



DEBT

MANAGEMENT

STRATEGY

2001-2002

Canada



DEBT MANAGEMENT STRATEGY

2001-2002



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 *Debt Management Strategy* of the Government of Canada for fiscal year 2001-02. This marks the second consecutive year that the Government has tabled the *Debt Management Strategy*, in keeping with the changes made in 1999 to the Financial Administration Act.

The commitment to sound financial management will once again be fulfilled as the Government expects to report a surplus of at least \$10 billion in 2000-01, marking the fourth consecutive year in which a surplus has been recorded. Taking into account the tax cuts and spending initiatives announced in the February 2000 budget and the *Economic Statement and Budget Update* of October 2000, the Government is committed to maintaining balanced budgets or better in 2001-02 and 2002-03. This will mean six consecutive years of balanced budgets or surpluses, an accomplishment that has not been matched in the past 50 years.

From a post-war peak of 71.2 per cent in 1995-96, the debt-to-GDP ratio will fall to about 54 per cent in 2000-01 and is projected to fall to about 40 per cent by 2005-06. This is important because as the ratio declines, Canada's public debt becomes less of a burden for Canadian taxpayers. As such, the Government's ongoing effort to reduce federal debt continues to pay dividends for all Canadians.

That being said, the level of debt remains significant and needs to be well managed. It is thus important to ensure that debt-servicing costs are kept low and stable. A crucial element of this objective is the management of the Government's market debt. This is the focus of the *Debt Management Strategy*, which provides comprehensive information on the Government's debt management plans for the coming fiscal year.

The Government's intention in tabling this document is to ensure all Canadians are aware of this strategy and the results it is intended to achieve.

The Honourable Paul Martin, P.C., M.P.
Minister of Finance
Ottawa, February 27, 2001

Highlights of the 2001-02 Debt Strategy

- The target fixed-rate share of the debt will be maintained at two-thirds.
- No major restructuring of domestic debt programs is planned in 2001-02. Bond and Treasury bill programs are expected to operate at levels similar to those of 2000-01.
- To enhance the liquidity of the Government of Canada securities market, the target benchmarks for 10- and 30-year bonds will be increased from \$9 billion-\$12 billion to \$12 billion-\$15 billion.
- To facilitate cash management, the 30-year issuance pattern will be adjusted by adding a third issue in 2001-02. The one-time additional issuance will be substantially offset by bond buybacks of outstanding long-term bonds, and is thus not related to the Government's projected borrowing needs.
- To improve the transparency and effectiveness of the bond buyback program, bond buyback operations will be more frequent, encompassing a range of maturities, with target volumes announced quarterly with the bond auction schedule.
- The cash management bond buyback pilot program will be extended into 2001-02.
- To reduce risk and broaden access, the Government is developing a new framework for the management of cash balances.
- Discussions will continue with market participants and regulators on enhancing the integrity and regulation of the Government of Canada securities market.

Debt Management Framework

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

The federal government pursues two main objectives in managing market debt:

- The fundamental objective 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 liquidity, transparency, regularity and integrity. For this reason, the Government borrows on a regular, pre-announced basis in key segments of the market, builds large bond benchmarks and maintains effective rules for participation at Government of Canada security auctions.
- 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 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 costs. The Government structures the debt to provide reasonable cost stability under a range of potential interest rate environments and a balanced maturity profile. 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.
- The Government maintains a diversified investor base.

Foreign Currency Debt Management

Principles

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

- Foreign currency borrowings by the Government are used to fund Canada's foreign exchange reserves.
- Major risks, including currency risk 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 slightly less than the cost of funding. Liabilities are managed in conjunction with the reserve assets to limit the cost of holding reserves, and a prudent maturity structure is maintained to limit refinancing needs.
- The Government's foreign exchange reserves are held predominantly in US dollars, with a small portion in euro- and yen-denominated reserves.

Debt Management Environment

Fiscal Outlook

Budgetary Balance

The Government is committed to balanced budgets or better in 2001-02 and 2002-03.

