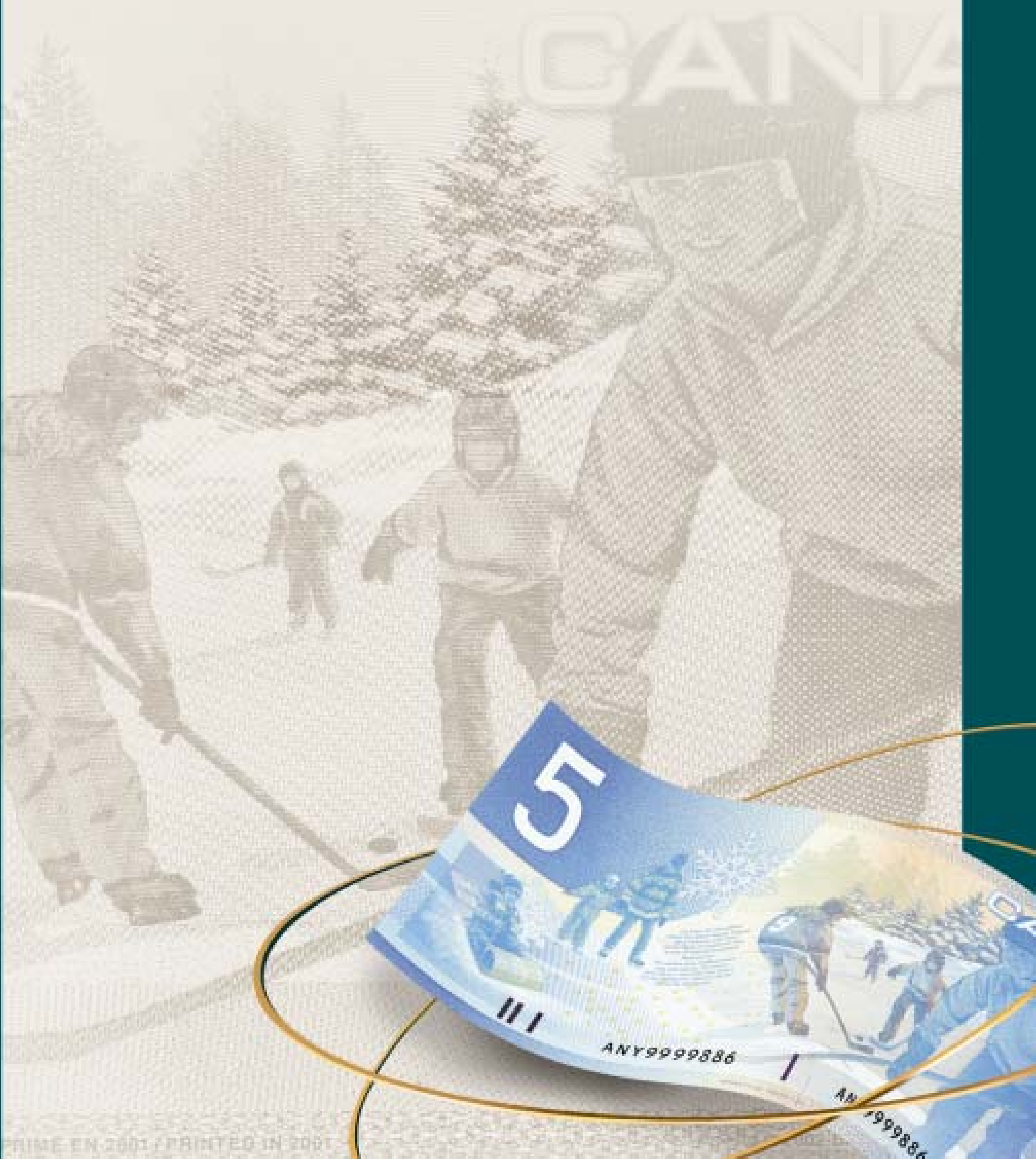
BANK OF CANADA ANNUAL REPORT

2002



Bank of Canada
234 Wellington Street
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5080
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BANK OF CANADA
David A. Dodge
Governor - Gouverneur

BANQUE DU CANADA
Ottawa K1A 0G9

28 February 2003

The Honourable John Manley, PC, MP
Minister of Finance
55 Metcalfe Street
15th Floor
Ottawa, Ontario
K1A 0A3

