section, which describes detailed initiatives being undertaken in 2004–05 to maintain and enhance operational effectiveness in the areas of domestic debt, cash and reserves management. For further information, detailed reports on topics of discussion and views received from market participants are posted on the Bank of Canada's Web site at www.bankofcanada.ca.

As in past years, the Government plans to consult further with market participants on potential adjustments to debt program plans during the 2004–05 fiscal year. Discussion papers and reports on these future consultations will be posted on the Bank of Canada's Web site following the consultations.

2004–2005 Debt Strategy Action 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 2004–05:	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 $110 billion-$115 billion in 2003–04 to approximately $130 billion in 2004–05. Issue about $36 billion of bonds in 2004–05, $4 billion less than in 2003–04. Due to large bond maturities and continued cash management bond buyback operations, the bond stock is expected to decrease by some $16 billion. Continue bond buybacks at a planned level of about $11 billion, as in 2003–04.	Facilitate market adjustment to changes in the bond and Treasury bill programs.
Maintain a stable maturity profile.	Limit the need to refinance a large portion of debt in any given period and help maintain stability in debt programs over time.

Domestic Debt Programs

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

Action for 2004–05:	Intended Result:
Continue regular issues of marketable bonds in four maturity sectors, Treasury bills in three maturity sectors and a long-dated index-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, seek input from market participants on major adjustments to programs, and provide timely notices of government policy decisions.	Maintain transparency and efficiency.
Maintain current benchmark target sizes for 2-, 5-, 10- and 30-year bonds.	Maintain a liquid market for on-the-run issues and building-benchmark issues.
Maintain issuance of real return bonds, with issuance equal to or marginally higher than in previous years.	Continue the Government's commitment to the real return bond program to help diversify its product and investor base on a cost-effective basis.
Beginning April 1, 2004, change turnaround time for auctions and buybacks to a best efforts basis.	Enhance the bidding process and participation.
Expand the basket of bonds eligible for 10-year cash and switch buybacks to include more longer-dated maturities.	Promote liquidity by reaching target benchmark sizes within a one-year cycle.
Maintain the switch buyback program on an ongoing basis.	Promote liquidity by helping build benchmarks within a reasonable time frame.
Maintain the pilot 10:30 a.m. timing for Treasury bill auctions and 11:15 a.m. timing for cash management bond buybacks on an ongoing basis.	Support participation in these operations.

Foreign Reserves and Debt Programs

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

Action for 2004–05:

- Continue to use cross-currency swaps for the majority of reserves funding.

Intended Result:

- Keep the cost of carrying reserve assets low.

2004–2005 Debt Strategy Plan

Domestic Debt Programs

Modifications to debt programs in 2004–05 will continue the orderly adjustment toward the new debt structure target. In this context, the Government will focus on the maintenance of a well-functioning market.

In particular, starting April 1, 2004, the Government will reduce the turnaround time for auctions and buyback operations from a fixed time to a "best efforts basis" (i.e. when ready). Turnaround times for auctions and buybacks are expected to decline to about 5 and 10 minutes respectively. Release times will vary from operation to operation, subject to a maximum turnaround time for auctions and buybacks of 10 and 15 minutes respectively. The Government will continue to take steps in the fiscal year to streamline these operations to further reduce turnaround times. Reducing the turnaround time will reduce the market risk for market participants, further enhancing the efficiency of the auction and buyback process. Market participants support this change in turnaround time.

Fixed-Coupon Marketable Bond Program

Gross bond program issuance in 2004–05 is planned to be about $36 billion, $4 billion less than in 2003–04. Net bond issuance of about $25 billion will also be moderately lower than in 2003–04. Taking into account bond maturities and cash management bond buyback operations during the year, the stock of bonds is expected to decline from $257 billion to about $241 billion.[1]

In 2004–05 the Government will continue to hold quarterly auctions of 2-, 5- and 10-year bonds and semi-annual auctions of 30-year bonds. 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 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.