The Government's fiscal policy sets the context for debt management operations. In the October 2000 *Economic Statement and Budget Update*, the Government committed to paying down a minimum of \$10 billion of net public debt in 2000-01, bringing the total debt paydown over the last four years to at least \$28.7 billion. The Government will continue to follow a prudent approach to budget planning as set out in its Debt Repayment Plan. Taking into account the tax cuts and spending initiatives announced since the February 2000 budget, including the new measures announced in the *Economic Statement and Budget Update*, the Government is committed to maintaining balanced budgets or better in 2001-02 and 2002-03. This will mean six consecutive years of balanced budgets or surpluses – a performance not matched in the past 50 years.

The net public debt burden is expected to decline over time.

Consistent with the Debt Repayment Plan, the Government will continue to use the contingency reserve to reduce the net public debt in those years when it is not required. Furthermore, the Government has added an important new element to the Debt Repayment Plan. Each fall it will announce whether more of that year's surplus should be dedicated to debt paydown, depending on the economic and fiscal circumstances at that time.

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;
- continuing to add an extra degree of economic prudence to provide further assurance against falling back into a deficit; and
- announcing each fall whether more of that year's surplus should be dedicated to debt paydown – the amount would depend on the economic and fiscal circumstances at that time.

This enhanced Debt Repayment Plan, combined with 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 will fall to about 54 per cent in 2000-01 and is projected to fall to about 40 per cent by 2005-06. This would take the ratio back to where it was in 1983-84.

Financial Balance

The key budgetary measure for debt management planning is the financial balance (see box on next page). In general, balanced budgets can be expected to reduce market debt as they are normally accompanied by financial sources. However, the precise relationship between the budgetary balance and the financial balance will vary from year to year, as it depends in large part on the timing of cash payments. The budgetary balance is largely presented on an accrual basis of accounting, including liabilities when incurred, whereas the financial balance is presented on a cash basis of accounting.

For 2000-01 the Government is committed to paying down at least \$10 billion in net public debt. Consistent with this commitment, the Government is projecting a financial source of \$3 billion. The difference primarily reflects a number of one-time cash payments, which on a budgetary basis were recorded in previous years. These are the \$2.5-billion health supplement paid under the Canada Health and Social Transfer and pay equity payments made subsequent to the ruling of the Canadian Human Rights Tribunal. In addition, the reforms to the public sector pension plans, whereby contributions are now invested in the private capital market, have permanently reduced the difference between the budgetary balance and the financial balance. Further, a number of Crown corporations that are currently members of the public sector pension plan will be establishing their own pension plans. The Government will transfer to these corporations the actuarial value of their accrued assets over the 2000-01 to 2002-03 period.

For 2001-02 the Government has committed to a balanced budget or better. Consistent with this commitment and a net requirement from non-budgetary transactions of \$3 billion, the Government is projecting a financial requirement of \$3 billion. However, the balanced budget target includes the contingency reserve of \$3 billion and normal economic prudence of \$1 billion. The contingency reserve, if not needed, would be applied to reducing the debt. In addition, the budget plan for the year includes a remaining balance of \$4.3 billion. As indicated by the Minister of Finance in the October 2000 *Economic Statement and Budget Update*, some of this remaining balance could also be directed to further debt reduction.

The Budgetary Balance and Financial Balance

The budgetary balance – deficit/surplus – is one measure of the Government's financial situation. It is presented on a modified basis of accounting, recording liabilities when they are incurred, regardless of when the actual cash payment is made.

The financial balance – requirements/source – provides a measure of the net cash requirements needed to fund the Government's programs and debt charges. 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. Excluding foreign exchange requirements, the Government recorded a financial source in each of the last four years.

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 source in each of the last three years.

Foreign Exchange Transactions

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

In recent years foreign exchange transactions, although modest, have resulted in a reduction in the net financial balance. 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 high quality financial assets of the Government, thus offsetting foreign exchange liabilities.

Market Debt Impact

Market debt declined by \$4.0 billion in 1999-2000, bringing total market debt retirement over the past three years to over \$20 billion. Additional market debt retirements are projected for 2000-01. While market debt is generally on a downward track, it is expected to remain largely unchanged in 2001-02, primarily due to financial requirements associated with public sector pension reform.

No additional market borrowing is expected to be required in 2001-02.

The Government is positioning itself to meet any planned non-budgetary transactions in 2001-02 without any additional borrowing, largely through an increase in cash balances this year. 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 from the 1996-97 Borrowing Authority Act.