Dear Mr. Manley,

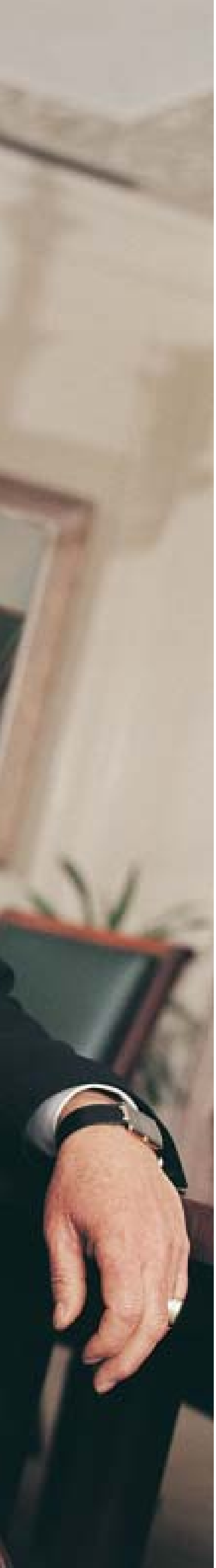
In accordance with the provisions of the Bank of Canada Act, I am submitting the Bank of Canada's *Annual Report* for the year 2002 and the Bank's audited financial statements as at 31 December 2002.

Yours sincerely,

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 quality 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

Head Office, Ottawa



MESSAGE FROM THE GOVERNOR

In the year just ended, the global economy faced a number of exceptional challenges, reflecting a wide range of economic, financial, and geopolitical risks and uncertainties. These included the fallout from the September 2001 terrorist attacks, corporate accounting scandals, stock market volatility, and developments in the Middle East. Despite this global backdrop, the Canadian economy outperformed virtually all other industrial economies, growing by about 3 1/4 per cent and creating 560,000 jobs, while inflation expectations remained well anchored to the Bank of Canada's 2 per cent inflation-control target.

One reason why our economy performed as well as it did in 2002 is the macroeconomic policy framework that we have in place in Canada—a framework focused on maintaining low, stable, and predictable inflation and sound public finances. Indeed, the events of the past year have underlined the importance of establishing and maintaining sound policy and decision-making frameworks to deal not only with today's challenges, but also with those of the future.

For the Bank, dealing effectively with the risks and uncertainties of 2002 was crucial to meeting our responsibilities, not just for monetary policy, but also for financial system stability, funds management, and currency. In 2002, business-continuity planning and risk management were a key focus of our internal management.

While the subsequent sections of our *Annual Report* provide more detail, I would like to highlight here some of the activities and decisions taken by the Bank in 2002 to help us meet our commitment to Canadians.

Meeting the Policy Challenges of 2002

Fostering Confidence in the Value of Money

The best contribution the Bank can make to good economic performance is to preserve confidence in the future value of money. This means that Canadians should not have to worry about the effects of inflation when they make everyday decisions as consumers, business people, savers, and investors. It means that they should be able to go about their affairs confidently, knowing that they can count on the Bank of Canada to do whatever is necessary to keep inflation low, stable, and predictable. To deliver this confidence, the Bank targets the 2 per cent midpoint of its 1 to 3 per cent range for inflation control.

But since monetary policy actions take from 18 to 24 months to register their full effect on inflation, it is essential for the Bank to take a medium-term approach, looking well beyond current events. Good policy-making should, of course, always be forward-looking. When we say that monetary policy is forward-looking, we mean that our actions are based on our best judgment about future inflation pressures—not just today's.

The Canadian economy has also been benefiting from the improved fiscal framework put in place over the past several years to reduce Canada's burden of deficits and public debt. And it has profited from freer trade and various structural reforms carried out in both the public and private sectors to enhance the growth of productivity and our ability to compete in world markets.

As 2002 progressed, it became clear that the Canadian economy was growing strongly and moving close to its full production capacity. With its medium-term inflation-control objective in mind, the Bank began reducing the substantial monetary stimulus that had been provided over the previous year by raising the target overnight interest rate on each of its April, June, and July policy announcement dates. But in the second half of the year, global uncertainties intensified, with financial confidence undermined by high-profile corporate governance and accounting failures in the United States. In addition, geopolitical risks were rising, particularly in relation to the Middle East. As a result, economic growth was expected to slow, and the Bank responded by holding the overnight rate steady for the rest of the year and into early 2003.

