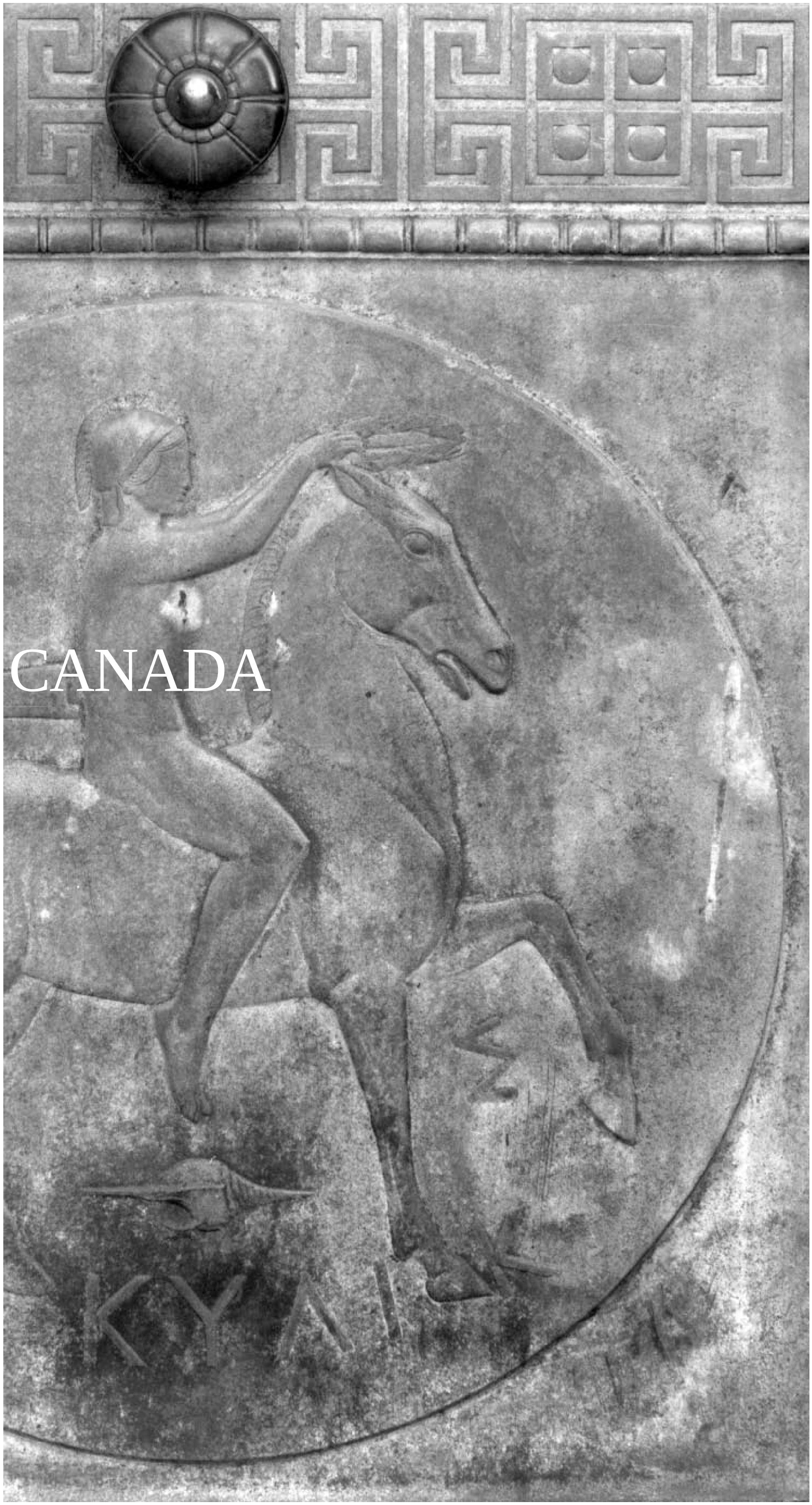
BANK OF CANADA



Annual Report
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HIGHLIGHTS 1996

- In 1996 inflation remained within the Bank's target range but was subject to downward pressure. The low rate of inflation contributed to a major easing in monetary conditions, and interest rates reached their lowest level in 30 years.

- Further steps were taken to enhance the openness and transparency of monetary policy:

  - A new method of setting the Bank Rate was established to provide a clearer signal to Canadians of changes in the Bank's monetary policy stance.

  - Press releases were issued explaining each change in the Bank Rate.

  - Plans for the expansion of the Bank's regional presence were initiated.

- Parliament passed legislation giving the Bank formal responsibility for overseeing Canada's key clearing and settlement systems.

- Following a review carried out in collaboration with financial institutions, a new approach to the distribution of bank notes was introduced.

- The $2 coin replaced the $2 note, resulting in a $7 million annual saving in bank note production costs.

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Bank of Canada • Banque du Canada

Gordon G. Thiessen
Governor - Gouverneur

Ottawa K1A 0G9

24 February 1997

The Honourable Paul Martin, PC, MP
Minister of Finance
Ottawa

Dear Mr. Martin,

In accordance with the provisions of the Bank of Canada Act, I am submitting the Bank of Canada's *Annual Report* for the year 1996 and the Bank's audited financial statements as at 31 December 1996.

Yours sincerely,

Annual report of the Governor to the Minister of Finance and financial statements for the year 1996

Cover: Calabria, Tarentum, gold stater, 380-345 BC

One of six cast bronze panels embellishing the main door of the Bank's Ottawa headquarters. Each panel portrays an ancient Greek coin.

Photo: James Zagon

Our Commitment to Canadians

To contribute to the economic well-being of Canadians by

- conducting monetary policy in a way that fosters confidence in the value of money
- promoting the safety and soundness of Canada's financial system
- supplying bank notes that are readily accepted without concerns about counterfeiting

To provide efficient and effective central banking and debt-management services

To communicate our objectives openly and effectively and to be accountable for our actions

Statement from the Governor

Gordon Thiessen

The Bank of Canada has been reviewing its operations during the past few years, like many other public institutions, and has been taking steps to fulfil its responsibilities more effectively and at a lower cost.

Part of that process was to set out a clear statement of objectives—a set of commitments to Canadians, shown on the opposite page.

As Canada's monetary authority, our primary commitment is to contribute to the economic well-being of Canadians by ensuring that money can do its job properly.

"As Canada's monetary authority, our primary commitment is to contribute to the economic well-being of Canadians by ensuring that money can do its job properly."

Money is important in a sophisticated economy. It is the standard in which goods and services are priced and the means by which we buy and sell them. It allows us to accumulate savings over time and to lend those savings to someone else. Money enables us to make contracts in many areas—undertaking to do something now for payment in the future.

If money is to perform these functions satisfactorily, and thereby encourage an economic climate favourable to sustained growth and job creation, its value must be stable. Our commitment is to fostering confidence in the value of money by resisting general price rises; in other words, we want to prevent the value of money from being undermined by inflation.

The various instruments used as money and the institutions and markets that assist Canadians in borrowing, saving, and investing are all part of Canada's financial system. The Bank is committed to promoting the safety and soundness of the financial system so that Canadians can be confident about using it.

The form of money used most frequently to carry out small, daily transactions is an exclusive Bank of Canada product: bank notes. We are committed to supplying bank notes that Canadians can use readily without concern about counterfeiting.

The Bank also provides certain financial services to the federal government, to financial institutions, and to the general public. Like any other good service-provider, the Bank is committed to furnishing these services efficiently and in a manner that is responsive to the needs of our clients.

"The Bank has also expanded its regional outreach program to bring senior officers and members of the Bank's Board of Directors into contact with Canadians across the country."

As a public institution, it is important that the Bank provide information on the measures taken to fulfil the commitments we have made and on the results we have achieved. Important steps were taken in 1996 to make our actions more transparent and thus make the Bank more accountable. Each change in the Bank Rate is now explained in a press release. The Bank has also expanded its regional outreach program to bring senior officers and members of the Bank's Board of Directors into contact with Canadians across the country.

The Economy: Review and Outlook

The Canadian economy continues to undergo a major transformation. That transformation has been a response to the rapid evolution of technology in recent years, increasingly open and competitive world markets, the decline of inflation in Canada from high levels, and the need to reverse an unsustainable trend of debt accumulation in this country, particularly by the federal and provincial governments.

Profound changes were required, and a great deal has been accomplished over the last few years. Canada now has a much more productive and competitive economy. Inflation is low and the country is on a path to a less vulnerable debt position.

While this transformation was absolutely necessary, it has disrupted the lives of Canadians and has left many anxious about their futures. Corporate and public sector cutbacks were bound to lead to some temporary increases in overall unemployment. However, the expected recovery in employment has proceeded more slowly than had been hoped. The magnitude of the adjustments taking place in Canada has diminished consumer confidence and thus has held back the expansion in economic activity.

These difficult circumstances have led to some rather gloomy views about Canada's economic future. In fact, there are grounds for a good deal of optimism. The major changes that our economy and finances have undergone have placed Canada in a much sounder position than I have seen for some time. I include in these improvements the Bank's success in holding inflation within our target range. Our commitment to keeping inflation low, together with this improved economic and financial situation, has permitted a marked decline in interest rates over the past year. Not only are most interest rates at their lowest levels since the 1960s, but they are also below U.S. rates by the widest margins seen since the early 1970s.