Debt Structure and Holdings

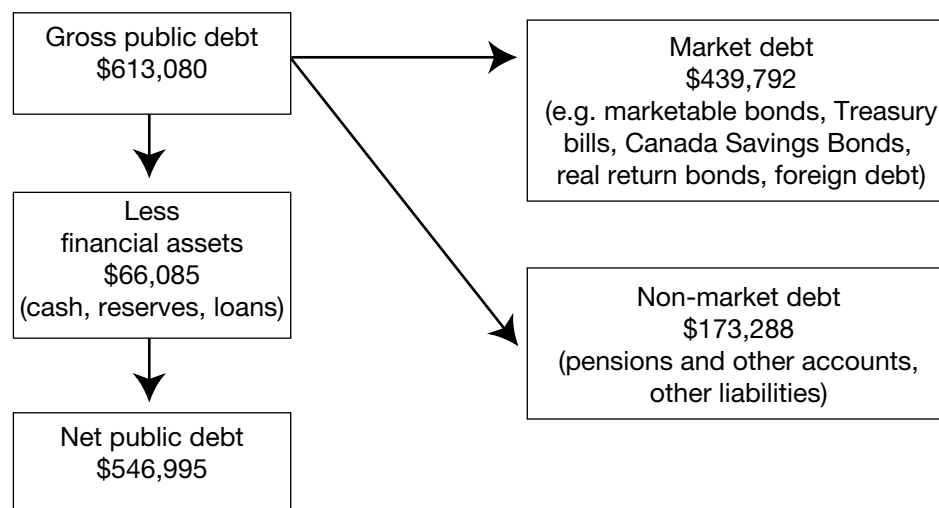
Debt management operations focus on market debt, which is only one component of the public debt. The other component – non-market debt – is taken into account in debt strategy planning, but is not actively managed. Non-market debt includes federal public sector pension liabilities and the Government’s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

The federal government’s market debt consists mainly of fixed-rate marketable bonds, real return bonds, Treasury bills, retail non-marketable debt (Canada Savings Bonds and Canada Premium Bonds) and foreign-currency-denominated debt.

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

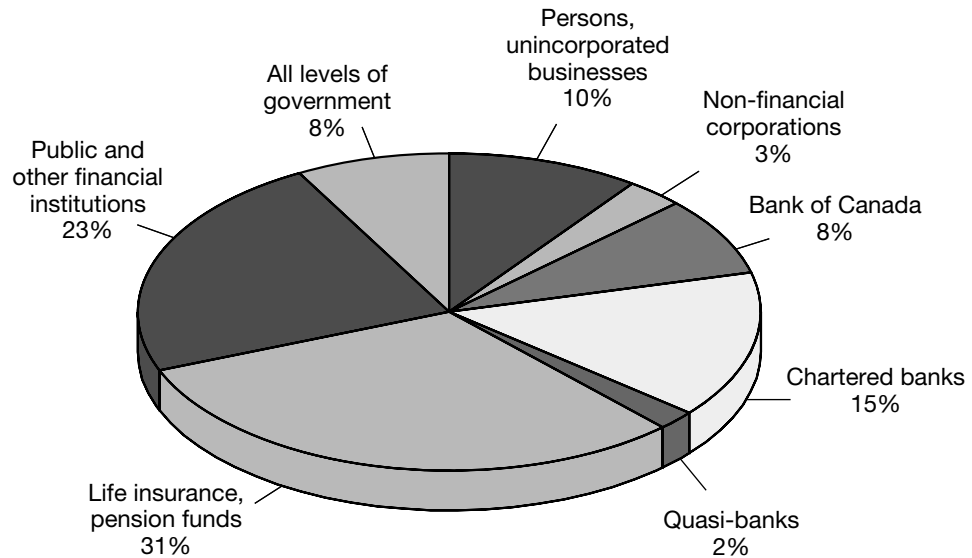
Total Public Debt as at December 31, 2000

(in millions of dollars)



Source: Department of Finance Canada, *The Fiscal Monitor* (results for December 2000), February 13, 2001.

Distribution of Domestic Holdings of Government of Canada Market Debt



Source: Statistics Canada, *National Balance Sheet Accounts – 1999*.

Note: 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 elsewhere included), 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 past few years, decreasing from a peak of 28 per cent of total market debt in 1993 to around 22 per cent today.

