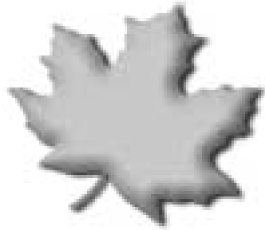
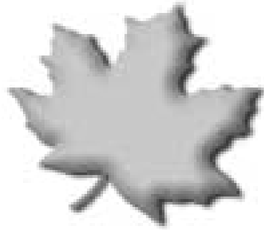


Debt Management Strategy

2002-2003

Canada



Debt Management Strategy

2002-2003

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 2002-03. It provides comprehensive information on the Government's debt management strategy in the coming fiscal year.

In keeping with its track record of sound fiscal management, the Government projected in December 2001 that the budget would be balanced or better in 2001-02 and in each of the two subsequent years. This would mean seven consecutive years of balanced budgets or surpluses.

From a peak of about 71 per cent in 1995-96, the debt-to-GDP (gross domestic product) ratio is expected to fall to below 50 per cent in 2002-03. This is important to all Canadians because, as the size of the debt declines relative to the size of the economy, the debt becomes more manageable. To that end, the Government has taken steps to reduce the debt not only in relation to the size of the economy but also in absolute terms, paying down $36 billion in net debt in the last four years.

Still, the level of debt remains significant, with debt-servicing costs taking about 23 cents of each revenue dollar collected by the federal government. But this is a major improvement compared to the 36-cent debt-servicing cost in 1995-96.

While Canada is in the midst of a global economic slowdown – a slowdown made worse by the September 11, 2001, terrorist attacks on the United States – it is important to keep debt-servicing costs as low and as stable as possible. A crucial part of these efforts is the management of the Government's market debt.

The Honourable Paul Martin, P.C., M.P.
Minister of Finance
Ottawa, March 14, 2002

Purpose of This Publication

The *Debt Management Strategy* is an annual publication of the Department of Finance that provides information on the federal government's objectives and strategies for managing the outstanding stock of debt 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 major strategic initiatives and on outstanding debt. This publication is available shortly after the release of the Public Accounts in the fall.

Highlights of the 2002-2003 Debt Strategy

- The Government is committed to balanced budgets or better in 2001-02 and in each of the next two fiscal years.
- Given the fiscal outlook, no restructuring of domestic debt programs is planned in 2002-03.
  - The target for the fixed-rate share of the debt will be maintained at two-thirds.
  - The Treasury bill program is planned to operate at levels similar to last year.
  - The gross issuance of bonds is planned to be similar to last year. The total amount of bonds issued through auctions is expected to be lower than last year, with the decline offset by new issuance through bond buybacks on a switch basis.
  - The bond program will continue to offer marketable bonds in four maturity sectors (2-, 5-, 10- and 30-year) and one bond that is inflation index-linked (30-year).
  - Current benchmark targets will be maintained for nominal bonds: 2-year ($7 billion-$10 billion), 5-year ($9 billion-$12 billion), and 10- and 30-year ($12 billion-$15 billion).
- Debt strategy initiatives aimed at enhancing the Government of Canada securities market include the following:
  - The processing time for auctions and bond buyback operations will be further reduced as the year progresses to lower market risk for participants and promote participation.
  - Bond issues that are targeted in buyback operations will be expanded to include some older benchmark bonds. A larger ceiling for individual buyback operations will be adopted to improve the effectiveness of the bond buyback program.
  - The pilot cash management bond buyback program, introduced in 2001-02 to smooth the Government's cash requirements, will continue in 2002-03.
  - Work will continue with market participants and regulators to enhance market integrity, transparency, liquidity and efficiency.
  - Collateral-based frameworks will be implemented for domestic cash balances, cross-currency swaps and foreign cash balances to ensure prudent management of counterparty risk.

Debt Management Framework

Debt Management Objectives

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

The fundamental debt management objective is to raise stable, low-cost funding for the Government. A key strategic objective is to maintain a well-functioning market for Government of Canada securities. A well-functioning market contributes to keeping costs low and benefits financial markets in general.

Debt Management Principles

Debt management operations are planned and executed in keeping with a number of key principles.

In the pursuit of these objectives, the Government abides by the following operational principles.

- Prudence: Raise all the required funding for its operational needs in the domestic market. Manage the composition of the domestic debt to protect the Government's fiscal position from unexpected increases in interest rates and to limit refinancing needs in any given period. Minimize, to the extent possible, risks arising in the management of the Government's foreign reserves portfolio.
- Transparency, liquidity and regularity: Emphasize transparency, liquidity and regularity in the design and implementation of its domestic debt programs in order to maintain a well-functioning domestic market and keep costs low.
- Diversification: Borrow using a variety of instruments and range of maturities to keep costs low and maintain a diversified investor base.
- Market integrity: Work with market participants and regulators to enhance the integrity and attractiveness of Government of Canada securities to investors.
- Consultations: Actively 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.