During the recent round of debt strategy consultations, market participants suggested that the sizes of nominal bond auctions are approaching their lower limit, particularly in the 10- and 30-year maturities, and that structural adjustments to the bond program may be required in the years ahead.

[1] 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 2002–03 *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.

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 1 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 program, 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 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.

Consultations with market participants indicated broad support for both the cash and switch buyback programs as a way of helping to maintain liquidity and new issuance of Government of Canada securities. Market participants suggested that it might be increasingly difficult to conduct large-scale buyback operations in the future due to the shrinking pool of eligible bonds to buy back.

The Government plans to conduct about $11 billion in bond buyback operations in 2004–05, similar to 2003–04. The amount of buybacks on a switch basis will be decreased by approximately $1 billion to roughly $4 billion, while cash buybacks will be increased by about $1 billion to nearly $7 billion. The quarterly maximum repurchase target amounts for the regular bond buyback program and the timing of each operation will be announced through the quarterly bond auction calendar published by the Bank of Canada at www.bankofcanada.ca.

To supplement buyback operations in the 10-year sector, starting April 1, 2004, bonds included in the basket of eligible bonds for buyback operations in the 30-year sector will also be included in the basket of eligible bonds for buyback operations in the 10-year sector.

To broaden participation in buyback operations, buybacks on a switch basis were introduced on a pilot basis in December 2001 with the first operation conducted in February 2002. During debt strategy consultations, market participants expressed strong support for the switch program. From the Government's perspective, the program is successfully meeting its objectives and, therefore, it will be maintained on an ongoing basis.

Cash Management Bond Buybacks (CMBBs)

To reflect market participants' preference for CMBB operations to follow Treasury bill auctions, the timing of CMBB operations was moved from 10:30 a.m. to 11:15 a.m. on a trial basis effective June 17, 2003. Based on positive comments received during 2004–05 debt strategy consultations, this timing will be maintained on an ongoing basis.

Real Return Bonds (RRBs)

In light of the evolution in the macroeconomic environment and the consequent change in the target debt structure to a lower fixed-rate share, the Government announced in the 2003–04 *Debt Management Strategy* that it would assess the RRB program as a method of funding for the Government of Canada.

Over the 2003–04 fiscal year, the Department of Finance and the Bank of Canada examined both the program's performance in achieving its stated objectives and the program's future value in the domestic debt program.

In addition to the internal review the Government sought the views of market participants on the RRB program. The Bank of Canada published a consultation document[2] and a cost-effectiveness study.[3] During consultations the Government spoke with over 50 different parties, including institutional investors, primary dealers and pension consultants. The Government also received a number of comments from various interested parties via e-mail. A summary of these consultations was published on the Bank of Canada Web site.[4]

The review found that the program has generally fulfilled its stated objectives. It found that global sovereign issuance of inflation-indexed securities has increased in recent years and that demand for RRBs continues. In the context of ongoing debt program adjustments, continued RRB issuance levels at around current levels over the next few years should not be an immediate constraint on maintaining issuance levels in nominal bond sectors and would have very little effect on the move to a lower fixed-rate share.

As a result of the review, the Government will maintain the RRB program, with expected issuance equal to or marginally higher than the $1.4 billion issued in 2003–04.

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[2] See http://www.bankofcanada.ca/en/notices_fmd/consult03.htm.
[3] See http://www.bankofcanada.ca/en/notices_fmd/rrb2003.htm.
[4] See http://www.bankofcanada.ca/en/notices_fmd/market_consult03.htm.

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 $15 billion-$20 billion to about $130 billion by the end of 2004–05.

To encourage participation by a broader range of market participants and to reflect market participants' preferences, the timing of Treasury bill auctions was changed from 12:30 p.m. to 10:30 a.m. effective June 17, 2003. Based on positive comments received during the 2004–05 debt strategy consultations, this timing will be maintained on an ongoing basis.