2001-02 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. Including multiple refinancings of maturing short-term Treasury bills, some \$262 billion of federal market debt will be maturing or repriced over the 2001-02 fiscal year.

Determining the Debt Structure Target

Given the large stock of outstanding debt, the Government's debt strategy aims to keep debt-servicing 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 keep a balanced maturity profile, which serves to maintain investor and credit rating agency confidence.

The debt structure target is reviewed annually to assess its ongoing suitability given changes in the fiscal and economic environment. For 2001-02, the target fixed-rate share of the debt will be maintained at two-thirds.

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 – fixed/floating ratio, average term to maturity, duration, Cost at Risk – the Government's key target is the share of interest-bearing debt issued at fixed rates (i.e. maturing or repriced beyond one year). 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 is currently.

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 2001-02, the target fixed-rate share of the debt will remain at two-thirds.

Implications of the Target Debt Structure

The Government uses a number of indicators in assessing the implications of the target debt structure.

The impact of a 100-basis-point increase in interest rates on debt charges has been cut in half since the mid-1990s.

The Government's decision to maintain the fixed-rate share of the debt at two-thirds 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, the first-year impact of a 100-basis-point increase was estimated at about \$1.8 billion.

A further benefit of maintaining the fixed debt structure at two-thirds is that it limits the need to refinance a large portion of the debt in any given period. 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 allows for lower debt-servicing costs should short-term rates remain lower than long-term rates.

Maintaining a higher fixed-rate share of debt may, however, give rise to increased debt-servicing costs for the Government since short-term funds are usually cheaper relative to long-term funds. By way of illustration, debt-servicing costs would differ by \$100 million next year for a 5-percentage-point difference in the debt structure. That is, given the forecast for interest rates contained in the October 2000 *Economic Statement and Budget Update* and the maturity profile of various types of government debt, the cost of a 5-per-cent higher fixed stock (72 per cent) would be \$100 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 \$100 million over the next fiscal year. The difference in the cost of alternative debt structures is affected by the slope of the yield curve, which at present is somewhat flatter than in recent years.

The two-thirds fixed-rate structure limits the fiscal impact of interest rate shocks.

Cost at Risk analysis, which evaluates debt costs under multiple interest rate paths (see box on next page), indicates that there are benefits to maintaining a two-thirds target debt rate structure relative to a lower fixed structure. 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 over the two-year budget horizon. While this would also be true of a higher fixed-rate structure, debt-servicing costs would also be higher. Under worst-case scenarios of significantly higher interest rates that continue for some time, debt-servicing costs under the current structure would be less affected than under a lower fixed-rate structure.

The Government takes a long-term strategic view of the debt structure, balancing the benefits of greater stability in debt-servicing costs, given the greater volatility in short-term interest rates, against the costs of achieving stability. As well, debt structure decisions take into account the inherent unpredictability associated with the long-term path of interest rates, as they will change significantly over time due

to both internal and external developments. On balance, the Government has adopted a prudent structure, similar to that maintained by other comparable sovereigns.

Cost at Risk Analysis

The Government recently expanded its long-term analytical capabilities with the introduction of a measure known as Cost at Risk (CaR), which is used by a number of sovereign borrowers to assess the cost and risk associated with different debt structures. Calculation of CaR is based on the future interest costs of a given debt stock under numerous different interest rate scenarios, and allows a comparison of the long-term interest rate risk of alternative debt structures. On the basis of these scenarios, a probability distribution of costs can be determined.

CaR depends largely on the assumptions used to simulate scenarios; changes in modelling techniques and the interest rate environment will change results from year to year. However, CaR is an important supplement to established measures such as the fixed-rate share and the maturity profile.

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 liquid and transparent domestic wholesale debt programs 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, regularity and integrity, 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 provide important pricing and hedging tools.

The Government will continue to maintain the principles of liquidity, transparency, regularity and integrity 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.

Past Debt Strategy Initiatives

The federal government pursued a number of initiatives in 2000-01, including:

- increasing the target benchmark sizes for 5-, 10- and 30-year bonds to enhance the liquidity and attractiveness of the Government of Canada securities market;
- implementing, on an ongoing basis, the bond buyback program to support the maintenance of a liquid new bond issue market;
- reviewing the structure of the Treasury bill program to ensure it continues to function well;
- implementing a pilot bond buyback program for cash management purposes;
- approving new rules related to the stripping and reconstitution of Government of Canada bonds;
- continuing discussions with market participants and regulators on the development of electronic trading systems in the domestic fixed-income market; and
- releasing a discussion paper proposing changes to the cash management system framework, including broadening access to bidding for balances and introducing a credit framework to govern the investment process.