Debt Management General Strategy

The general approach taken by the Government to achieve the debt management objectives is as follows.

Domestic Market

The Government borrows strategically in domestic markets.

- The Government structures the maturity profile of the debt in a way that balances lower financing costs with reasonable cost stability and lower refinancing risk under a range of potential interest rate environments over the long term. The target debt structure is not based on a particular interest rate outlook.
- To enhance the functioning of the market, 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 securities auctions.
- The Government maintains a diversified investor base by auctioning nominal bonds, real return bonds and Treasury bills in the wholesale market and by selling savings products to Canadians in the retail market.

Foreign Currency

The Government operates on a discretionary basis in managing the foreign reserves portfolio.

- 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.
- Foreign liabilities are matched with reserve assets to limit currency and interest rate risks.
- The Government funds its foreign exchange debt through diverse sources and structures the maturity of the debt to limit refinancing needs.

Debt Management Environment

Fiscal Outlook

Budgetary Balance

The Government projects balanced budgets or better for 2001-02 and for each of the next two fiscal years.

The Government's fiscal policy sets the context for debt management operations. The Government has recorded budgetary surpluses over the past four fiscal years and has paid down $35.8 billion of the net public debt. Taking into account the economic slowdown and initiatives announced in the 2001 budget, the Government is committed to maintaining balanced budgets or better for 2001-02 and for each of the next two fiscal years.

Contingency Planning in the Current Environment

The Government sets aside an annual Contingency Reserve to cover risks arising from unpredictable events and variations in economic forecasting.

The unforeseen circumstances of both the slowdown in the global economy and the September 11th terrorist attacks created a high degree of uncertainty and exceptional fiscal pressures. In this regard, the Government announced in the December 2001 Budget that it plans to use a portion of the Contingency Reserve.

- The Contingency Reserve is set at $1.5 billion for 2001-02, rising to $2.0 billion in 2002-03 and $2.5 billion in 2003-04.
- The Government intends to restore the level of the Contingency Reserve as soon as possible.

The Contingency Reserve for 2001-02 will be used for debt paydown. For 2002-03 and 2003-04 the Government plans to use the Contingency Reserve, to the extent that it is not needed to meet unexpected circumstances, to pay down the debt as well.

Combined with forecast economic growth, the debt-to-GDP ratio – the level of debt in relation to the country's annual income – remains on a downward track. From a peak of 70.7 per cent in 1995-96, the ratio is expected to fall to under 50 per cent in 2002-03 – the lowest ratio in 17 years – and to about 47 per cent by 2003-04.

Financial Balance (Excluding Foreign Exchange Transactions)

The measure used for debt management planning is the Government's financial balance.

The key budgetary measure for debt management planning is the financial balance – requirement or source – rather than the budgetary balance (see box below). The budgetary balance is presented on a modified accrual basis, recognizing liabilities when they are incurred rather than when they are actually paid out. In contrast, the financial balance is on a cash basis.

Foreign Exchange Transactions

The net financial balance is affected by foreign exchange transactions.

In the past several years foreign exchange transactions, which were used to build up Canada's foreign exchange reserves, have reduced the size of net financial balances. In 2002-03 the level of Canada's foreign exchange reserves is expected to remain largely unchanged, although a modest financing requirement may be engendered by transactions related to Canada's commitment to the International Monetary Fund (IMF).

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

The budgetary balance and financial balance 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 fiscal situation. It is presented on a modified accrual basis of accounting, recording liabilities when they are incurred, regardless of when the actual cash payment is made.

The financial balance – requirement or source – provides a measure of the net cash position needed to fund the Government's programs and debt charges. The budgetary balance includes obligations incurred by the Government during the course of the year, whereas the financial balance includes only the cash outlay related to these obligations.

The net financial balance includes foreign exchange transactions, which represent all transactions in international reserves held in the Exchange Fund Account and commitments to the IMF. The net financial balance corresponds closely to the unified budget balance measure used in the United States.

Transactions for the Year Ending March 31, 2001
(in millions of dollars)

Budgetary surplus
$17,148

+

Non-budgetary transactions
$1,843

← Loans, investments and advances, pensions and other accounts, and other transactions

=

Financial source
$18,991

–

Foreign exchange transactions
$8,776

← Foreign exchange reserves, IMF subscription and allocations

=

Net financial source
$10,215

Source: *Public Accounts of Canada*, 2000-01.

Market Debt Outlook

The outlook is for some modest market debt retirement in 2002-03.