Because of these lower rates, monetary conditions in Canada are now much easier than they were a year ago. This has recently begun to counteract the restraint on spending in the economy coming from private and public sector restructuring and the associated decline in consumer confidence. Moreover, as monetary easing takes time to have its full impact on the economy, we should expect to see increasing signs of its effects through 1997. With the positive underlying trends in our economy, it is only a matter of time before we see a sustained improvement in economic performance.

I do not mean to imply that all the economic adjustments I have just described are behind us. Clearly they are not. But I believe we are at a stage where the positive impact of this transformation is being felt and will outweigh the disruptions and the uncertainty.

There is no doubt in my mind that the single most important contribution that the Bank of Canada can make to sustain these positive trends is our commitment to fostering confidence in the value of money. That way, money will be a source of stability and certainty for Canadians in their everyday transactions and in their planning for the future.

"Our aim is to ensure that the Bank is well informed about economic developments across Canada and that Canadians can readily obtain information and have their views on monetary policy heard."

Managing the Bank

I would like to make particular mention here of the results of the activity review that the Bank has carried out over the past two years.

The review covered all areas of the Bank but focussed particularly on those core activities that had not been thoroughly assessed for some time. The review led to a number of changes: a greater concentration on basic central banking business, the shedding of some peripheral activities, a stronger focus on client requirements, and a general improvement in the overall efficiency and effectiveness of the Bank's operations. When all the changes are fully in place in 1998, the activity review is expected to have resulted in savings amounting to 20 per cent of operating expenses.

This major review of the Bank's core activities is now largely complete; however, all of the Bank's activities will be regularly re-examined on at least a five-year cycle.

One of the main results of the review is a change in the roles and responsibilities of our staff. More emphasis is being placed on delegation of responsibilities. This has required a new approach to management and a much greater reliance on the knowledge and analytical abilities of our staff. Many employees have been working hard to improve their existing skills and to acquire new ones.

In responding to the challenge of change, the Bank's staff have shown competence, creativity, and commitment in the face of difficult circumstances. I would like to thank them for that contribution.

Keeping in Touch with Canadians

The Bank of Canada is a national institution, and its business is national in scope.

In the conduct of monetary policy, this means that the Bank needs to be well informed about the regional developments that make up the national economic picture. For many years, the Bank has had representatives in Montreal, Toronto, and Vancouver who have been engaged in economic and financial market liaison. In recent years, the activities of these representatives have been increasingly supplemented by regular visits across the country from the members of the Bank's Governing Council and from head office staff participating in our regular industrial and provincial government liaison program.

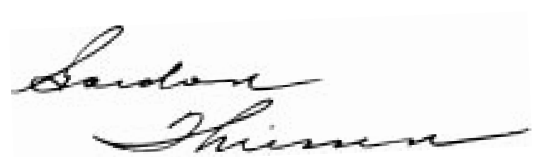
PHOTO: TREVOR SUTTON, LEADER-POST, REGINA

Governor Thiessen with students in Fort Qu'Appelle, Saskatchewan

To enhance the Bank's regional economic liaison and analysis, new representative offices are being established in Calgary and Halifax, and our regional staff is being expanded in Montreal, Toronto, and Vancouver. These regional representatives will work closely with the members of the Bank's Board of Directors, who come from every province. Our aim is to ensure that the Bank is well informed about economic developments across Canada and that Canadians can readily obtain information and have their views on monetary policy heard.

Staff in these regional offices will also be actively engaged in communicating other aspects of the Bank's activities, including a program to increase the awareness among Canadians of the anti-counterfeiting features of bank notes. At the same time, steps are being taken in each region to deliver the Bank's bank note, bond, and banking services (activities profoundly affected by new technologies) more cost-effectively by contracting out some services and consolidating others. This will involve closing down some of our traditional operations. Our new regional offices will oversee and monitor ongoing responsibilities for these activities in co-operation with our private sector partners.

These regional offices will improve communication between the Bank and Canadians across the country—another step in our ongoing effort to make the Bank more open and accessible.



The Bank at a Glance

What the Bank Does

The Bank of Canada's primary responsibilities, as set out in the Bank of Canada Act, can be grouped into four broad areas.

Monetary policy

The Bank's most important responsibility is monetary policy. Monetary policy is concerned with managing the rate of monetary expansion in a way that is consistent with preserving the value of money.

Central banking services

The Bank carries out a variety of activities that support and oversee Canada's principal systems for clearing and settling payments and other financial transactions. The Bank also provides a number of central banking services to the federal government, financial institutions, and the general public.

Bank notes

The Bank is responsible for issuing bank notes in Canada—undoubtedly our best-known product. This involves note design (including anti-counterfeiting features) as well as the printing and distribution of bank notes and their eventual replacement.

Debt-management services

As fiscal agent, the Bank advises the government on matters relating to the public debt and is responsible for issuing debt, maintaining bondholder records, and making payments on behalf of the government for interest and debt redemption.

International activities

Bank staff are also active on the international front. These activities help us to meet our domestic responsibilities more effectively and to bring a Canadian perspective to international economic and financial discussions.

The Bank participates in regular meetings and conferences of major international organizations, where the emphasis is on sharing and gathering information to assist in domestic policy deliberations. The Bank also provides technical assistance to developing countries and helps strengthen international financial markets through the development and implementation of sound supervisory and regulatory practices.

In 1996 Bank staff contributed to several important studies on international financial matters. These included studies on sovereign liquidity crises, the design of a new International Monetary Fund borrowing arrangement, and electronic money (see page 29).

How the Bank Works

The Bank's responsibilities are carried out by a highly professional staff of about 1,600. Staff are organized into eleven departments—six directly involved in the Bank's four main areas of activity, four corporate service departments, and an internal audit department. During 1996 the corporate service departments were restructured as part of the Bank's overall initiative to increase efficiency, to become a more open institution, and to further the delegation of responsibilities.

Department chiefs are responsible for operations and service delivery in their own areas; each chief reports to one of the Bank's four deputy governors or to the Senior Deputy Governor.

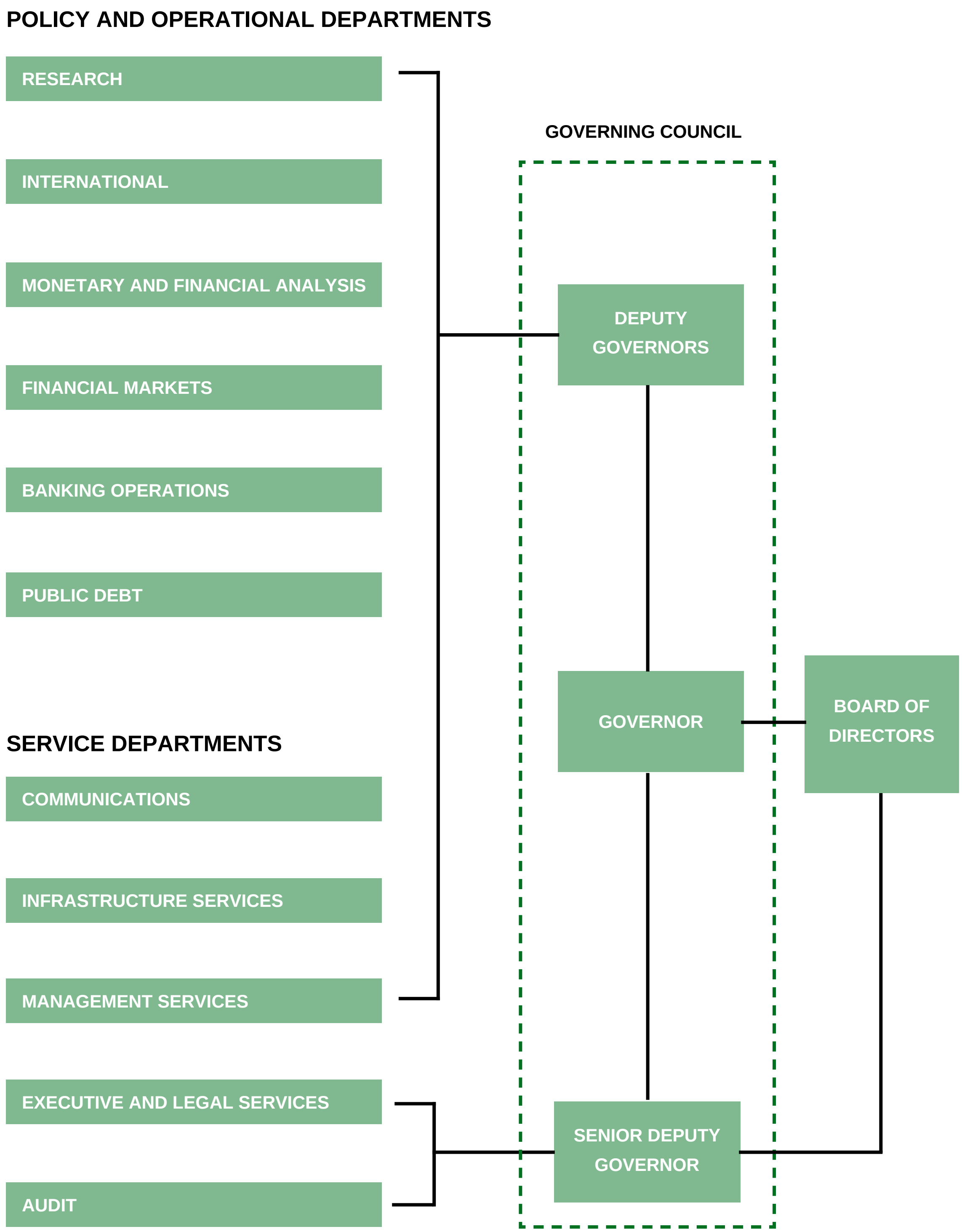
The Governing Council, which consists of the Governor, Senior Deputy Governor, and the four deputy governors, takes collective responsibility for the Bank's affairs. These responsibilities include dealing with broad organizational and strategic issues, as well as the formulation and implementation of monetary policy.