A number of initiatives have been pursued by the Government to ensure that a well-functioning Government of Canada securities market is maintained.

2001-02 Debt Strategy Initiatives

Domestic Debt Programs

No major restructuring of domestic debt programs is planned in 2001-02.

Given that domestic debt programs are expected to operate at similar levels to those of 2000-01, no major restructuring is planned in the near term. In the development of the 2001-02 debt strategy, market participants were consulted on the desirability of restructuring the Treasury bill program to improve liquidity. The general consensus was that, provided the stock remains near current levels (i.e. in the range of \$75 billion to \$95 billion), no change is needed to the structure of the Treasury bill program. The domestic bond program will continue to have four benchmark maturities (2, 5, 10 and 30 years) as well as a real return bond benchmark.

To maintain transparency 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 upcoming debt operations, attracts a wide range of investors and promotes secondary market liquidity.

In 2001-02 the Government will continue to hold quarterly auctions of 2-, 5- and 10-year bonds and real return bonds.

The 30-year issuance pattern will be adjusted to facilitate cash management.

To facilitate cash management, the Government will adjust the semi-annual issuance pattern for 30-year bonds, switching from spring/fall to summer/winter. Currently the 30-year bond auctions are held in quarters where cash balances are already high. By altering the issuance pattern of the 30-year bonds, the Government will better match the issuance cycle to its cash flow needs. This will be achieved by adding a third 30-year issue in the fourth quarter of fiscal year 2001-02. The one-time issuance will be substantially offset by buybacks (see below) of outstanding long-term bonds, and is thus not related to the Government's projected borrowing needs.

Benchmark targets and planned reopening periods for 10- and 30-year bonds are being increased.

In consultations market participants expressed a desire for increased liquidity in longer-dated bonds. Therefore, in order to promote liquidity and trading in benchmark Government of Canada securities, the benchmark targets for 10- and 30-year bonds are being increased from \$9 billion-\$12 billion to \$12 billion-\$15 billion. The increased benchmark size will be achieved through extended reopening periods (new issues of bonds are generally reopened several times to increase the size of the issue to the target benchmark size). As is currently the practice, the Government and the Bank of Canada will continue to consult with government securities distributors prior to making a decision on whether a particular auction will be a new issue or a reopening. These decisions will continue to be announced with the release of the *Call for Tender*. The targets for 2- and 5-year bonds will be maintained at \$7 billion to \$10 billion and \$9 billion to \$12 billion, respectively.

Bond Buybacks

To enhance liquidity in the market for Government of Canada securities, a bond buyback program was introduced in 1998-99 and implemented on an ongoing basis in 2000-01. 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. (A list of outstanding Government of Canada bonds, including maturity dates, can be found in the *Debt Management Report 1999-2000*, which is available on the Department of Finance Web site at www.fin.gc.ca. A list is also available in the forthcoming annual publication, *Summary of Government of Canada Direct Securities and Loans*, which will be available on the Bank of Canada's Web site at www.bankofcanada.ca.)

Bond buyback operations will be more frequent, encompassing a range of maturities, with target volumes announced quarterly with the bond auction schedule.

The planned size of the bond buyback program and the number of transactions depend on a number of factors, including the desired size of the new issuance and buyback programs, market feedback and financial requirements. In 2001-02 it is expected that buyback volumes will be modestly greater than in 2000-01. To enhance transparency and participation, the Government will increase the frequency of bond buyback operations and will announce the total target volume for each quarter in the quarterly bond auction schedule published by the Bank of Canada. (The current schedule is available on the Bank of Canada's Web site at www.bankofcanada.ca.)

Bond Buybacks for Cash Management

The cash management bond buyback pilot program will be extended into 2001-02.