The net public debt has declined by $35.8 billion over the past four fiscal years, including a $30.5-billion decline in market debt. A small financial source is currently foreseen for 2002-03. A net financial source is uncertain as it is affected by foreign exchange transactions occurring during the year. At this time the outlook is for some modest market debt retirement in 2002-03.

The Government does not expect to borrow net new funds in 2002-03. If necessary, it can draw on the existing amount of $4 billion in non-lapsing borrowing authority provided by the 1996-97 Borrowing Authority Act.

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 in the form of a borrowing authority bill to raise net new debt.

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

Debt Composition

Only the market debt component of the gross public debt is actively managed.

Debt management operations focus on market debt, which is only one component of the gross public debt, and financial assets. The other component of the gross debt, non-market debt, is taken into account in debt strategy planning but is not actively managed. Non-market debt generally includes federal public sector pension liabilities and the Government's accrued liabilities. The chart below illustrates the relationships between the components of the public debt.

Total Public Debt as of March 31, 2001
(in millions of dollars)

Component		Includes
Market debt $446,403	←	Marketable bonds, Treasury bills, Canada Savings Bonds and Canada Premiun Bonds, real return bonds, foreign debt
+		
Non-market debt $186,473	←	Pensions and other accounts, other liabilities
=		
Gross public debt $632,876		
–		
Financial assets $85,498	←	Cash, foreign exchange reserves, loans, investments and advances
=		
Net public debt $547,378		

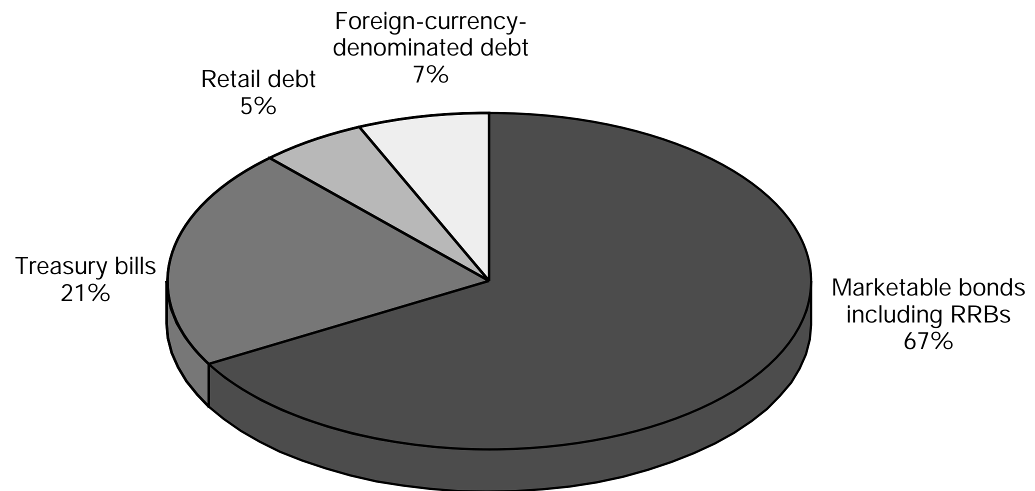
Source: *Public Accounts of Canada*, 2000-01.

The composition of market debt is expected to remain largely unchanged in 2002-03.

The federal government's market debt consists mainly of fixed-rate marketable bonds, real return bonds (RRBs), Treasury bills, retail non-marketable debt (Canada Savings Bonds and Canada Premium Bonds) and foreign-currency-denominated debt. Financial assets held by the Government include operating cash balances, loans and investments, and foreign exchange reserves.

Over the coming year the composition of market debt is expected to remain largely unchanged. Debt programs are planned to operate at similar levels to the 2001-02 fiscal year. The chart on the next page shows the forecast composition of federal market debt at the end of the 2001-02 fiscal year.

Forecast Composition of Market Debt, March 31, 2002



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

2002-2003 Debt Management Strategy

Key Considerations

Maintaining a Prudent Debt Structure

Prudence remains important given the outstanding debt stock.

Canada's outstanding stock of market debt, which stood at $446 billion as of March 31, 2001, is exposed to interest rate changes originating in Canada and around the world. Interest rate changes can significantly affect annual debt charges, as the portion of debt that matures must be reissued at the new prevailing market interest rates. Including multiple refinancings of maturing short-term Treasury bills, some $324 billion of the federal market debt will be maturing or repriced over the 2002-03 fiscal year.[1]

The Government takes a long-term perspective with respect to the debt structure.

In determining the composition and maturity profile of the debt, the Government takes a long-term perspective with respect to the trade-off between the cost and risk of issuing various forms of debt. The trade-off reflects the fact that, from a borrower's point of view, longer-term debt instruments are generally more costly but less risky than shorter-term debt instruments.

