Debt Strategy Consultations – 2008/09

Overview

The Department of Finance and the Bank of Canada are seeking the views of government securities distributors, institutional investors, and other interested parties on issues relating to the design and operation of the domestic Government of Canada debt program for the fiscal year 2008/09 and beyond. The government considers these consultations to be an integral part of the debt-management process. Views are also sought on the functioning and liquidity of the Government of Canada domestic debt and related fixed-income markets over the past few months in light of market events since August.

As the sovereign and the largest issuer of Canadian fixed-income securities, the government seeks to maintain a well-functioning government securities market. A liquid, efficient, and transparent government securities market contributes to keeping the government's borrowing costs low and provides important pricing and hedging tools for market participants.

A summary of the comments received will be released on the Bank of Canada website concurrently with the release of the 2008/09 *Debt Management Strategy*.

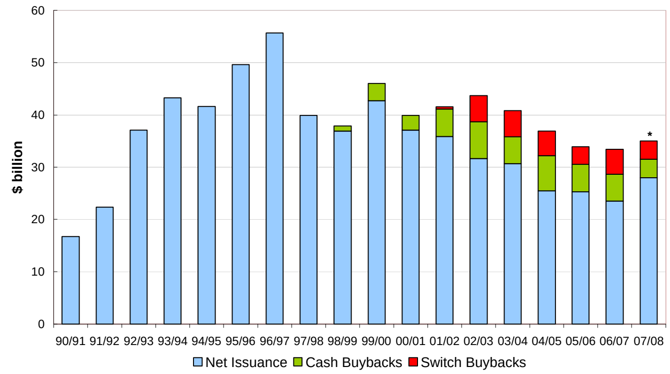
Background

The government's fiscal position has improved substantially since the current medium-term debt target, of reducing the fixed-rate share of the debt from two-thirds to 60 per cent, was set in 2003. Since 2002/03, the federal market debt, composed of marketable bonds, treasury bills, retail debt, foreign currency debt, and Canada Pension Plan (CPP) bonds, has been reduced by $20 billion to $419 billion, and is down $58 billion from its peak in 1996/97. In 2006/07, the market debt paydown was $8 billion, reflecting the government's continued strong fiscal position. To date in 2007/08, the government's fiscal position has been better than had been foreseen at the time of the 2007 *Budget*. Stronger than expected revenue flows have meant that the issuance of treasury bills has been considerably lower than would otherwise have been the case. As a result, progress on reducing the fixed-rate share of the debt has been slower than the plan referenced in the 2007/08 *Debt Management Strategy*.

In seeking to maintain bond issuance across the yield curve, and to support the bond benchmark securities, the government has implemented several key measures over the past five years, including the use of the bond buyback program and the adoption of fungible benchmarks. These measures have thus far been effective in helping to maintain issuance and liquidity in all four bond maturities. However, depending on the evolution of the government's fiscal position, the impact of Crown consolidation, and corresponding decisions on the debt strategy target, structural changes to the bond program may be required in the foreseeable future.

The projected gross Government of Canada domestic bond issuance for 2007/08 is $35 billion, slightly higher than the $33 billion issued in the last fiscal year, but down from its 1996/97 peak of $56 billion. Net of buybacks, bond issuance is expected to be about $28 billion in fiscal 2007/08 (see Figure 1).

Figure 1: Annual Marketable Bond Issuance



*Projected issuance for Fiscal year 2007/08.

The total amount of bonds outstanding at the end of fiscal year 2006/07 was $257 billion, $37 billion less than the peak reached at the end of 1998/99.