The Governing Council and department chiefs meet as a group to prepare the Bank's medium-term plan and annual budget for approval by the Board of Directors.

PHOTO: ANDREW BALFOUR

Members of the Governing Council, L-R, front: Gordon Thiessen, Sheryl Kennedy; second row: Bernard Bonin, Tim Noël, Paul Jenkins, Charles Freedman

ORGANIZATION CHART



The Board of Directors

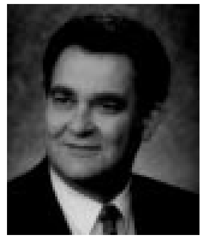
The Bank is under the management of a Board of Directors.

The Board is composed of 12 directors from outside the Bank plus the Governor and the Senior Deputy Governor. The Deputy Minister of Finance sits on the Board as a non-voting member.

The directors' diverse backgrounds contribute to the effective operation of the Board. In addition, directors come from across Canada, thereby providing an important link between the Bank and all regions of the country. Directors are appointed for three-year terms by the Minister of Finance (subject to approval by order-in-council) and may be reappointed at the end of their terms.

The Board is responsible for the internal management and administration of the Bank, including the broad corporate policies for human resources and financial affairs. The Board takes a general interest in all aspects of the Bank's operations and provides oversight and advice.

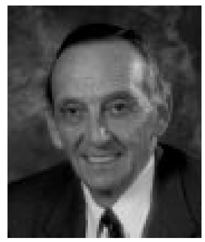
The Board appoints the Governor and Senior Deputy Governor (subject to approval by order-in-council) as well as the deputy governors, and reviews senior management succession planning. The Board helps to chart the strategic direction of the Bank and to set objectives and initiatives.



Winston Baker
St. John's, Newfoundland

Walter Dubowec, FCA
Winnipeg, Manitoba

Raymond Garneau
Westmount, Quebec



James S. Hinds, QC
Sudbury, Ontario

Aldéa Landry, QC
Moncton, New Brunswick

Harold H. MacKay, QC
Regina, Saskatchewan

Paul Massicotte *
St-Laurent, Quebec

Judith Maxwell *
Ottawa, Ontario
Lead Director

James S. Palmer, QC *
Calgary, Alberta

Joseph Segal
Vancouver,
British Columbia

Barbara Stevenson, QC *
Charlottetown,
Prince Edward Island

David A. Dodge **
Deputy Minister of Finance
(Ex officio)

* Member of the Executive and Corporate Governance Committees
** Member of the Executive Committee

One position was vacant on 31 December 1996.

Senior Deputy Governor Bernard Bonin and Director Raymond Garneau at a luncheon meeting with the Chicoutimi, Quebec, Chamber of Commerce

The Board of Directors meets at least seven times a year. One meeting is usually held outside Ottawa. Between Board meetings, the directors are involved in Bank operations through a series of committees.

The Executive Committee, composed of the Governor, Senior Deputy Governor, four directors, and the Deputy Minister of Finance, typically meets between Board meetings. In 1996 a Corporate Governance Committee was created to review the role of the Board, its committees, and the methods and processes by which the Board fulfils its duties and responsibilities. The chairperson of this committee is also the Lead Director of the Board. Other committees of the Board, which meet according to the requirements of their subject areas, are the Planning and Budget Committee, the Audit Committee, the Human Resources and Compensation Committee, and the Premises Committee.

An Account of Our Stewardship

Monetary Policy

"Low inflation, sounder public sector finances, and a healthier balance of payments have led to a significant drop in domestic interest rates."

The goal of monetary policy is to preserve the value of money. Stability in the value of money promotes economic prosperity by providing a framework in which households and businesses can make sound economic decisions. In a joint statement reaffirming this goal in December 1993, the federal government and the Bank of Canada announced their objective of keeping inflation within a target range of 1 to 3 per cent for the period 1995 to 1998. A decision will be reached by the end of 1998 on a future target range that is consistent with price stability.

The adoption of inflation-control targets represents a key element of the Bank's commitment to reducing uncertainty about monetary policy. These targets help clarify the objective of policy and make it easier for financial market participants and the public at large to understand and assess monetary policy actions. The better those actions are understood, the more effective they will be.

While monetary policy has a determining influence on the course of inflation, its impact is indirect and is felt only over time. Monetary policy must therefore be forward-looking.

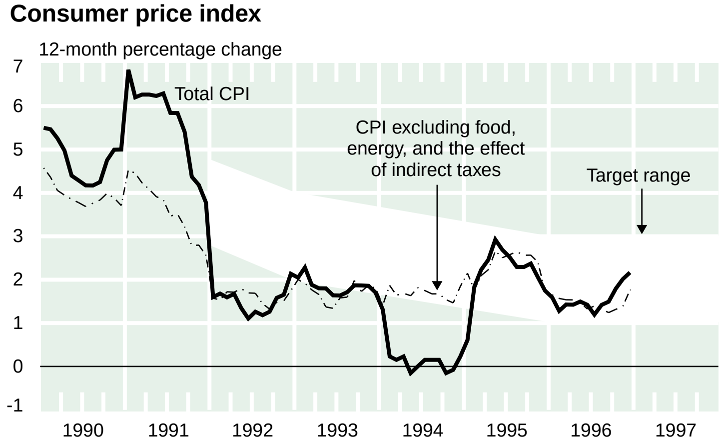
Year in review

In 1996 inflation remained within the target range. The total consumer price index (CPI) rose by 2.2 per cent during the year, and core CPI, which excludes volatile components like food and energy prices and changes in indirect taxation, increased by 1.8 per cent.

Low inflation, sounder public sector finances, and a healthier balance of payments have led to a significant drop in domestic interest rates. Most rates have fallen to their lowest levels since the early 1960s. They dropped below their U.S. counterparts for all maturities under 10 years. These developments reflect a much higher level of confidence in the value of our money on the part of both Canadian and foreign investors.

The Bank has taken further measures to enhance the effectiveness and transparency of its operations. Since February 1996, the Bank Rate has been set at the upper limit of the operating band for the overnight interest rate, the rate over which the Bank has the most direct influence. Whenever the Bank Rate and the operating band are changed, the Bank now issues a press release to inform the public and to explain the reasons for its action.

Consumer price index



In addition, the *Monetary Policy Report*, published in May and November, has offered an increasingly detailed assessment of the economic outlook. After each issue is released, senior Bank officials appear before the Finance Committee of the House of Commons to discuss the *Report*. They also offer briefing sessions in various regions of the country and in major international financial centres.

In November the Bank hosted a conference on the exchange rate and monetary policy. The proceedings of this conference will be published in 1997.

The Bank continued to emphasize its outreach program, under which members of the Board of Directors and senior Bank officials meet with groups of Canadians in all parts of the country. The Bank is also taking steps to strengthen its contacts with various sectors of the economy, associations, government officials, economists, and educational institutions across Canada. In 1997 the Bank's new offices in Halifax and Calgary will be opened, and the staff of economists in Vancouver, Toronto, and Montreal will be expanded.

At the international level, Bank representatives participated in regular meetings of the major economic and financial organizations, sharing and gathering information to contribute to domestic deliberations on economic policy issues. In November an order-in-council named the Governor of the Bank of Canada as the Minister of Finance's alternate on the Board of Governors of the International Monetary Fund.

The formulation of monetary policy relies heavily on analysis and research. The work of Bank staff in these areas is frequently published or presented at conferences. In 1996 the Bank's publications included a collection of articles dealing with the transmission of monetary policy in Canada (Bank of Canada 1996), as well as two technical reports describing the model used by Bank analysts for their economic projections.

PHOTO: ANDREW BALFOUR

A panel of senior officials with members of the media at a quarterly briefing session

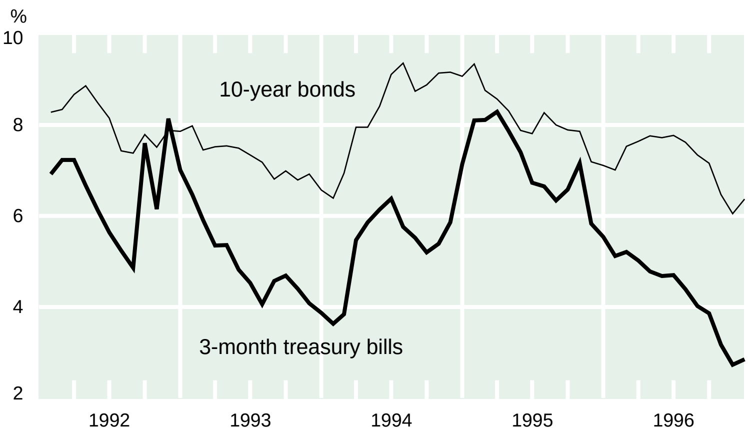
The Bank pays close attention to feedback from other economists and to research under way in the private sector, in universities, and at other central banks. To promote the exchange of information and ideas, it hosts a yearly conference on monetary policy issues. The proceedings of these bilingual conferences are published in both official languages. The theme of the 1996 conference was the exchange rate and monetary policy. Topics included the credibility of monetary policy, the effectiveness of exchange market intervention, the role of market speculation, and the relative merits of various exchange rate regimes. The 1997 conference will focus on price stability, inflation targets, and monetary policy. It will provide an opportunity to

The Bank of Canada and interest rates

The Bank of Canada's operations have an important influence on very short-term interest rates in Canada, and the Bank has established a target band for the overnight rate of interest. However, the direct influence of the Bank's actions diminishes as terms lengthen.