The key operational measure of the debt structure is the fixed-rate portion of debt.

The primary measure of the debt structure is the fixed-rate share, which is the proportion of interest-bearing debt having fixed rates (debt that does not mature or need to be re-priced within a year). Consideration is also given to the debt structure's average term to maturity, or average length of time before debt instruments need re-pricing.

Target Fixed-Rate Share

The Government has achieved greater debt cost stability over the past several years by increasing the fixed-rate target from about 50 per cent to the current target of two-thirds. Over the past three fiscal years the fixed portion of debt has remained around the two-thirds level, although small fluctuations occur as operations are conducted throughout the year.

The fixed-rate target is reviewed annually.

As part of debt strategy planning, the fixed-rate debt structure target is reviewed annually to assess its suitability given changes in the fiscal and economic environment. Factors that influence the decision on the target structure are the short-term volatility of debt costs (given the interest rate environment), the structure's impact on borrowing requirements, and the long-term cost/risk profile.

For 2002-03 the target fixed-rate share of the debt will remain at two-thirds.

Based on the analysis of costs and risks, the Government will maintain the target fixed-rate share of the debt at two-thirds for 2002-03. The Government will continue to evaluate the fixed-rate debt structure target needed to balance the long-term cost/risk profile against short-term fiscal and economic constraints. In this regard, work is ongoing to assess the costs and risks of alternative fixed-rate debt structures.

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[1] Includes cross-currency swaps. By comparison, the amount maturing or repriced excluding cross-currency swaps is $276 billion, modestly higher than in 2001-02 ($262 billion).

2002-2003 Analysis of Fixed-Rate Debt Structures

The analysis of the target debt structure compares the expected debt costs and debt cost variability of the current fixed-rate debt structure to debt structures that have ±5 percentage points fixed-rate shares.

The comparison of alternative fixed-rate debt structures indicates that debt costs would likely be about $600 million higher next year if the fixed-rate portion of debt were 5 percentage points higher (72 per cent) while debt costs would likely be about $400 million lower next year if the fixed-rate portion of debt were 5 percentage points lower (62 per cent) (see chart on next page). By comparison, last year's analysis indicated that debt costs would likely be about $100 million higher (lower) with a 72-per-cent (62-per-cent) fixed-rate share. Last year's values were lower because the yield curve was very flat compared to the historical yield curve shape. Compared to last year, there is currently a greater differential between short- and long-term rates.

The above comparative analysis is indicative of higher and lower cost/risk profiles that could only be achieved over time. The differences in debt costs depend on the yield curve, which is likely to be different when the debt is actually refinanced. For example, if a change were made next year to a 2-percentage-point lower (or higher) fixed-rate structure, debt costs would be about $100 million lower (higher).

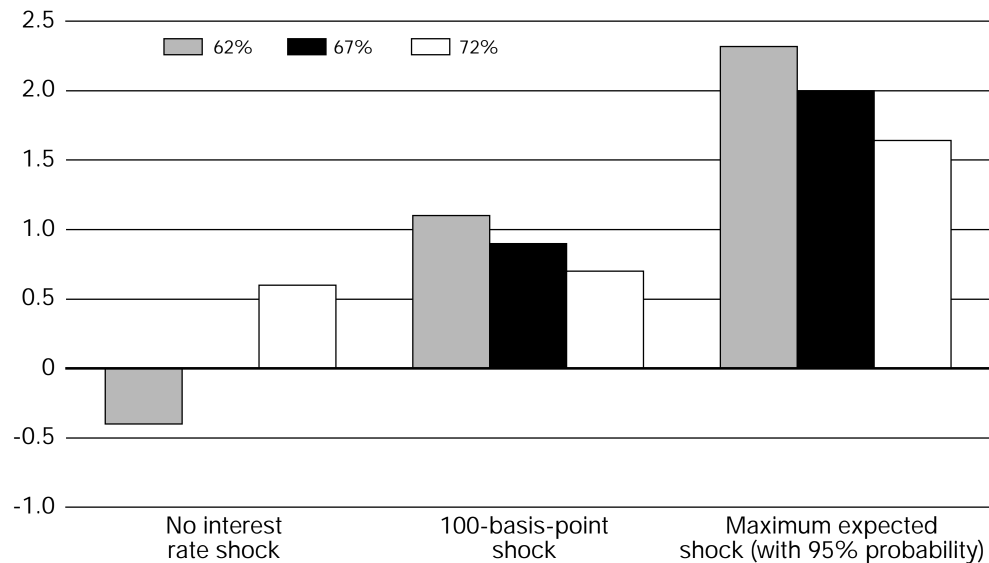
The fixed-rate share of debt affects not only debt costs but also the volatility of debt costs. Cost at Risk (CaR) analysis,[2] which quantifies the debt cost risk under a particular fixed-rate debt structure, suggests that, over a long-term horizon, the costs and risks of alternative debt structures within the range of 62 per cent to 67 per cent are fairly similar. Over time the expected debt cost savings with a lower fixed-rate structure would offset the potential volatility in debt costs due to interest rate risk and offer some prospect for overall lower debt costs.