To help in smoothing the Government's cash requirements, a pilot program of cash management bond buybacks was implemented in 2000-01. The purpose of the program is to reduce the peak levels of government cash balances needed to redeem upcoming benchmark bond maturities. In contrast to the buyback program for liquidity maintenance purposes, this involves buying back bonds with less than 12 months to maturity. The pilot program will be continued in 2001-02 as operational issues are assessed. An evaluation involving consultations with market participants will be conducted during the year to determine whether it is meeting objectives and can become a regular part of the Government's debt management operations.

Primary Market Enhancements

Communications with market participants will be ongoing in 2001-02 on operational enhancements to debt programs.

In 2000-01 the Government made adjustments to debt programs to enhance the functioning of the market for Government of Canada securities. Market participants were consulted on proposed initiatives through notices and information posted on the Bank of Canada's Web site (www.bankofcanada.ca). Through this approach, the Government seeks to maintain a high standard of transparency, improve operational flexibility and obtain external input into its decisions on debt management operations.

In 2001-02 this process will continue. Initiatives currently contemplated are the continued reduction in auction result turnaround time, as well as evaluation of alternative methodologies for bond buybacks.

Domestic Market Initiatives and Integrity

The Government has a strong interest in ensuring the well functioning and integrity of the market for fixed-income securities, particularly Government of Canada securities, which are the benchmark of the market. The Government of Canada securities market is a highly liquid market, primarily involving professional financial institutions, which serves the interests of Canadian taxpayers and a wide range of fixed-income market participants.

Discussions with market participants and securities regulators on enhancing market integrity and regulation are ongoing.

Given the rapid advance of electronic trading in fixed-income markets, the Canadian Securities Administrators (CSA) have made proposals for the regulation of electronic trading and for the appropriate framework for the regulation of the domestic fixed-income market. The Department of Finance and the Bank of Canada have an active dialogue with the CSA and market participants on these matters. Given the nature of the marketplace, the Government's preferred approach is to avoid imposing unnecessary and potentially burdensome regulatory structures, while continuing to deal with public interest issues as they arise, in full consultation with market participants and the CSA.

The Government is encouraging the development of greater transparency of the secondary market for Government of Canada securities.

In this context, the Government is supporting the enhancement of transparency mechanisms. A current initiative is the further development of the CanPx system. A screen-based, real-time information system established by dealers and inter-dealer brokers in 1999, CanPx provides market participants with best bid and offer prices and trading volumes in a range of benchmark fixed-income securities in the inter-dealer marketplace. The CanPx system, which has yet to operate in the manner intended due to technical problems, is being fixed and expanded in 2001 to ensure market participants are provided with a high standard of transparency.

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 be volatile and difficult to forecast at times. Thus, substantial cash balances are often held.

The federal government is developing a new framework for the management of cash balances in 2001-02.

In July 2000 the Department of Finance and the Bank of Canada released a public discussion paper on proposed changes to the cash management framework. Under the current framework, cash balances are placed with direct participants in the Large Value Transfer System through a competitive auction process. The federal government is developing a new framework, based on the feedback received from market participants, which includes the introduction of a credit management system to better manage the risk of investing its cash balances and to support the broadening of participation in the bidding process.

Foreign Debt Programs

Foreign Exchange Reserve Assets

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

The Government's foreign exchange reserve assets provide it with foreign currency liquidity and ensure that it is able to meet international requirements or unforeseen obligations at all times. Reserves may also be used for intervention in the foreign exchange markets to promote orderly conditions for the Canadian dollar. (Further detail on the management of international reserves is available in *Exchange Fund Account – Annual Report*, available on the Department of Finance Web site at www.fin.gc.ca.)

In recent years the Government has increased the level of foreign exchange reserves to bring them in line with those of other comparable sovereigns. The foreign currency reserve assets and the liabilities financing those assets are managed on a portfolio basis, based on many of the same principles used by private sector financial institutions, including prudent risk management principles. In this regard, interest rate and currency risks are immunized to the extent possible. On the asset side, attention needs to be paid to asset liquidity and quality, diversification and credit limits with counterparties. On the liability side, the same attention is paid to diversified means of raising funds and a diversified investor base, as well as the cost of different sources of funds and the maturity profile of the liabilities.

Key considerations in managing the foreign currency reserve assets and liabilities are minimizing the cost of carrying reserves and prudently managing risk.