Interest rates at all terms depend on the supply of and demand for funds. From the lender's perspective, interest rates must provide an acceptable return in comparison with other investments. Thus changes in foreign interest rates, particularly U.S. rates, also exert a major influence over Canadian interest rates. Other key factors include the difference between the inflation rate in Canada and in other countries, prevailing economic conditions at home and abroad, and premiums for risk and liquidity.

Canadian interest rates



The Bank of Canada's influence over interest rates for all terms thus derives more fundamentally from the effect of its actions on inflation expectations.

When inflation is lower in Canada than elsewhere, the Canadian dollar can be expected to appreciate without undermining the country's competitive position. The prospect of an appreciation increases the attractiveness of Canadian dollar investments and reduces the interest rate acceptable to investors. Higher inflation, on the other hand, raises the prospect of a depreciating dollar and leads to higher interest rates.

The pronounced drop in medium- and long-term interest rates that occurred in Canada in 1996 primarily reflected a reduction in the risk premiums demanded by investors, in light of the significant improvement in public finances and in Canada's current account.

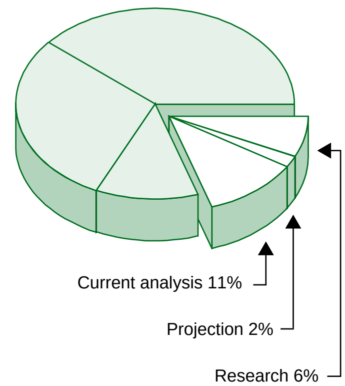
With lower risk premiums and Canada's low inflation, short-term interest rates have fallen to levels that have not been seen for many years.

examine these important issues in depth before a new inflation-control target range consistent with price stability is chosen by the end of 1998.

Operating expenses

The Bank spent $35 million, or approximately 19 per cent of its total operating expenditures, on monetary policy formulation in 1996. There was a further streamlining of operations during the year and a relative shift in resources towards research. Savings helped to offset the increased costs resulting from new investments in computer systems and equipment, including the replacement of the Bank's system for accessing external market information (necessitated by technological change), the integration of its internal information systems, and the upgrading of the computer platform used for analysis and research in support of monetary policy.

Operating expenses related to monetary policy formulation



Central Banking Services

The central banking services provided by the Bank include a wide range of policy, regulatory, and operational activities. These activities support the implementation of monetary policy and contribute to the safety and soundness of Canada's financial system. The Bank also provides services to various clients, including the federal government, financial institutions, and the general public. In carrying out these activities, the Bank is committed to being open about its market operations and to meeting the needs of its clients as efficiently and effectively as possible.

Year in review

The Bank has worked closely with the government to streamline its banking arrangements in anticipation of LVTS implementation.

Bank of Canada market operations

In implementing monetary policy, the Bank carries out transactions in the financial market. In recent years, these transactions have focussed largely on the overnight (one-day) interest rate. The Bank offers one-day resale or repurchase transactions to the market to keep the overnight rate within its operating band of 1/2 of a percentage point. These transactions were offered on 29 occasions in 1996 to keep the rate from rising above the band and 15 times to keep the rate from falling under the lower limit of the band. When the band for the overnight rate and the Bank Rate (which is set at the upper limit of the band) were reduced, the Bank offered one-day transactions at a rate that signalled the change to the market.

With the Bank Rate no longer tied to the interest rate on 3-month treasury bills, there is less reason for the Bank to operate in the treasury bill market and, consequently, less need for the Bank to hold these bills. As a result, the Bank initiated a change in the mix of its assets during 1996. Its holdings of treasury bills were reduced, and those of government bonds were increased, moving the mix closer to that of the government's outstanding debt. This allowed more treasury bills to move into the market to help it adjust to a smaller supply, as overall government borrowing was reduced and the government continued to lengthen the maturity of its debt.

Promoting the safety and soundness of the Canadian financial system

While operating virtually undetected, systems that clear and settle large-value payments and financial transactions involving securities and foreign exchange are crucial to an efficient and well-functioning economy. The increasing values and volumes of transactions flowing through these complex systems raise concerns about possible risks. The Bank is particularly concerned about systemic risk—the potential for problems that affect one participant in a clearing and settlement system to spread to other participants or throughout the financial system. The Bank is working closely with both private and public sector entities to address these

The Payment Clearing and Settlement Act, 1996

The Payment Clearing and Settlement Act gives the Bank of Canada formal and explicit responsibility for the regulatory oversight of major clearing and settlement systems. Specifically, the Bank will review all eligible systems and identify their potential to cause systemic risk. Systems with this potential are subject to designation under the act. Designated systems will have to satisfy the Bank that they have appropriate risk-control mechanisms in place. The Bank may carry out examinations and, in situations where it is judged that systemic risk is being inadequately controlled, the Governor may issue directives to a designated system.

The Bank has focussed on three systems to date: the Large-Value Transfer System (LVTS), being developed by the Canadian Payments Association to handle large-value payments; the Debt Clearing Service, operated by The Canadian Depository for Securities Limited and designed to clear and settle trades in bonds and money market securities; and the Multinet system for clearing and settling large-value foreign exchange transactions. The Bank has worked closely with the designers of these systems to ensure sound risk-containment mechanisms. As well, the Bank is currently reviewing other systems operating in Canada that might be judged capable of posing systemic risk and, hence, would be subject to regulation under the act.

The new act also strengthens the legal arrangements governing the operations of a clearing and settlement system to ensure that it will function as expected in periods of financial stress. For example, the act contains provisions to increase the legal certainty regarding the enforceability of netting arrangements and the settlement rules of designated systems.

The Payment Clearing and Settlement Act also gives the Bank of Canada new powers to provide certain services. In particular, the Bank can now guarantee settlement of designated systems and can pay interest on special deposits from clearing houses or participants.

risks. As a result of new federal legislation that came into force in 1996, the Bank now has explicit responsibility for overseeing certain clearing and settlement systems.

The Large-Value Transfer System (LVTS), being developed by the Canadian Payments Association to handle large-value payments, is expected to become operational in late 1997. During the year the Bank took two initiatives to further preparations for the system. The Bank will guarantee the settlement of the system; a claim on this guarantee is considered to be extremely unlikely because of the commitment by the private sector to cover major losses. The Bank will also offer special interest-bearing deposits as a new form of collateral that would be available to private sector participants to secure any advances required from the Bank to enable them to meet their settlement obligations. The Bank also promoted discussions among participants regarding the links between the LVTS and other major domestic and international clearing and settlement systems.

PHOTO: DAVID NICKERSON, TIMES GLOBE, SAINT JOHN, NB

Deputy Governor Sheryl Kennedy, speaking on the Saint John campus of the New Brunswick Community College

The Debt Clearing Service was designed by The Canadian Depository for Securities Limited (CDS) to clear and settle trades in bonds and money market securities. In 1996 the Bank worked with the CDS to ensure adequate risk-containment arrangements as this system expands to include provincial securities and, at a later date, private sector debt and equity.

The Bank also worked closely with Canadian participants in Multinet, a system to clear and settle large-value foreign exchange transactions. Central banks in the Group of Ten (G-10) countries are co-operating to oversee cross-border or multicurrency netting and settlement arrangements. The U.S. Federal Reserve System is primarily responsible for the oversight of Multinet, since the system will be located in the United States. The Bank of Canada, acting in co-operation with the Federal Reserve, has responsibility for overseeing the soundness of Multinet's procedures for the settlement of Canadian dollar transactions.

Client services

... to the federal government

As the federal government's banker, the Bank ensures that the government's operating accounts have enough cash to meet daily requirements and raises funds to meet anticipated short-term needs. It also takes steps to minimize the cost to the government of holding these balances by investing excess funds in term deposits that earn interest at a higher rate than demand deposits.

In 1996 the Bank conducted 552 term deposit auctions in addition to 52 weekly auctions of shares of the government's demand deposits.

As agent for the Minister of Finance, the Bank intervenes in the foreign exchange market, buying or selling Canadian dollars to moderate movements in the value of the dollar. In April 1995 the Bank, on behalf of the Minister, introduced new criteria that call for less frequent intervention. Coupled with a relatively stable exchange rate, these led to very few interventions in exchange markets in 1996.

The Bank also manages the government's foreign exchange reserves. This includes investing the reserves, buying foreign exchange to cover the requirements of government departments, managing borrowings to replenish reserves, hedging foreign currency positions, and engaging in gold transactions. At the end of 1996, international reserves were approximately U.S.$20.6 billion, an increase of U.S.$5.4 billion from the end of 1995.

The Bank has set up a risk-management unit to monitor and manage the financial risk exposures of the government. This initiative reflects the government's desire to ensure that its risk-management practices and those of its Crown corporations are in line with the "best practices" being followed by financial institutions and by other countries.

... to financial institutions

The Bank of Canada maintains deposit and safekeeping accounts for approximately 100 clients, including major Canadian financial institutions, international financial institutions, and other central banks. The Bank is developing a new generation of computer systems, to be implemented by mid-1997, that will provide on-line access for these clients and will facilitate payments through the LVTS.