Towards year-end, however, rates of inflation began to come in higher than expected. Although the Bank had anticipated a spike upwards in consumer price inflation in the fourth quarter in response to several one-off price movements, these became more persistent. In addition, consistent with various other indicators that the economy was operating closer to capacity at year-end than had been expected, there was evidence of some broadening of price pressures. With the stance of monetary policy very stimulative, the Bank has signalled the need for a reduction of stimulus in order to return inflation to the 2 per cent target over the medium term.

The Bank's commitment to openness and public accountability is also integral to achieving its key policy objectives. The better and more widely monetary policy is understood, the better it can work. During the year, the Bank stepped up its efforts to explain its conduct of monetary policy and to provide perspective on related issues.

Promoting the Safety, Soundness, and Efficiency of Canada's Financial System

Sustaining a healthy pace of economic activity also depends critically on maintaining confidence and trust in financial institutions, markets, and clearing and settlement systems. In 2002, the Bank worked with its partners in the financial system on a number of fronts to contribute to the safe and efficient operation of these key components of the system.

Canada has made significant progress over the past few years in reducing the potential for unexpected events to threaten the operation of the Canadian financial system. This past year was no exception. A new clearing and settlement arrangement began operation in Canada and six other countries to reduce or eliminate the very significant risks associated with the settlement of foreign exchange trades. This system, together with the existing well-risk-proofed systems for transferring large-value payments and for settling almost all securities trades in Canada, has made the financial system much safer than it was five years ago. These systems provide a solid foundation on which we can continue to promote financial stability.

Another initiative aimed at strengthening the safety of the Canadian financial system is a heightened focus on business-continuity planning for operations that are crucial to the system as a whole, as well as to the economy. As part of this effort, we enhanced our own contingency arrangements in support of the essential services that we provide to payment and other clearing and settlement systems.

Internationally, we contributed actively to a number of groups working on international stability issues, including the G-20 and the Financial Stability Forum, with a strong emphasis on improving the framework for preventing and resolving financial crises.

In addition to increasing our research on financial system issues, the Bank moved to increase public knowledge and discussion of the subject by launching a new publication, the *Financial System Review*. Published semi-annually, it will highlight developments and changes in the Canadian financial system. More broadly, the Bank participated in discussions aimed at maintaining trust and confidence in the Canadian financial system and supported initiatives to enhance the efficiency of Canadian capital markets.

Supplying Secure Bank Notes

Throughout the year, the Bank faced continuing challenges in its efforts to keep ahead of the use of advanced technology to counterfeit Canadian bank notes.

The Bank acted on several fronts in 2002 to protect Canada's currency from counterfeiting. Because counterfeiting is an international issue, we continued to work with other central banks, note-issuing authorities, and equipment manufacturers and suppliers on a wide range of issues, including the design, production, and distribution of bank notes, as well as bank note technology and security issues.

In addition to working closely with the Royal Canadian Mounted Police on counterfeiting issues, we increased contacts with provincial and municipal law-enforcement agencies to support enforcement and education activities. More broadly, the Bank stepped up its public education program on the security features of bank notes, emphasizing both national and regional partnerships with interested groups.

Finally, we developed improved security features to be incorporated in the high-denomination notes of the *Canadian Journey* series. The launch of the first higher-denomination note is planned for the first half of 2004, with the remaining two to follow over the subsequent 12 months.

Managing the Bank

Effective internal management of the Bank is vital to our ability to deliver on our commitment to Canadians, and is all the more so during highly uncertain times. A priority in the post-11-September environment has been the ongoing strengthening of our operations through greater security and business-continuity planning in all critical areas.

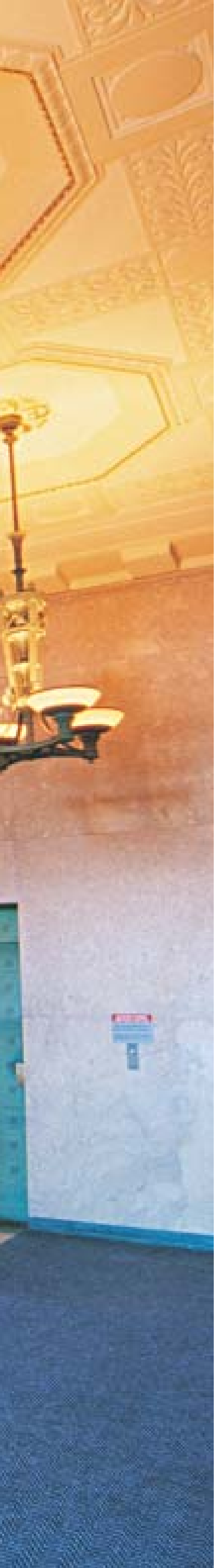
After an extensive review of the Bank's strategic direction and priorities, the Board of Directors adopted a new medium-term plan in 2002. Covering the years 2003 to 2005, the plan sets out key initiatives that will sharpen the Bank's focus on its core functions and foster excellence in all its work.