One consideration in managing reserve assets and liabilities is to minimize the cost of carrying reserves. The main strategy used to reduce this cost has been to modify the composition of Exchange Fund Account assets by shifting a portion of the Government's investments in sovereign issues to other higher-yielding but still liquid high quality, fixed-income securities. These securities bear returns near the rate of interest Canada pays on its foreign liabilities. To further reduce carrying costs, a more aggressive use of the Government's euro-currency portfolio has been undertaken, when comparative carrying cost advantages relative to US-dollar assets exist. Finally, the cost of holding securities has been further reduced by proceeds derived from the Government's active securities lending program.

Foreign Currency Assets and Liabilities (as of December 31, 2000)

	US\$ billions
Total assets*	28.9
Liabilities:	
Canada Bills	3.8
Canada Notes	0.6
Euro Medium-Term Notes	3.0
Global bonds	13.5
Cross-currency swaps	14.3
Total liabilities	35.3

Note: Numbers do not add due to rounding.

*Only liquid reserves are included (i.e. securities and deposits).

On the risk management side, a risk management framework has recently been put in place. Improved investment guidelines have been implemented, requiring that investments be permitted only in securities from issuers with a high minimum credit rating, and that the amount invested in each issue and category of issuer be capped in order to limit risks and ensure diversification. Collateralization is being introduced in 2001 to further enhance risk management.

In recent years foreign currency liabilities came to exceed liquid foreign currency assets in the Exchange Fund Account, largely as a result of extensive foreign exchange intervention and important commitments to the International Monetary Fund in 1998. At its widest point, the excess liability amounted to some US\$13 billion. Consistent with the Government's policy of immunizing currency and interest rate risk in Canada's reserve program, the Government is taking steps to bring foreign currency liabilities in line with foreign currency assets.

In December 1998 the Department of Finance, in collaboration with the Bank of Canada, implemented a program of purchases of US dollars in foreign exchange markets. These US dollars are used to reduce US-dollar-denominated liabilities. Purchases of US dollars are small in relation to the large daily flows in foreign exchange markets and are undertaken with sensitivity to market conditions. This program has reduced the gap between foreign currency assets and liabilities to some US\$6.5 billion as of the end of December 2000, and the plan is to close it over the next few years.

Funding Foreign Exchange Reserves

The Government has access to a wide range of sources to fund its foreign currency assets. 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. In 2000-01 cross-currency swaps of domestic obligations and purchases of US dollars have served as the primary sources of funding of the foreign exchange reserves program.

In addition to minimizing its funding costs by diversifying its funding sources, the Government aims to maintain a balanced profile of liability maturities to minimize rollover and financing risks. The general target is to ensure that foreign currency liabilities maturing in the next year do not exceed one-third of reserve assets; the Government has kept well within this target.

Sources of Foreign Exchange Reserves (April 1 to December 31, 2000)

	US\$ billions
Sources of reserves:	
Purchases of US dollars	2.4
Cross-currency swaps	1.1
Public market borrowings	0.0
Total sources	3.5
Foreign exchange reserve requirements:	
Net maturing debt	(2.0)
Net foreign exchange debt charges	(0.5)
Government requirements and other	(0.2)
Requirements	(2.7)
Increase in foreign exchange reserves	0.8

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

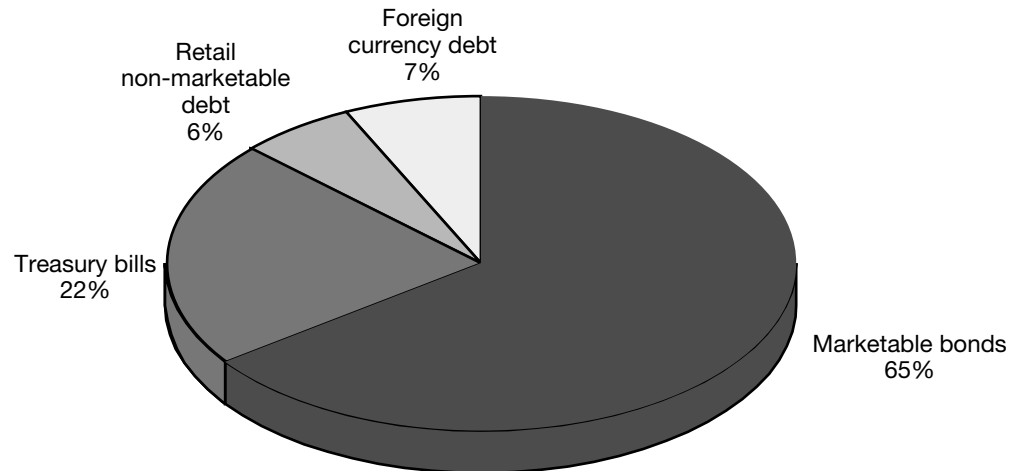
In 2001-02 the precise mix of funding sources will depend on a number of considerations, including relative cost, market conditions and opportunities, and the desire to maintain a prudent foreign-currency-denominated debt maturity structure. It is expected that cross-currency swaps of domestic obligations and purchases of US dollars will continue to be primary sources of reserve funding.