This result needs to be interpreted with care, however, as the impact of extreme interest rate shocks is not considered in the CaR analysis and remains a factor in the prudent debt structure decision. Under worst-case scenarios of significantly greater interest rate shocks, the impact on debt costs under lower fixed-rate structures could disrupt the fiscal plan.

[2] A more detailed description of the analytical measures used to determine the debt structure target is contained in *Debt Management Report 2000-2001*, which is available on the Department of Finance Web site at www.fin.gc.ca.

A prudent debt structure ensures that the Government's exposure to a variety of interest rate shocks in the short term is confined to tolerance levels in keeping with the current fiscal plan. CaR analysis indicates that the two-thirds fixed-rate structure is highly likely to limit the fiscal impact of unanticipated increases in interest rates to $2 billion or less over the next year (see chart below).

Debt Cost Sensitivity to Interest Rate Shocks
(in billions of dollars)



Note: Values represent the estimated deviation from expected debt costs with a two-thirds fixed-rate structure.
Source: Department of Finance.

With the two-thirds fixed-rate structure, a 100-basis-point increase in interest rates would now raise net debt-servicing costs by $0.9 billion next year; by comparison, the impact of the same interest rate shock was estimated at $1.8 billion in the mid-1990s with a one-half fixed-rate structure.

With the two-thirds debt structure, the Government also limits the need to refinance a large portion of debt in any given period. In 2002-03 the Government is expected to refinance, on average, $4 billion per week in maturing Treasury bills compared to $7 billion per week in the mid-1990s, when the fixed-rate portion of debt was one-half.

Average Term to Maturity

The average term to maturity of the debt has been increasing.

Average term to maturity (ATM), measured in years, represents the average length of time before debt instruments mature and are subject to refinancing risk. The ATM of marketable debt has increased from roughly 4 years in 1990 to 6.4 years in March 2001. The upward trend in ATM resulted from the increase in the fixed-rate share, the reduction in the stock of Treasury bills, and the continued issuance pattern of marketable bonds that includes 30-year bonds (the first 30-year bond issue, sold in 1990, will not mature until 2021).

While the fixed-rate share has remained relatively constant over the past three years, the ATM of the debt is projected to increase to roughly 6.6 years at the end of March 2002 given the current issuance pattern of the Government of Canada bond program.

The costs and operational implications of changing the ATM will be evaluated.

Further analytical work on the composition of the fixed-rate portion of the debt will be done in 2002-03, in particular on the costs and operational implications of changes in the market debt's ATM.

Maintaining a Well-Functioning Market

Maintaining a well-functioning market for Government of Canada securities is a key objective of the debt strategy.

For over a decade federal debt strategy has placed great emphasis on the development of a well-functioning Government of Canada securities market. As a major sovereign country and frequent borrower, the Government must employ regular and transparent programs that sustain a liquid and efficient market. A well-functioning market attracts broad investor interest, which helps to provide stable, low-cost financing over time. A liquid and efficient Government of Canada securities market also provides key pricing and hedging tools for market participants and thereby contributes to the health of the broader fixed-income market.

The Government monitors turnover and bid-offer spreads as key indicators of the status of the market, as well as best practices. In these respects, recent studies indicate that Canada compares favourably with other major sovereigns. However, in the recent environment of limited borrowing requirements and a declining debt stock, developing and testing initiatives to maintain and enhance market liquidity remains a key focus of the Government's debt strategy.

In 2002-03 a number of operational initiatives will be undertaken to enhance liquidity and activity in Government of Canada securities (see the next section for details). Among other things, participation in buybacks will be encouraged by increasing the range of securities involved and the use of a pilot program of buybacks on a switch basis. These adjustments will assist in converting less liquid outstanding securities for new liquid bond benchmarks and help to build target bond benchmarks more quickly.

The market risk borne by auction and buyback participants will be reduced by moving to shorter operational turnaround times. In addition, transparency will be enhanced through regular market consultations on the development of debt policies and programs, with reports on topics of interest and views received posted on the Bank of Canada's Web site at www.bankofcanada.ca.

2002-2003 Debt Strategy Plan

Domestic Debt Programs

No major restructuring of domestic debt programs is planned in 2002-03.