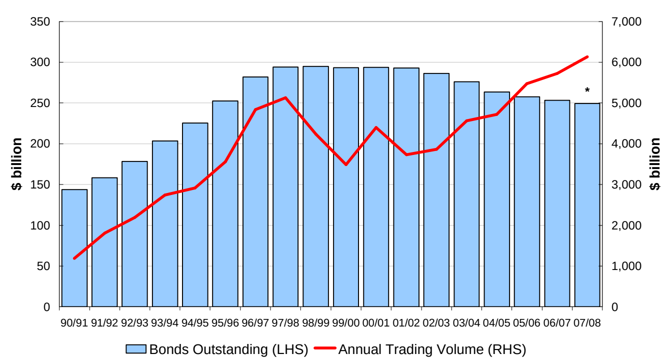
Although gross issuance levels have been relatively stable over the past two years, the allocation of issuance between the various maturity sectors has been adjusted slightly. Increased use of fungibility has allowed proportionately less gross bond issuance in short- to medium-term sectors, in favour of longer-term bonds. This sectoral reallocation has been absorbed without any apparent impact on the cost-effectiveness of the Government's debt program.

As outlined in previous *Debt Management Strategy* documents, the government's plan is to reduce the size of the bond buyback program, given the increased concentration and lower number of outstanding old benchmark bonds. While the pace of the reduction of the bond buyback program will be influenced by a number of factors, including market conditions and fiscal trends, a decline in the volume of buybacks continues to be assumed.

Beginning in 2008, the consolidation of the domestic borrowings of the Business Development Bank of Canada, Farm Credit Canada, and the non-CMB issuance of the Canada Mortgage and Housing Corporation is expected to result in additional Government of Canada bond issuance, although it is still too early to make assumptions as to precisely how the Crowns will structure the terms of their borrowings in 2008/09.

Overall, the Government of Canada bond market appears to be functioning well. Trading volumes in Government of Canada bonds continue to rise, and turnover has reached record levels (see Figure 2). According to comments received in prior consultations, bid-offer spreads have declined, and liquidity has remained ample in benchmark securities. Derivative activity linked to Government of Canada securities shows a similar increase in trading patterns. The trading volume in the 10-year Government of

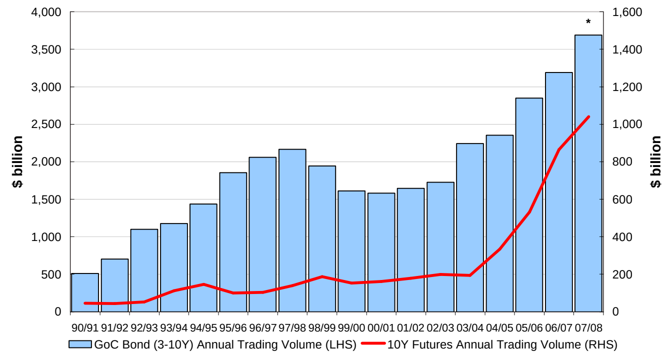
Figure 2: Government of Canada Bond Annual Trading Volume and Outstanding Stock



*Fiscal year 2007/08 bonds outstanding as of September 2007.
Trading volume annualized based on data for April - June 2007.

Canada bond future is now approaching that of the underlying benchmark bond (see Figure 3).

Figure 3: 10-Year Government of Canada Bond Future (CGB) versus Government of Canada Bond (3- to 10-Year) Annual Trading Volumes



*Trading volume annualized based on data for April - June 2007.
Bond Future Data Source: Montreal Exchange

Treasury bill trading volumes have stabilized at moderate levels. According to market participants, treasury bills are being increasingly used for collateral-management purposes and/or purchased by buy-and-hold accounts. Treasury bill auctions continue to function well, with good investor participation.

Issues for Discussion

Against this background, this year's debt strategy consultations are primarily focused on measures that could be taken to allow the government to pursue its strategic debt-management objectives, in a declining debt environment, while promoting the efficient functioning of the domestic market for government securities. The government is also interested in the views of market participants on the functioning of the Canadian government securities markets over the recent period of increased market volatility.

Current Market Conditions

Since the beginning of August, money and fixed-income markets internationally have, to varying degrees, been experiencing increased volatility and liquidity pressures, and at times this has led to increased demand for government securities. Trading volumes, especially in the money market, have declined recently, and according to market participants, there has been a reduction in the availability of very short-dated treasury bills in the secondary market. In light of these conditions:

1. What are your views regarding the liquidity and functioning of Government of Canada securities and related fixed-income markets, across the various maturity sectors?
2. Do you have any comments on whether recent market events have had an impact on the effectiveness of the government's auction process over this period?
3. How did these events affect electronic trading?