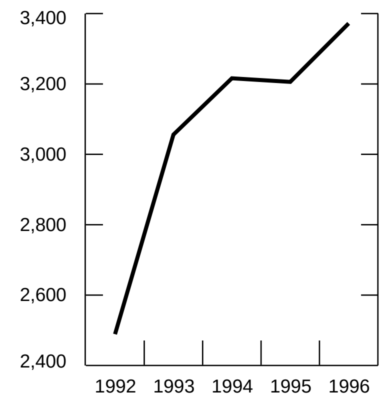
With the closing of many of its agencies, the Bank is restructuring the way it fulfils its responsibilities for the registration of security interests granted under the Bank Act. Alternative arrangements are being developed for implementation in 1997.

In April 1996 charges were introduced for certain custodial services that the Bank provides to institutional clients and that are available to them elsewhere. In total, charges for custodial services generated revenue of close to $1 million in 1996.

In January 1996 the Banco de México repaid in full its outstanding drawings of Can.$216 million made earlier under the bilateral swap facility with the Bank of Canada. No further drawings were made in 1996. This facility was renewed for one year in December 1996 in the amount of Can.$1 billion. A similar

The Bank responded to some 8,700 general inquiries concerning unclaimed bank balances in 1996. It completed 20,600 searches and made payments totalling $3.4 million to more than 3,350 claimants.

Number of accounts claimed



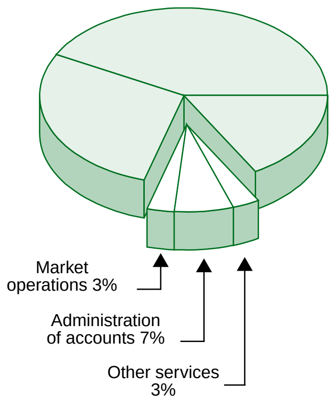
U.S.$2 billion facility between the Bank of Canada and the New York Federal Reserve Bank was also renewed, as was the North American Framework Agreement (NAFA). The NAFA sets out the terms and conditions of a simultaneous draw by one country on the bilateral swap facilities of the other two countries.

... to the general public

Chartered banks are required to transfer to the Bank of Canada all unclaimed bank balances maintained in Canada in Canadian currency that have been inactive for a period of 10 years. As custodian for these unclaimed balances, the Bank responded in 1996 to some 8,700 general inquiries, completed 20,600 searches, and made payments totalling $3.4 million to more than 3,350 claimants.

Early in 1996, the Bank of Canada implemented a new computer system to support the processing of unclaimed balances. The Bank continues to investigate ways to improve the public's access to this information.

Operating expenses related to central banking services



Operating expenses

Expenditures in 1996 on central banking services were just under $23 million, about 13 per cent of the Bank's total operating costs. The streamlining of operations flowing from activity reviews continued in 1996. The resulting savings were more than offset by investment in computer systems necessitated by the development of the LVTS and the need to replace and update systems in the areas of unclaimed balances, foreign exchange operations, and account administration.

Bank Notes

The Bank is committed to providing Canadians with bank notes that they can use with confidence and without concern about counterfeiting. It does this in the most economical and efficient manner possible. The Bank meets this commitment by using private sector partnerships, wherever practical, to produce and distribute notes, while continuing to maintain a high degree of security in the overall operation. Public education on the anti-counterfeiting features of bank notes is an important part of the strategy for keeping bank notes secure.

At the end of 1996, there were about 1.2 billion bank notes, worth over $29 billion, in circulation. The chances of encountering a counterfeit note were 1 in 16,900.

Year in review

The bank note function was the area in which the Bank's recent activity review led to the most dramatic change in the way business is conducted. In 1996 the first phase of a new bank note distribution system was implemented, which will make it possible to discontinue the processing of bank notes in seven of the Bank's nine regional agencies. This change will create major efficiencies and savings that will grow as the system is put in place through 1997. It will result in a workforce reduction of nearly 200 positions from 1994 levels. The closure of cash operations has, in turn, created an opportunity to re-examine all the other operations carried out in the agencies and will lead to further efficiencies.

Other significant changes in 1996 were the replacement of the $2 note by a coin and the contracting out of note-finishing operations (which include inspection, cutting, and packaging) to security printers.

A new approach to bank note distribution

The new method of distributing bank notes was developed, and is now being implemented, in close partnership with financial institutions, which will have more responsibility for note distribution under the new system. These institutions participated in every aspect of the system design, including the procedural framework and the supporting computer network. The new distribution arrangements were launched in Calgary in October 1996 and in the city of Québec in January 1997.

In the past, financial institutions deposited surplus notes at the Bank's nine regional processing centres. The Bank processed these notes—about 2 billion per year—and then stored them until they were withdrawn again when needed by institutions. Under the new system, the Bank and the financial institutions will jointly manage the flow of notes among institutions, but the majority of the notes in circulation will not pass through the

The most important weapon against counterfeiting is the public's ability to recognize a genuine bank note.

Bank's hands until they are no longer fit for reissue. The Bank's management of information instead of physical notes is the key to the major savings, of some $10 million annually, that will accrue to the Bank, and thus to the Canadian public, under the new arrangements.

The Bank's cash operations in Ottawa were discontinued in June 1996; operations in Saint John, Halifax, Regina, Calgary, Winnipeg, and Vancouver will close during 1997 as the new distribution system is implemented. The Bank will continue to introduce new notes into the system through its facilities in suburban Toronto and Montreal.

New regional representation

Although many of the Bank's note-processing operations and other functions in the regions are being consolidated or contracted out, the Bank will maintain an important presence in five regional offices in Halifax, Montreal, Toronto, Calgary, and Vancouver. Communications initiatives related to monetary policy will be carried out by these regional offices, which will also serve as contact points for all of the services provided by the Bank. Officers will maintain liaison with financial institutions in the regions in support of the operation of the new bank note distribution system. For the Canadian public, education programs on anti-counterfeiting measures will be offered, and information will be available on activities such as searches for unclaimed bank balances.

In the first six weeks of 1996, nearly 40,000 sheets of 40 $2 notes, representing a face value of over $3 million, were sold to collectors.

Withdrawal of the $2 bank note

On 16 February 1996, the Bank issued the last new $2 notes and discontinued the sale of sheets of uncut $2 bills. At that time, about 230 million $2 bills were in circulation. The $2 note had a short lifespan, only 14 months, because small-denomination notes changed hands often and wore out rapidly. The withdrawal of the $2 note will generate annual savings of some $7 million in production costs, plus further reductions in distribution and handling costs.

Research and anti-counterfeiting measures

The Bank conducts ongoing research into anti-counterfeiting measures and into production methods aimed at improving cost-effectiveness and increasing the durability of bank notes. This research is carried out in co-operation with private sector suppliers of material and equipment used in the production of bank notes.

Research on optical security material is conducted in conjunction with the National Research Council, and regular consultations are held with note-issuing authorities in other countries. The Bank also consults the printing industry and the manufacturers of photocopier equipment in order to reduce the risk of printing equipment being used to counterfeit bank notes.

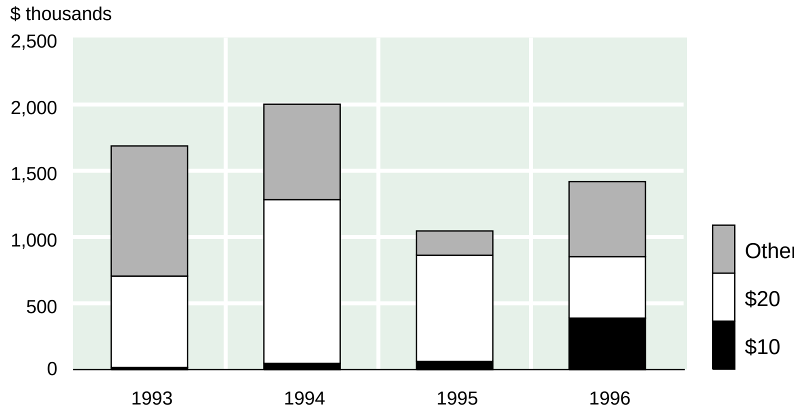
The Bank is also monitoring the domestic development of electronic cash or "smart cards" and their impact on the demand for bank notes.

Public education

The most important component of the Bank's program to deter counterfeiting is the ability of the public to recognize the features of a genuine bank note. Through the Bank's Currency Museum, public and school displays, and contacts with the retail sector, the Bank informs the public about the features of genuine notes. The most visible anti-counterfeiting measure is the Optical Security Device (OSD), the reflective rectangle in the upper left-hand corner of the $20, $50, $100, and $1,000 notes, which changes colour from gold to green when tilted against the light. Genuine bank notes also have a distinctive look and feel, owing to the varying thicknesses of ink created by the intaglio printing process.

In December the RCMP issued a press release in consultation with the Bank advising of an increase in the number of counterfeit $10 notes in circulation and reminding Canadians how to identify genuine bank notes. The Bank closely monitors the incidence of counterfeiting and maintains contingency plans to deal with changes in technology that might be used by counterfeiters. Statistics on the counterfeiting of Canadian currency are available to the public from both the Bank and the RCMP.