Domestic debt programs are expected to operate at similar levels to those of 2001-02, and no restructuring is planned in 2002-03. In developing the debt program plans below, the Government has conducted extensive consultations with market participants in recent months. A report on these consultations, and others conducted earlier in 2001-02, is available on the Bank of Canada Web site at www.bankofcanada.ca. The Government will continue to consult with market participants during fiscal year 2002-03 on potential adjustments to program plans.

Fixed-Rate Marketable Bond Program

In 2002-03 some $35 billion of bonds will be maturing. Gross bond program issuance in 2002-03 will be about $40 billion, taking into account the issuance of new bonds that are exchanged for existing bonds under the pilot program of buybacks on a switch basis.

Thirty-year bond issuance will continue.

Benchmark bond size targets will remain unchanged.

Consultations have indicated that market participants strongly favour continued issuance of 30-year bonds. From the Government's perspective, these securities play an important role in the stability of the Government's debt portfolio. Accordingly, the domestic bond program will continue to have four benchmark maturities (2-, 5-, 10- and 30-year) with benchmark target sizes unchanged from last year (2-year bonds: $7 billion to $10 billion; 5-year bonds: $9 billion to $12 billion; 10- 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 until the benchmark target range is reached.

A regular, transparent calendar of auctions will be maintained. In 2002-03 the Government will continue to hold quarterly auctions of 2-, 5- and 10-year bonds and semi-annual auctions of 30-year bonds. The Bank of Canada will announce the quarterly auction calendar shortly before the start of each quarter.

Auction and buyback turnaround time will be reduced.

The process time for bond auctions will be reduced as the year progresses to lower market risk for participants. The auction turnaround time is planned to be lowered from 15 minutes to 10 minutes as the year progresses. The process time for bond buyback operations will be reduced from 30 minutes to 15 minutes.

Bond Buyback Program

The objective of the existing bond buyback program is to permit the maintenance of a liquid new bond issue program. The program targets older, less liquid bonds for repurchase. Transactions are conducted in conjunction with auctions of similar maturity bonds.

Pilot bond buybacks on a switch basis will accompany the ongoing buybacks on a cash basis.

In December 2001, following consultations with market participants, the Government announced that it would pilot buyback operations on a switch basis to broaden participation. Buyback operations on a switch basis involve the exchange of existing, less liquid bonds for new-issue bonds on a duration-neutral basis; that is, the bondholder can switch an off-the-run bond for the current benchmark issue with no impact on portfolio structure. The first switch operation was recently held in the 30-year sector.

With the introduction of buybacks on a switch basis, bond buyback volumes will be larger.

The Government intends to conduct both cash and switch buyback operations in 2002-03 on a larger scale than in 2001-02, taking into account the pilot switch program. The target size of the bond buyback programs and the timing of operations will be announced through the quarterly bond auction calendar published by the Bank of Canada.

During consultations the Government sought the views of market participants on adding flexibility to buyback activity, including expanding the bond buyback basket and allowing the Government to buy back a larger amount of bonds should market conditions be favourable.

Bond issues included in buyback operations will include some older benchmark bonds and their fungibles.

In 2002-03 the buyback basket will be expanded to include some older benchmark bonds and their fungibles. Bonds that will continue to be excluded from buybacks include issues in the 2-, 5- and 10-year sectors that are currently being built as a benchmark, the current and preceding benchmark, as well as those having maturities greater than or equal to 25 years. The decision on specific bond issues to be included in buyback operations will take into account the views of market participants and will continue to be announced with the Call for Tender.

The ceiling for individual operations will be increased.

The announced ceiling for individual buyback operations will be raised from 2001-02 levels, and will continue to represent the maximum amount of bonds that the Government would buy back during that operation. The increase in the ceiling will permit the Government to take advantage of favourable buyback opportunities, depending on financial requirements at the time and prevailing price levels. On most occasions it is expected that the amount purchased by the Government will be lower than the announced ceiling.

The auction schedule is available on the Bank of Canada's Web site at www.bankofcanada.ca. A list of outstanding Government of Canada bonds, including maturity dates, can be found in *Debt Management Report 2000-2001*, 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 also be available on the Bank of Canada's Web site.

Real Return Bonds

RRB issuance will continue.

In 2002-03 the federal government plans to issue about $1.4 billion of RRBs through quarterly uniform price auctions.

Retail Debt Program

The retail debt program will focus on balancing cost-effectiveness and innovation.

In 2002-03 the Government will focus on balancing the need to be cost-effective in an environment of declining retail stock with investments in innovation required to maintain a vibrant and creative Retail Debt Program.

Targeted initiatives aimed at broadening access and diversifying the investor base, including on-line access, direct sales and a focus on youth, will be continued and in some cases expanded in the upcoming year. As well, more cost-effective and flexible means of delivering systems and operations support services will be actively pursued.