We will continue to build on our culture of learning and knowledge-sharing across all functions. We will enhance our efforts to attract and retain talented staff. Our already strong emphasis on innovative research and sound analysis will be increased, as will our efforts to work through partnerships that extend our capabilities and share knowledge. And we will continue to strive for clear, open communication inside and outside the Bank. I want to highlight here one of our important new corporate initiatives that has a more public face. This is the Bank of Canada Fellowship Program, which we launched in 2002 to advance leading-edge research and build new partnerships beyond the Bank.

In 2002, the Bank's employees were again called on to rise to a number of challenges—some planned and some emerging from the turbulent environment around us. I want to thank all of our employees for their considerable efforts during the year. I also want to extend my appreciation to the Board of Directors for their support. As a result of all these efforts, the Bank of Canada was able to deliver on its commitment to Canadians in 2002, while enhancing its capacity to meet future challenges.

David A. Dodge

ABOUT
THE BANK



THE BUSINESS OF THE BANK

The Bank of Canada's responsibilities focus on the goals of low and stable inflation, a safe and secure currency, financial system stability, and the efficient management of government funds and public debt. These responsibilities are carried out as part of the broad functions described below.

Monetary Policy

Contributes to solid economic performance and rising living standards for Canadians by keeping inflation low, stable, and predictable

Currency

Designs Canada's bank notes (including anti-counterfeiting features), issues and distributes new bank notes, and replaces worn notes

Central Banking Services

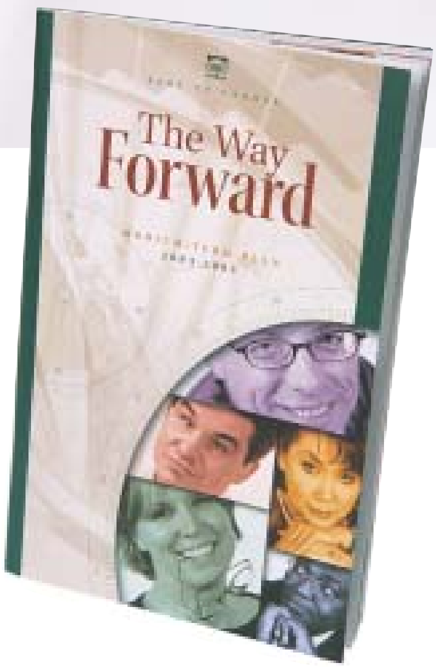
Promotes financial system stability and provides efficient funds-management services to the federal government

Retail Debt Services

Ensures that all holders of Canada Savings Bonds and Canada Premium Bonds have their information registered and their accounts serviced through efficient operations and systems support

Corporate Administration

Provides expertise in a range of services, such as human resources, technology, finance, communications, and administration



LOOKING **AHEAD**

The Medium-Term Plan

In 2002, the Bank established an ambitious new medium-term plan that describes its objectives for the next three years. Three major themes emerge and apply Bankwide: leading-edge research, partnerships with outside organizations and individuals, and clear communication among our ourselves and with Canadians.

To implement the plan, three Bankwide priorities were identified: to develop methods to enhance the effective sharing of knowledge throughout the organization; to attract, engage, and retain quality staff; and to provide certainty and soundness in our work environment through effective risk management and comprehensive measures for business continuity.

The Way Forward

Implementation of the plan will affect all of the Bank's functional areas as well as its regional offices.

Monetary Policy

The Bank will broaden its research and analysis on structural and sectoral issues affecting the economy. It will also strengthen its regional presence to enhance its contacts with provincial governments, industry, educational institutions, and the public. By augmenting our research capability in the regions we hope to improve our understanding of regional and sectoral economic trends.

Currency

A new bank note strategy will focus on increasing the security of bank notes, educating Canadians to recognize counterfeits, and raising the awareness of police officers and prosecutors with regard to the economic and social costs of counterfeiting.