Value of counterfeit bank notes found in circulation

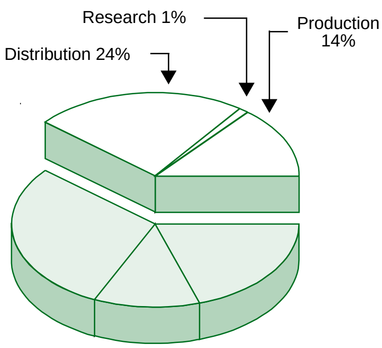


The Optical Security Device was introduced on new series of higher-denomination notes starting in 1989. The June 1993 issue of a new $20 series carrying the OSD and the accelerated withdrawal of old $20 notes from circulation have been effective in reducing counterfeiting of this important denomination. The Bank is currently examining a variety of measures to address the recent increase in counterfeit $10 notes.

Operating expenses

Expenditures for bank note activities were $69.6 million in 1996, about 39 per cent of the Bank's total operating costs. There was a significant reduction in the cost of producing new

Operating expenses related to bank note issue



notes owing to the withdrawal of the $2 note and lower requirements for replacement notes in other denominations. The closing of cash operations in Ottawa and the reduction of distribution costs in other regional agencies also began to have an effect on 1996 expenses. Further savings will accrue in 1997 and beyond, as the new distribution arrangements take full effect and agencies are closed.

Electronic money

Electronic money (e-money) has the potential, over time, to significantly reduce the use of other methods of payment (particularly coins and notes) in small-value transactions.

E-money is a way of storing purchasing power electronically. It can take the form of a card (sometimes referred to as a "smart" or "stored-value" card or an "electronic purse"), or it can be software on a computer network (sometimes referred to as "digital cash"). The consumer obtains a certain value from an e-money "provider"; the value of purchases is subtracted from this balance.

Promoters of various e-money schemes are currently conducting pilot projects in cities across Canada. While predicting the commercial success of e-money is very difficult at the moment, its acceptance will ultimately depend on its attractiveness to consumers, merchants, and providers. Governments and central banks in a number of countries have begun to consider the policy issues raised by e-money. Of particular interest to central banks are the implications for central bank revenues, monetary policy, and the payments system in general. Among the questions being raised are: Who should provide e-money? Should the providers be regulated and, if so, how? What is the appropriate form of consumer protection? Are existing laws sufficiently clear on the legal rights and obligations of e-money users and providers? What are the implications for criminal activities, particularly counterfeiting, fraud, and money laundering? And, finally, what are the consequences of a serious technical malfunction?

During 1996 the central banks in the Group of Ten (G-10) countries (including the Bank of Canada) actively studied and discussed many of these issues. Much of this work was carried out under the auspices of the Bank for International Settlements and led to the publication of two reports (BIS 1996).

Further studies by G-10 governments are under way in the areas of consumer protection, law enforcement, and the possible supervision and regulation of e-money products and providers.

Debt-Management Services

In providing debt-management services for the federal government, the Bank strives to carry out its agency role in a way that is satisfactory to the government and to the retail debt agency recently established within the Department of Finance. The Bank is also responsible for serving the investing public and for promoting, through its handling of government borrowings, the functioning of Canadian debt markets.

The services traditionally provided to the federal government include advising on borrowings, managing new debt offerings, and servicing outstanding debt. These services were provided for all of the government's debt issued domestically, regardless of the type of borrowing.

In 1995 a distinction was made regarding that portion of the debt held by individuals and commonly referred to as the government's retail debt. A special agency, now known as Canada Investment and Savings, was established by the federal government to be responsible for all of the government's retail debt operations. This agency handles the Canada Savings Bond (CSB) campaign as well as the development of new retail products and marketing initiatives. The Bank of Canada continues to provide operations and systems support for the program. Amendments to the Bank of Canada Act, scheduled for 1997, will enable the Bank to charge the federal government for these services.

For CSB information:

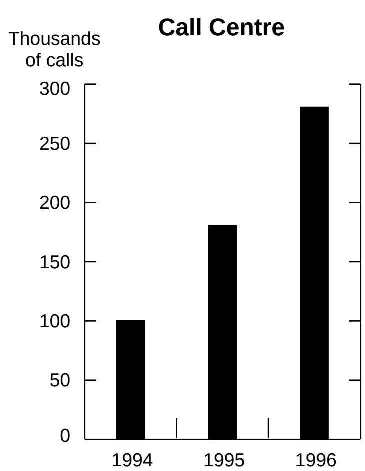
Use our 1-800 Call Centre

(1-800-575-5151) or

http://www.cis-pec.gc.ca/

on the World Wide Web.

Other debt-management responsibilities are unchanged. These relate to treasury bills and marketable bonds issued by the government and to borrowings on behalf of the Exchange Fund Account (EFA). This debt is placed largely with institutional investors.



Year in review

Government retail debt services

The Bank administers some 7 million accounts for CSB holders. To enhance service and to ensure effective handling of new products, a major new computer-based system has been under development since 1994. With a change in systems supplier during the year, this project is scheduled for completion in 1998. Meanwhile, steps taken in 1996 resulted in more efficient processing of CSB orders and certificates. The Bank also undertook measures to support new retail debt initiatives for introduction as early as 1997.

Since 1994 the Bank has operated a 1-800 Call Centre to provide information on CSBs. The centre was expanded in 1996 to provide pre-sales marketing support and to meet additional demands related to the broadened RRSP eligibility of CSBs. The CSB Web site, developed in 1995, was enhanced during 1996. The Bank also supported a program for direct sales of CSBs and piloted a new method of selling the bonds through instalments.

Other government debt services

Government treasury bills and marketable bonds are issued through auctions run by the Bank. There were 61 auctions of treasury bills, including regular weekly offerings and short-term bills for government cash-management purposes, and 26 auctions of marketable bonds during 1996. Towards the end of the year, the Bank released a discussion paper on possible changes to bidding rules and to the Bank's surveillance of the auctions. The proposed changes should ensure continued confidence in the auction process.

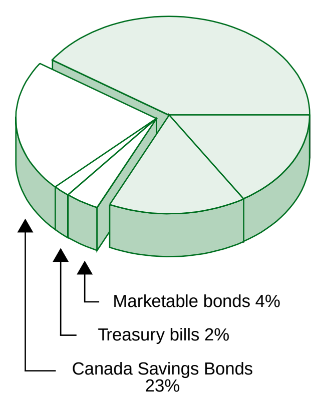
The Bank is also responsible for the administration of the government's treasury bills and marketable bonds after they are issued. Because transactions now clear and settle through the computerized Debt Clearing Service of the CDS, the Bank's operations in this area have diminished considerably.

In 1996 the Bank was involved in raising U.S. dollars for the EFA through two global bond issues and two swap transactions. Regular short-term U.S. dollar funding of the EFA also continued through the Canada Bills program. As well, a medium-term note program was initiated in the United States to raise U.S. dollars for terms beyond nine months, and preparations were made to launch a similar program outside North America early in 1997.

Operating expenses

Expenditures on debt-management services were nearly $52 million in 1996, about 29 per cent of the Bank's total operating costs. There were further significant declines in costs from the increasing benefits of the Debt Clearing Service of the CDS. However, investment in systems and services to support the new direction for retail debt and to support treasury bills and marketable bonds services partially offset the savings that were generated.

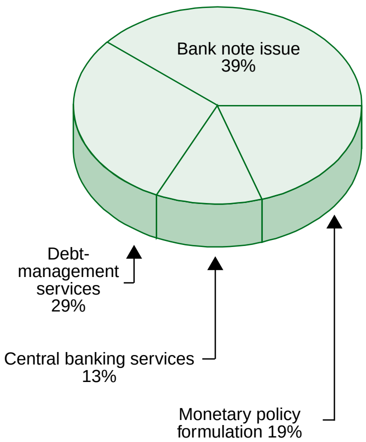
Operating expenses related to debt-management services



Financial Summary

Financial Summary

Operating expenses by function



As described in this report, 1996 was a year of change at the Bank of Canada, driven mainly by the activity review that was initiated in 1995. Overall, expenses were down in 1996, despite significant one-time expenses and higher costs associated with a modification in the way the Bank accounts for staff benefits. Of particular note is the steady decline over the past three years in the proportion of resources spent on bank note issue (39 per cent in 1996 compared with 48 per cent in 1994).

Operating expenses

Total operating expenses for 1996 were about 3 per cent lower than the 1995 level. Excluding the one-time expenses, operating costs fell by nearly $9 million, or by 5 per cent. This is about $30 million below the level recorded in 1994, which is the base year identified in the activity review for measuring progress on achieving efficiency gains. It is expected that once all the planned changes from the activity review are completed in 1998, the direct annual savings to the Bank will be in the order of $40 million. However, some of these savings will be offset by new initiatives such as the regional offices and developments in the retail debt area.

Salaries and other staff costs were lower overall in 1996. The reduction is associated with the partial-year effect of early retirements and voluntary departures under the Bank's Workforce Adjustment Program. Nearly 370 employees left the Bank voluntarily during 1996. The lower staff requirement was made possible by lower volumes and by the many changes in business procedures and service levels that resulted from the activity review.

Although staff benefits have not changed, there was an increase in other staff expenses in 1996 because of a shift in the timing of expense recognition for staff benefits. The costs of all staff benefits are now either accrued or paid as they are earned. The change brings the Bank's accounting practices fully in line with generally accepted accounting principles. In all, the changes in accounting practices added close to $4 million to other staff expenses in 1996.