A separate Retail Debt Plan will not be released in 2002-03 by Canada Investment and Savings, the Government's retail debt agency, but specific initiatives that are developed will be announced at the appropriate time.

Treasury Bill Program

The Treasury bill program is expected to operate at similar levels to last year.

The Treasury bill stock varies over the year largely as a result of changes in the Government's funding and cash needs. Based on funding needs indicated in the 2001 budget, the Treasury bill program is expected to operate at similar levels to 2001-02. The stock of Treasury bills at the end of fiscal year 2002-03 is expected to be in the range of $90 billion to $100 billion.

Bond Buybacks for Cash Management

The pilot cash management bond buyback program will be continued in 2002-03.

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 large bond maturities.

The program currently involves buying back bonds with less than 12 months to maturity. The pilot program will be continued in 2002-03, as operational parameters and effectiveness are assessed and potentially adjusted.

Primary Market Enhancements

Consultations on debt management operations will continue.

Market participants will continue to be consulted on ways of enhancing debt program operations. Through this approach, the Government seeks to maintain a high standard of transparency, to improve operational flexibility and to obtain external input into its decisions on debt management operations. Communications will be conducted through notices and information posted on the Bank of Canada's Web site (www.bankofcanada.ca).

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.

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

The Department of Finance and the Bank of Canada have an ongoing dialogue with the Canadian Securities Administrators and market participants on the regulation of electronic trading and the appropriate framework for the regulation of the domestic fixed-income market.

In this context, the Government supports the enhancement of transparency mechanisms. A current initiative is the proposed use of the CanPx system as the consolidator for information on fixed-income securities trading across various marketplaces. CanPx is a screen-based, real-time information system that provides market participants with best bid and offer prices and trading volumes, conducted on inter-dealer broker screens, in a range of benchmark fixed-income securities.

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 operating and liquidity requirements. Under the current framework the cash balances are placed with participants of the Large Value Transfer System as uncollateralized deposits through a competitive auction process.

The Government is implementing a cash management framework in 2002-03 to reduce credit risk.

The Government has developed a new credit framework for investing the cash balances.[3] The new framework will be implemented in mid-2002-03 and is in line with the best practices of other governments and market participants. The two key modifications to the framework are the introduction of a credit management system, using credit ratings, credit lines and collateral to better manage credit risk, and a broadening of the list of eligible counterparties to encourage more competitive bidding at auctions.

Foreign Debt Programs

Foreign Exchange Debt and Reserve Assets

The Government holds foreign exchange reserves for liquidity and intervention purposes.

The Government's foreign exchange reserve assets, held in the Exchange Fund Account, provide the Government with foreign currency liquidity and may be used for intervention in the foreign exchange markets to promote orderly conditions for the Canadian dollar. Further details on the management of international reserves are available in the *Exchange Fund Account Annual Report,* available on the Department of Finance Web site at www.fin.gc.ca.

The Government's foreign currency reserves are funded through foreign currency borrowings. 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 private sector financial institutions, including prudent risk management principles.

The key objectives of the reserves program are:

- ensure that an appropriate level of reserves is maintained while minimizing the cost of carrying reserves (i.e. the difference between interest earned on reserve assets and interest paid on foreign currency liabilities);
- immunize to the extent possible currency and interest rate risk by selecting reserve assets that match the liabilities in currency and duration; and
- maintain diversified funding sources and a prudent liability structure to help manage refinancing needs.

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[3] A detailed description of the cash management investment framework is contained in *Debt Management Report 2000-2001*, which is available on the Department of Finance Web site at www.fin.gc.ca.