Central Banking Services

Here, the Bank will conduct research and develop policy approaches regarding payment, clearing, and settlement systems, financial markets, and its role as lender of last resort.

As fiscal agent for the Government of Canada, the Bank will be increasing its research and analytic capacity in the area of managing the government's foreign exchange reserves, treasury, and domestic debt. It will also be introducing new policy frameworks, performance benchmarks, and information and transactions-processing systems to enhance operational excellence and improve risk management.

Retail Debt Services

The Bank will oversee operations that have been outsourced, strive for further efficiencies, and provide solid policy advice to the Department of Finance and its agency, Canada Investment and Savings, regarding the retail debt program.

Corporate Administration

This function will continue to restructure its operations to enhance its focus on the specialized work of human resources, technology, finance, and communications to reduce costs and provide staff throughout the Bank with what they need to accomplish their goals.

www.bankofcanada.ca

New Features and Services

The Bank continued to use the World Wide Web in 2002 as a key means of communicating its monetary policy messages to the public. Use of the Bank's Web site increased throughout the year, reaching an average of 125,000 visits (360,000 page hits) per week.

In January, the Bank began a regular schedule of live audio "Webcasts" of the Governor's speeches, press conferences, and other public appearances. These have proven particularly popular with the media and the markets, making "real-time" access to such events more convenient.

Nearly 3,400 subscribers have signed on to "Bank Messenger," a service launched in January that allows the public to receive immediate e-mail notification of new speeches, research papers, press releases, and other publications or events.

Another new feature, *Research at the Bank of Canada* (which will be updated annually), describes key aspects of the Bank's research program, including its broad themes for 2002 and brief summaries of work being conducted in support of each of the Bank's functions.

The Web site also helps Bank watchers to anticipate the general direction of monetary policy by offering a growing array of data on various key indicators. A significant step in this respect was the addition in October of a new data set, *Indicators of Capacity and Inflation Pressures for Canada.* This includes both standard indicators—such as the CPI, wages and costs, and labour market information—and data from business surveys conducted by our regional offices.

In December, the Bank's Currency Museum launched a new site that offers on-line visitors a virtual tour of the Museum's collection as well as a detailed history of the evolution of money.

Financial Requirements

To achieve the goals outlined in the medium-term plan, there will be an increase in operating expenses over the next three years, which will be partly offset by savings from further planned changes to the delivery of corporate services. The net increase in expenditures will support the Bank's expanded research program, a new bank note strategy, its enhanced role in funds management, and Bankwide initiatives in talent and knowledge management and technology.

Board meeting at Head Office

CORPORATE STRUCTURE: **PROVIDING LEADERSHIP**

Board of Directors

The Bank's Board is responsible for the governance of the Bank and has specific duties related to finance, human resources, and administration. The Governor is responsible for monetary policy and the other business of the Bank.

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 outside Directors come from across Canada and provide an important link to the various regions of the country. Directors are appointed for three-year terms by the Minister of Finance and may be reappointed at the end of their terms. If an appointment decision is delayed, Directors continue to fulfill their responsibilities as Board members until a new Director is named.

Board Stewardship in 2002

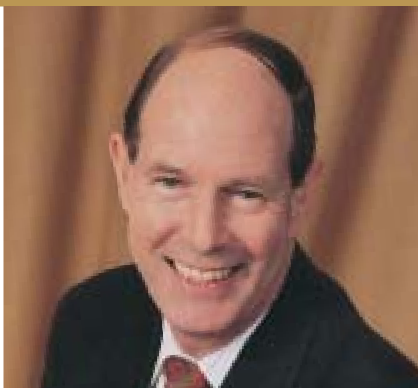
During 2002, the Board took an active role in developing the Bank's new medium-term plan. This included exploring the overall direction of the plan, its priorities, and the resources required to meet the plan's objectives. The Board continued to take a particular interest in the restructuring of the Corporate Services Department as a follow-up to the outsourcing of the operations and systems supporting retail debt services in 2001.

Given the increased incidence of counterfeiting, members of the Board formed an Advisory Group on Currency in 2002 to work closely with management and the Bank's currency experts on the new bank note strategy incorporated in the Bank's medium-term plan. A review of the Advisory Group's mandate is planned for the end of 2003.

The Board's oversight includes an interest in the Bank's risk-management framework, as well as in measures developed to ensure the security and continuity of the Bank's critical business operations following any unexpected events. Efforts in both these areas were enhanced in 2002 in light of uncertainties in the external environment.