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Operating expenses by function

Millions of dollars

	1994	1995	1996
Monetary policy	33.8	33.0	35.0
Central banking services	19.3	20.8	22.8
Bank notes	101.4	80.0	69.6
Debt-management services	54.7	54.0	51.6
Subtotal	209.2	187.8	179.0
Other (non-recurring) expenses		33.0	34.7
Total	209.2	220.8	213.7

The decrease in 1996 operating expenses is explained mainly by reduced expenses in the bank note function, continuing the marked downward trend since 1994. This reflects both lower volumes (driven primarily by the decision to stop issuing the $2 note) and the closure or consolidation of certain operations.

In 1996 expenses also fell in the debt-management function, specifically those expenses associated with treasury bill and marketable bond services. The cost of these services has been falling steadily over the past five years, largely because of the computerized clearing and settling of marketable bond and treasury bill transactions.

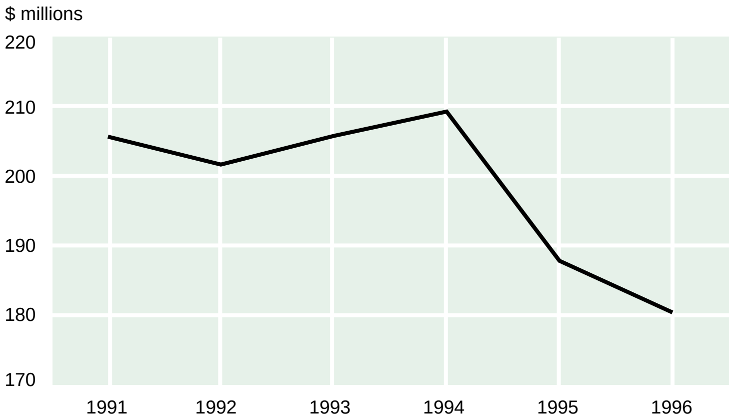
In the remaining two functions, monetary policy and central banking services, continuing efforts to streamline and rationalize activities were more than offset in 1996 by investment in systems and tools.

“Other expenses” of $34.7 million represent several one-time items. The largest expense ($22.3 million) relates to the cost of settling legal challenges to the Bank of Canada’s security interests in the liquidation of the Canadian Commercial Bank. After eight years of court challenges, these settlements with three major unsecured creditors should expedite the final liquidation of the institution. Also included in other expenses is $5 million that was expensed for the Bank’s Workforce Adjustment Program in 1996 to cover the estimated cost of termination benefits associated with the elimination of about 100 positions over the next two years. These positions were identified as a result of activity reviews conducted during 1996. The reductions are in addition to the approximately 500 positions that were identified and provided for in 1995.

Finally, other expenses include a one-time provision of $3 million to recognize a liability for unused vacation entitlements earned prior to 1996, and a $4.4 million loss on net book value resulting from the sale of the St. Andrew's Tower in Ottawa. The building was sold because the Bank's space requirements are falling as changes resulting from the activity review are being implemented.

Net operating expenses

Excluding *Other expenses*



In 1996, for the fifth consecutive year, salary ranges at the Bank remained unchanged. For 1997, with the end of the federal public sector salary freeze, the Bank's Board of Directors decided that there would be no general increase in salary ranges. Rather, increases averaging one per cent of total payroll have been given to lower-paid employees and to critical skill areas (information technology and economist groups) where market pressures are strong and the Bank's compensation levels are below those in the public and private sectors. These measures reflect the Bank's desire to ensure that it has a competitive, equitable salary structure that is also consistent with its responsibilities as a public sector institution. In addition, in line with the federal public sector, performance-based progression within pay ranges was restored beginning 1 January 1997.

Revenue

Total revenue was $1.6 billion in 1996, down from $2 billion in 1995. The Bank's principal source of revenue is interest earned on its holdings of federal government securities. Revenue declined mainly because falling interest rates resulted in a lower average return on these assets. With net expenses of $0.2 billion, net revenue paid to the Government of Canada in 1996 was $1.4 billion, down $0.4 billion from the previous year.

However, net revenue is not a good indicator of the Bank's management performance. The Bank deals in financial markets to achieve policy goals, not to maximize its revenues, and revenues are highly dependent on the general level of interest rates. For these reasons, the level of operating expenses is a better indicator of the Bank's stewardship of public resources.

YEAR ENDED 31 DECEMBER 1996

AUDITORS OF THE BANK OF CANADA
VÉRIFICATEURS DE LA BANQUE DU CANADA

C. P. 813, SUCCURSALE B | P.O. BOX 813, STATION B

OTTAWA, CANADA
K1P 5P9

CARON BÉLANGER ERNST & YOUNG | COOPERS & LYBRAND

To the Minister of Finance, registered shareholder of the Bank of Canada

We have audited the statement of assets and liabilities of the Bank of Canada as at 31 December 1996 and the statement of revenue and expense for the year then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Bank as at 31 December 1996 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with the preceding year except for the change in the method of accounting for pension and termination benefits as described in note 2(h) and (i).

Caron Bélanger Ernst & Young | Coopers & Lybrand

Chartered Accountants
Ottawa, Canada
24 January 1997

Bank of Canada
Statement of revenue and expense

Year ended 31 December 1996

	1996	1995
	Millions of dollars	
REVENUE		
Revenue from investments, net of interest paid on deposits of $9.8 million ($23.3 million in 1995)	**1,648.8**	2,037.0
EXPENSE by function (notes 1 and 3)		
Monetary policy	**35.0**	33.0
Bank notes	**69.6**	80.0
Central banking services	**22.8**	20.8
Debt-management services	**51.6**	54.0
	179.0	187.8
Other expenses	**34.7**	33.0
	213.7	220.8
NET REVENUE PAID TO RECEIVER GENERAL FOR CANADA	**1,435.1**	1,816.2

(See accompanying notes to the financial statements.)

Bank of Canada
Statement of assets and liabilities

As at 31 December 1996

ASSETS	1996	1995
	Millions of dollars	
Deposits payable in foreign currencies		
U.S.A. dollars	**235.0**	328.7
Other currencies	**4.0**	219.8
	239.0	548.5
Advances to members of the Canadian Payments Association (note 8)	**553.8**	545.4
Investments – at amortized values		
Treasury bills of Canada	**17,416.5**	18,072.0
Other securities issued or guaranteed by Canada maturing within three years	**2,328.3**	1,523.9
Other securities issued or guaranteed by Canada not maturing within three years	**5,635.2**	3,767.9
Other investments	**3,942.4**	5,293.0
	29,322.4	28,656.8
Bank premises (note 4)	**198.2**	225.0
Other assets (note 8)	**271.0**	224.9
	30,584.4	30,200.6

(See accompanying notes to the financial statements.)

LIABILITIES	1996	1995
	Millions of dollars	
Capital paid up (note 5)	**5.0**	5.0
Rest fund (note 6)	**25.0**	25.0
Notes in circulation	**29,109.1**	28,777.7
Deposits		
Government of Canada	**11.0**	17.6
Chartered banks	**945.5**	478.8
Other members of the Canadian Payments Association	**14.6**	38.9
Other deposits	**347.8**	629.2
	1,318.9	1,164.5
Liabilities payable in foreign currencies		
Government of Canada	**91.0**	185.4
Other liabilities	**35.4**	43.0
	30,584.4	30,200.6

Governor, **G.G. THIESSEN**

Chief Accountant, **F.J. MAHONEY**

Bank of Canada
Notes to the financial statements

Year ended 31 December 1996

1. Bank functions

The Bank of Canada's primary responsibilities are set out in the Bank of Canada Act and can be grouped into four broad functions. Net operating expenses in the Statement of revenue and expense are reported on the basis of these four corporate functions, which are described below. Net operating expenses by major objects of expenditure are presented in note 3.

Monetary policy

The Bank's most important responsibility is monetary policy. Monetary policy is concerned with managing the rate of monetary expansion in a way that is consistent with preserving the value of money.

Central banking services

The Bank carries out a variety of activities that support and oversee Canada's systems for clearing and settling payments and other financial transactions. The Bank also provides a number of central banking services to the federal government, financial institutions, and the general public.

Bank notes

The Bank is responsible for issuing bank notes in Canada. This responsibility involves note design (including anti-counterfeiting features) as well as the printing and distribution of bank notes and their eventual replacement.

Debt-management services

As fiscal agent, the Bank advises the government on matters relating to the public debt and is responsible for issuing debt, maintaining bondholder records, and making payments on behalf of the government for interest and debt redemption.

2. Significant accounting policies

The financial statements of the Bank are in accordance with generally accepted accounting principles and conform to the disclosure and accounting requirements of the Bank of Canada Act and the Bank's by-laws. The significant accounting policies of the Bank are:

a) Revenues and expenses

Revenues and expenses are accounted for on the accrual basis except for interest on advances to a bank ordered to be wound up where interest is recorded as received.

b) Translation of foreign currencies

Assets and liabilities in foreign currencies are translated to Canadian dollars at the rates of exchange prevailing at the year-end. Foreign currency assets and liabilities covered by forward contracts are converted to Canadian dollars at the contracted rates. Gains and losses from translation of, and transactions in, foreign currencies are included in revenue.

c) Advances

Advances to members of the Canadian Payments Association are fully collateralized, liquidity loans for which the Bank charges the Bank Rate. These loans are generally overnight in duration.

d) Investments

Investments consist mainly of Government of Canada treasury bills and bonds, which are recorded at cost adjusted for amortization of purchase discounts and premiums. The amortization as well as gains and losses on disposition are included in revenue. This category also includes other investments which are held under short-term foreign currency swap arrangements with the Exchange Fund Account of the Government of Canada as described in note 7(b).