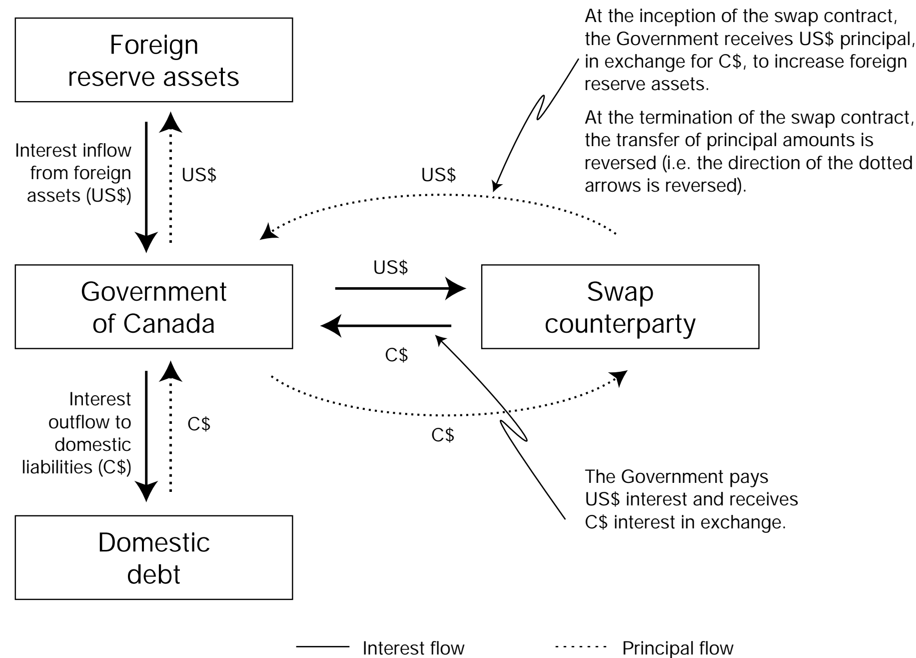
Funding Sources

The Government has access to a wide range of sources to fund its foreign currency assets.

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, which have proven to be a particularly cost-effective alternative, have been actively used in recent years.

Consistent with the Government's policy of immunizing currency and interest rate risk in Canada's reserve program, the Government occasionally purchases US dollars to meet international and other operational requirements and to bring foreign currency liabilities in line with foreign currency assets.

Cross-Currency Swap Contract to Raise Foreign Exchange Reserves



Note: This diagram is only a schematic representation of the currency flows associated with US$ cross-currency swaps.
Source: Department of Finance.

In 2002-03 the precise mix of funding sources will depend on a number of considerations.

In 2002-03 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.

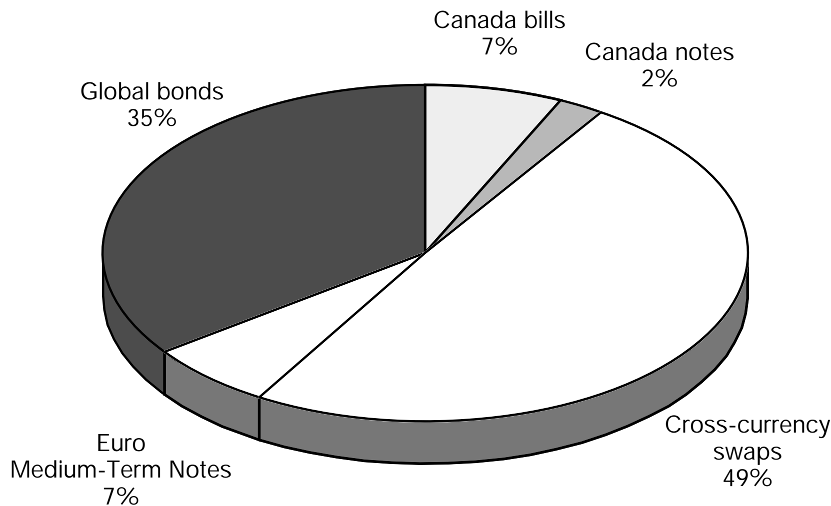
Credit Risk Management

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. The Government's risk management policies call for prudent management of treasury risks based on best practices. Standards for risk tolerance are very prudent, with market risks generally immunized and high credit quality and diversification standards followed.

In 2002-03 the Government will proceed to implement of a collateral management framework to better manage credit risk.

In 2002-03 the Government will be proceeding with the implementation of a collateral management framework to better manage the Government's credit risk to its financial institution counterparties associated with all Exchange Fund Account business, in particular cross-currency swaps and US-dollar short-term cash investments.

Forecast Composition of Foreign Currency Liabilities, March 31, 2002



Source: Department of Finance.

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 (one hundredth of a per cent).

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

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 (CPB): Introduced by the Government of Canada in 1998, CPBs are savings products for individual Canadians. They are offered for sale by most Canadian financial institutions and offer a higher interest rate compared to CSBs. They are redeemable once a year on the anniversary of the issue date or during the 30 days thereafter without penalty.

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

CanPx: A screen-based, real-time information system that provides market participants with best bid and offer prices and trading volumes in a range of benchmark fixed-income securities.

Contingency Reserve: Funds set aside in the fiscal projections to cushion against changes in the economy. When these reserves are not otherwise used they are applied to the federal 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 to provide foreign currency liquidity and promote orderly conditions for the Canadian dollar in the foreign exchange market.

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

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

fixed-rate marketable bond: Market debt instrument issued by the Government of Canada and sold via public tender. These issues have a specific maturity date and a specified interest rate. All Canadian-dollar 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.

government securities distributor (GSD): GSDs are members 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 both market debt and internal debt owed mainly to the superannuation fund 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: 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 debt: For debt management purposes, market debt is defined as the portion of debt that is funded in the public markets. It 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.

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

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

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

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.

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

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.