2001-02 Federal Debt Programs

Outlook for Market Debt

Over the coming years the composition of market debt is expected to remain largely unchanged. In 2001-02 debt programs are planned to operate at similar levels to the previous fiscal year.

Forecast Composition of Market Debt (March 31, 2001)



Note: Excluding bonds issued to the Canada Pension Plan.

2001-02 Federal Debt Program Plans

The federal debt management strategy for each debt program is presented on the next page. The strategy is based on the underlying fiscal policy of maintaining a balanced budget or better in 2001-02 and a projected financial requirement of \$3 billion. The federal debt program plan has been developed in consultation with market participants. The federal government will continue to consult with market participants in fiscal year 2001-02 on potential adjustments 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
- 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

Fixed-rate marketable Government of Canada bonds are issued in Canadian dollars and pay interest semi-annually. In 2001-02 about \$35 billion of bonds will be maturing.

The 2001-02 bond program (i.e. gross issuance), taking into account buyback operations and foreign funding activity, will be about \$40 billion on a gross basis.

Real Return Bonds

The target for real return bonds will be maintained.

As in 2000-01 the federal government plans to issue up to \$2 billion in real return bonds in 2001-02. In 2000-01, \$1.4 billion in real return bonds are being issued.

Treasury Bills

The Treasury bill program will operate at levels similar to those in 2000-01.

The Treasury bill stock varies over the year largely as a result of changes in the Government's funding and cash needs. In 2001-02, based on the fiscal plan in the budget, the stock at year-end is expected to be similar to the 2000-01 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 2001 by CI&S.

Foreign Currency Debt Programs

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

It is expected that the principal sources of funding for the foreign exchange reserves will continue to be cross-currency swaps of domestic obligations and purchases of US dollars.

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.

bid-offer spread: The difference between bid and offer prices. It is typically measured in basis points (hundredths of a per cent).

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

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. 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 savings product for individual Canadians introduced by the Government of Canada in 1998. It is offered for sale by most Canadian financial institutions, 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: Is currently offered for sale by most Canadian financial institutions to individual Canadians. It pays a competitive rate of interest that is guaranteed for one or more years. It may be cashed at any time and, after the first three months, pays interest up to the end of the month prior to encashment.

CanPx: A transparency system which 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: 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. The contingency reserve also provides an extra measure of backup against adverse errors in the economic forecast. If not needed, it is used to pay down the public debt.

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

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

Exchange Fund Account: A fund maintained by the Government of Canada for the purpose of promoting orderly conditions for 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 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 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.

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

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.

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 both of market debt in the form of outstanding securities such as Treasury bills and Canada Savings Bonds, and internal debt owed mainly to the superannuation fund for government employees and other current liabilities.

hedge: A transaction intended to reduce the risk of loss from price fluctuations.

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.

interest rate swap: An agreement that exchanges one type of return for another (e.g. a fixed for a floating rate of interest) and also exchanges the principal amount for the term of the swap.

market debt: For debt management purposes, market debt is defined as the portion of debt that is funded in the public markets, and includes 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.

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

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 public debt: Consists of gross public debt 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).

offer: Price at which a seller is willing to sell.

primary market: Market for new issues of securities.

real return bond: A Government of Canada real return bond pays semi-annual interest based upon a real interest rate. Unlike standard fixed-rate marketable bonds, interest payments on real return bonds are adjusted for changes in the consumer price index.

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

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

term structure of interest rates: The levels of interest rates from short- to long-term maturities.

tranche: A portion of a bond offering, delineated by maturity.

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

turnover ratio: 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.