Bond Program

The government continues to seek ways in which issuance can be best allocated, given its overall debt-management objectives and the projected continuing decline in its funding needs. Therefore, please comment on the following aspects of the bond program:

4. What would be the impact of reducing the 2-year bond to just one 2-year benchmark per year? If only one 2-year benchmark was issued, should it be non-fungible, i.e., with a 1 December maturity date, or be fungible, i.e., with a 1 June maturity date?
5. The maturity date of the 5-year bond was changed to 1 June in 2006/07. How has this change been received? What would be the impact if the number of auctions per fiscal year were reduced from three to two, with the corresponding reduction in the issuance amount, given the fungibility of new 5-year benchmarks with previously issued large bond maturities?
6. The trading volume of the 10-year bond future has increased significantly in recent years and is now approaching that of the underlying government security. How has this affected the functioning of the 10-year bond sector?
7. The government announced in the 2007/08 *Debt Management Strategy* an approximate $1 billion increase in the allocation to long-term bonds. How has this increase been received and what is the current demand for long-term bonds, both nominal and Real Return?
8. Crown corporations whose borrowings will be consolidated into the Government of Canada's debt program will retain discretion with respect to the amount and term structure of their borrowings, and will provide the government with their borrowing intentions on a quarterly basis. In this context, it is possible that bond issuance related to the borrowing needs of the consolidated Crowns could vary from the plan announced in the annual *Debt Management Strategy*. What would be the impact of changing the announced debt strategy plan for the bond program during the year?
9. For the future, what other factors should the government consider when assessing possible changes to the bond program?

Bond Buybacks

The gradual move towards a common 1 June maturity date will lead to an increased concentration of maturities, which will automatically reduce the potential size of the buyback program. A reduction in the buyback program will, all other things being equal, lead to a reduction in gross bond issuance.

10. How important for market participants is the buyback program as currently designed? Are there any modifications that could improve the design or effectiveness of the program?

The government would like to solicit comments on the following potential changes to the structure of the buyback program:

11. The current lower bound for the 2-year bond buyback basket is 18 months. Would you have concerns about reducing this to 12 months?
12. Would adding a bond fungible with a new benchmark to the basket of eligible bonds for switch operations help facilitate the increase in the size of the benchmark issue?

Short-Term Program

Cash-management bills have been an effective tool to increase the flexibility of the government's cash-management operations. However, with the upcoming Crown consolidation, there could be advantages to introducing additional funding instruments, such as a 1-month treasury bill, in addition to the current 3-, 6-, and 12-month auction tranches.

13. If a 1-month bill was introduced:
    - What impediments, if any, are there to having it issued on alternative weeks to the current treasury bill auctions?
    - What would be the appropriate tranche allocation between the 1-, 3-, 6-, and 12-month treasury bills? What would be the implications of adjusting these proportions from time to time?

Adjustments to the Bond Auction Schedule

The government's use of the fungible 1 June benchmark maturity date has increased cash-management requirements ahead of this date for both coupon and bond redemption payments. In order to alleviate these periodic cash-requirement peaks, the government is considering rebalancing the bond issuance schedule so that a larger proportion of the issuance occurs in the first and third fiscal quarters. In this regard, market participants' views are sought on the proposed changes to the bond auction schedule:

14. The 30-year bond has been auctioned semi-annually in the second and fourth fiscal quarters (July and January) since 2002. However, to help address the cash-management issues discussed above, the government is considering changing the 30-year auction cycle to the first and third fiscal quarters. This change could be achieved either by having two quarterly back-to-back auctions or by skipping one quarterly auction. What are your comments on this potential change?
15. Is the regularity of the sequence of the various maturities in the auction schedule from quarter to quarter, and/or year to year important? What would be the implications of varying this sequence between quarters to address sectoral bond demand or cash-management considerations?
16. What are your views on the optimal timing for bond auctions? Would there be any advantages in moving bond auctions to earlier in the day? If so what time would you recommend?