The Bank typically holds its investments in Government of Canada treasury bills and bonds until maturity. The amortized book values of these investments approximate the par values. At the year-end, the average yield on the Bank's holdings of treasury bills was 3.6 per cent, while the average yield for bonds maturing within three years was 7.5 per cent and for those maturing in over three years was 9.1 per cent.

e) Bank premises

Bank premises, consisting of land, buildings and equipment, are recorded at cost less accumulated depreciation. As well, computer software costs exceeding $2.0 million are capitalized and amortized over the estimated useful life of the software, ranging from 3 to 5 years. Depreciation is calculated using the straight-line method and is applied over the estimated useful lives of the assets, as shown below.

Buildings	25 to 40 years
Computer equipment/software	3 to 7 years
Other equipment	5 to 15 years

A full year of depreciation is charged against assets in the year of acquisition, except for projects in progress which are depreciated from the point of substantial completion. No depreciation is taken on assets in the year of disposal.

f) Notes in circulation

This liability represents the face value of all notes issued by, and not returned to, the Bank.

g) Deposits

The liabilities within this category are Canadian dollar demand deposits that typically do not earn interest.

h) Pension plan

The Bank sponsors a defined-benefit pension plan for its employees which is registered under the Pension Benefits Standards Act. The plan provides pension benefits based on length of service and rates of pay.

During the year, the Bank adopted the accrual method for determining pension benefit expense and this change has been applied prospectively from 1 January 1996.

Actuarial valuations of the pension plan are made periodically by an independent actuary using the projected benefit method prorated on service. Market-related values are used to value pension plan assets.

Based on the latest actuarial valuation as at 31 December 1995, the estimated present value of the accrued pension benefits as at 31 December 1996 was $418.8 million, and the estimated market-related value of the pension plan assets was $468.9 million.

Pension expense for 1996 of $7.0 million ($6.0 million in 1995) includes the actuarially computed cost of pension benefits in respect of current year service and the amortization of past service costs and experience gains and losses. Amortization is calculated on a straight-line basis over the average remaining service life of the plan members, currently 12 years.

i) Termination benefits

During the year, the Bank adopted the accrual method for determining the expense related to termination benefits. This change has been applied prospectively from 1 January 1996 and, accordingly, has increased termination benefits expense for the year ended 31 December 1996 by $3.7 million when compared with what termination benefits expense for 1996 would have been under the pay-as-you-go approach.

j) Insurance

The Bank does not insure against direct risks of loss to the Bank, except for potential liabilities to third parties and where there are legal or contractual obligations to carry insurance. Any costs arising from these risks are recorded in the accounts at the time they can be reasonably estimated.

3. Expense by object of expenditure

	1996	1995
	Millions of dollars	
Salaries	**71.3**	77.6
Other staff expenses	**23.4**	20.4
Bank note costs	**16.8**	22.6
Premises maintenance – net of rental income	**28.0**	31.3
Services and supplies	**16.1**	15.5
Depreciation	**23.4**	20.4
	179.0	187.8
Other expenses		
Settlement cost (note 8)	**22.3**	–
Workforce adjustment (note 9)	**5.0**	33.0
Miscellaneous	**7.4**	–
Total	**213.7**	220.8

Wages and benefits of Bank staff engaged in premises maintenance are not included in the *Salaries* or *Other staff expenses* categories, but rather as part of *Premises* expenses.

Expenses are net of fees charged for a variety of services provided by the Bank ($3.4 million in 1996 and $3.0 million in 1995).

Miscellaneous expenses of $7.4 million comprise two items. The Bank sold its St. Andrew's Tower in Ottawa for $16 million, which represented a loss of $4.4 million on the net book value of the building. Secondly, as part of its move to accrual accounting for staff benefits, the Bank incurred a one-time cost of $3 million to recognize the past service liability for unused vacation entitlements earned prior to 1996.

4. Bank premises

	1996			1995		
	Millions of dollars					
	Cost	Accumulated depreciation	Net book value	Cost	Accumulated depreciation	Net book value
Land and buildings	**224.0**	**97.6**	**126.4**	253.4	101.6	151.8
Computer equipment/software	**39.1**	**26.3**	**12.8**	50.6	42.1	8.5
Other equipment	**138.7**	**85.7**	**53.0**	144.2	83.6	60.6
	401.8	**209.6**	**192.2**	448.2	227.3	220.9
Projects in progress	**6.0**	**–**	**6.0**	4.1	–	4.1
	407.8	**209.6**	**198.2**	452.3	227.3	225.0

5. Capital paid up

The authorized capital of the Bank is $5.0 million divided into 100,000 shares with a par value of $50 each. The shares are fully paid and, in accordance with the Bank of Canada Act, have been issued to the Minister of Finance, who is holding them on behalf of the Government of Canada.

6. Rest fund

The rest fund was established by the Bank of Canada Act and represents the general reserve of the Bank. In accordance with the Act, the rest fund was accumulated out of net revenue until it reached the stipulated maximum amount of $25.0 million in 1955. Subsequently, all net revenues have been paid to the Receiver General for Canada.

7. Commitments

a) Bank premises

As at 31 December 1996, outstanding commitments under contracts for new computer systems, building upgrades and equipment purchases totalled $9.1 million ($12.2 million at the end of 1995). These contracts call for payments over the next year.

b) Foreign currency contracts

In the ordinary course of business, the Bank enters into commitments involving the purchase and sale of foreign currencies. In particular, the Bank enters into short-term foreign currency swap arrangements with the Exchange Fund Account (EFA) of the Government of Canada as part of its cash management operations within the Canadian banking system. These transactions, which are made with the concurrence of the Minister of Finance under a standing authority, involve the temporary acquisition by the Bank of foreign currency assets from the EFA. These assets are paid for in Canadian dollars at the prevailing exchange rate with a commitment to reverse the transaction at the same rate of exchange at a future date. The fair values of these assets are not materially different from their book values. At the year-end, the average yield for these investments was 6.1 per cent.

As well, the Bank of Canada is a participant in two foreign currency swap facilities with foreign central banks. The first, amounting to U.S.$2 billion, is with the U.S. Federal Reserve. The second, amounting to Can.$1 billion, is with the Banco de México.

A summary of outstanding commitments follows.

	1996	1995
	Millions of dollars	
Foreign currency contracts - purchases	**75.4**	64.2
- sales	**4,080.5**	5,646.2

As at 31 December 1996, outstanding foreign currency contracts included sale commitments of $4,005.1 million ($5,365.4 million at the end of 1995) under swap arrangements with the EFA, nil under the swap facility with the Banco de México, ($216.7 million at the end of 1995), and nil under the swap facility with the U.S. Federal Reserve (nil at the end of 1995).

8. Legal matters

On 3 September 1985 and 20 January 1986 respectively, winding up orders were issued for the Canadian Commercial Bank and the Northland Bank. At those dates, the Bank of Canada had liquidity advances outstanding of $1.3 billion to the Canadian Commercial Bank and $0.5 billion to the Northland Bank. During the intervening years, the Bank has received interim distributions from the two banks in liquidation. At 31 December 1996, the residual balances of advances outstanding were $26.9 million to the Canadian Commercial Bank and $1 million to the Northland Bank (both amounts are unchanged from 1995). On the basis of the available information, it is the opinion of the Bank of Canada that it will be fully repaid from the proceeds of the two liquidations.

The Bank of Canada's security for these advances includes the loan portfolios of those institutions. In the case of the Canadian Commercial Bank, the liquidator's conclusion that loans made form part of the Bank of Canada's security, in respect of the $1.3 billion of advances, has been challenged repeatedly in the courts regarding portions of the portfolio. If the challenges are successful, there could be some adjustment to amounts which have been recorded in income.

To forestall continuance of the court challenges, the Bank of Canada settled for a total of $22.3 million with three of the major unsecured creditors of the Canadian Commercial Bank (namely, the Canada Deposit Insurance Corporation, the Province of Alberta, and a consortium of six chartered banks) during 1996. Settlement should expedite the final liquidation of the Canadian Commercial Bank. As part of the settlements with these three creditors, the Bank also purchased the amounts remaining to be paid to them by the estate of the Canadian Commercial Bank for a total investment of $13.8 million, which is reported under Other assets on the Statement of assets and liabilities.

9. Workforce adjustment

In 1995 the Bank decided to eliminate approximately 500 staff positions and recorded $33 million in the accounts to cover the termination costs. This significant reduction in employment level resulted from extensive reviews of the Bank's activities and is being accomplished during 1996 and 1997 via early retirements, voluntary departures, and some layoffs. As at 31 December 1996, $27.6 million of the provision of $33 million had been paid.

Based on further reviews, the Bank now plans to eliminate approximately 100 additional staff positions. The termination costs are estimated to be $5 million and were recorded in the accounts in 1996.

All termination benefits are comparable to those offered by the federal government.

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* Member of the Bank of Canada Governing Council

1. Also Chairman of the Board of Directors of the Canadian Payments Association

2. Also Deputy Chairman of the Board of Directors of the Canadian Payments Association

Note: Positions as of 24 February 1997

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PHOTO: WILLIAM P. MCELLIGOTT, OTTAWA

Entrance to the Currency Museum, which is located in the centre building of the Bank of Canada, Ottawa. The museum houses the National Currency Collection, the most complete collection of Canadian bank notes, coins, and tokens in the world.