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 2004–05.

Domestic Market Development

The Department of Finance and the Bank of Canada have an ongoing dialogue with market participants and regulators on the development of the fixed-income market in Canada. Discussions are expected to continue to focus on the development and regulation of electronic trading systems in fixed-income securities. Electronic trading systems, which have recently appeared in Canada, have the potential to improve the transparency and efficiency of the market.

Retail Debt Program

In 2004–05 the Government will continue to focus on cost reduction, keeping the non-marketable retail debt portfolio and costs aligned with a declining debt environment. Retail debt instruments are available through financial institutions, through employer sponsoring organizations, and directly by telephone or through the Canada Investment and Savings Web site at www.csb.gc.ca.

Management of the Government's Cash Balances

The Government of Canada manages its cash balances in order 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 Government implemented a new framework in September 2002 to bring its operations in line with the best practices of other governments and market participants.

Under the new framework, 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 2004–05.

Foreign Reserves Debt Programs

The Government holds foreign exchange reserve assets in the Exchange Fund Account 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 *Annual Report to Parliament on the Operations of the Exchange Fund Account*, which is available on the Department of Finance Web site at www.fin.gc.ca.

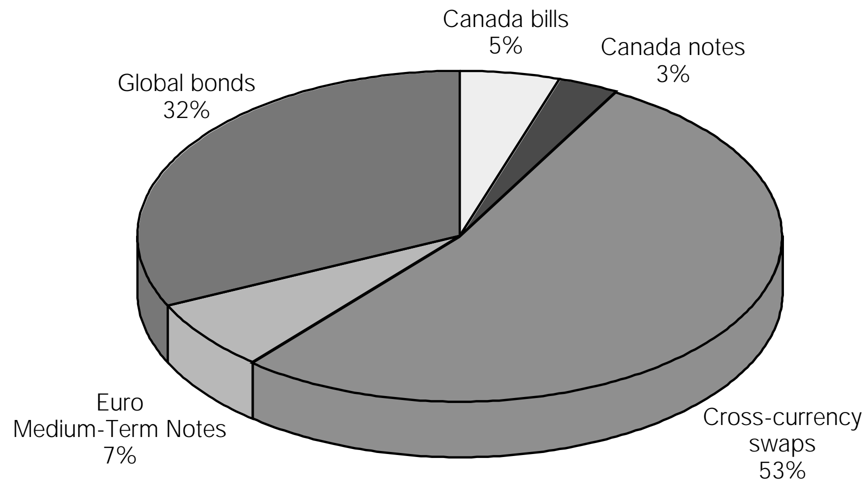
The Government's foreign currency reserves are funded through foreign currency liabilities. The foreign currency reserve assets, and liabilities financing those assets, are managed on a portfolio basis, based on many of the same principles used by other sovereigns and private sector financial institutions,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

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 2004–05 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, 2004.

Chart 2
Forecast Composition of Foreign Currency Liabilities
March 31, 2004



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 AM 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.

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.

average term to maturity: The average time remaining before debt matures, taking only principal amounts into account.

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

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.

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: 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: 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, which 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, which is redeemable on demand by the registered owner(s), and which, 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 unpredictable events. If not needed, it is used to pay down the public debt.

Cost at Risk: A measure based on the statistical distribution of debt charges that enables risk to be quantified in terms of the maximum costs that could occur within a specified probability range in a particular year.

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.

duration: Weighted average term to maturity of a bond's cash flow, used as a measure of interest rate sensitivity.

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

fixed-coupon 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 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.

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

government securities distributor: 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: 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.

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.

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, as well as bonds issued to the Canada Pension Plan.

market transparency: Within the context of debt management, characterization of a bond market where debt management strategies and operations are known and well understood by market participants.

net debt: Gross debt, net of financial assets.

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

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).

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: Market for the debt issued by a government.

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.

yield curve: 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.