The Board has also been closely following the Bank's new approach to developing the talent required to meet its business objectives and future leadership needs, especially in the

THE BOARD OF **DIRECTORS**



David Dodge

Malcolm Knight

Paul J. Massicotte

David Dodge
Governor

Malcolm Knight
Senior Deputy Governor

Paul J. Massicotte
Montréal, Quebec
Appointed in June 1995
Lead Director

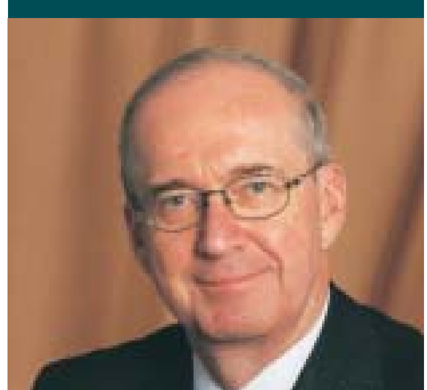
Raymond Garneau
Westmount, Quebec
Appointed in March 1996

James S. Hinds
Sudbury, Ontario
Appointed in March 1996

J. Spencer Lanthier
Toronto, Ontario
Appointed in March 2000

Raymond Garneau

James S. Hinds

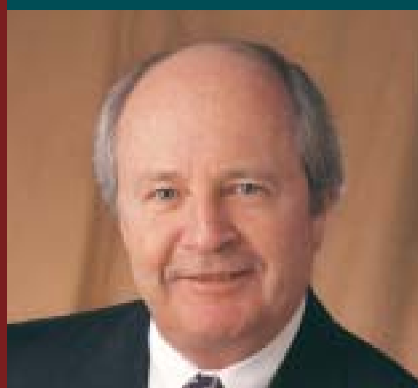


J. Spencer Lanthier


Winston Baker


Kit Chan

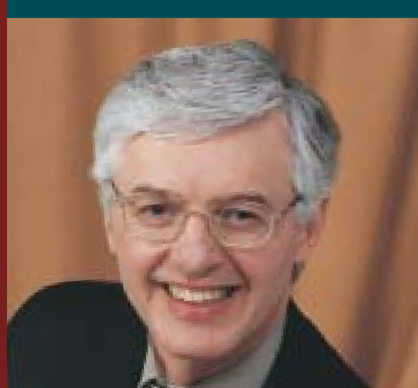

Walter Dubowec


Daniel F. Gallivan


Barbara Hislop


Aldéa Landry


Barbara Stevenson


Kevin Lynch

Winston Baker [1]
St. John's, Newfoundland
Appointed in March 1996

Kit Chan
Calgary, Alberta
Appointed in April 1999

Walter Dubowec [2]
Winnipeg, Manitoba
Appointed in March 1996

Daniel F. Gallivan
Halifax, Nova Scotia
Appointed in July 2000

Barbara Hislop
Vancouver, British Columbia
Appointed in March 1998

Aldéa Landry
Moncton, New Brunswick
Appointed in March 1996

Barbara Stevenson
Charlottetown, Prince Edward Island
Appointed in October 1994

Kevin Lynch
Deputy Minister of Finance
Member *Ex officio*

[1] On 10 December, Paul Dicks of Corner Brook, Newfoundland was appointed by Order-in-Council to replace Mr. Baker.

[2] On 10 December, Armin Martens of Winnipeg, Manitoba was appointed by Order-in-Council to replace Mr. Dubowec.

One position was vacant on 31 December 2002.

THE BOARD OF DIRECTORS

David Dodge

Governor

Malcolm Knight

Senior Deputy Governor

Paul J. Massicotte

Lead Director, Chair, Corporate Governance Committee, and member, Executive Committee and Advisory Group on Currency

Chartered Accountant

- President and Chief Executive Officer, Alexis Nihon REIT
- Member, Board of Directors of the Council for Canadian Unity
- Member, Board of Directors of St. Anne's Hospital Foundation

Raymond Garneau

Member, Audit Committee

- Chairman of the Board of Industrial Alliance, Insurance and Financial Services and its subsidiaries, National Life of Canada and Industrial Alliance Pacific Insurance and Financial Services
- Member of the boards of directors of several corporations, including MAAX Inc. and Canadian Life and Health Insurance Ombudservice

James S. Hinds

Member, Audit Committee, Human Resources and Compensation Committee, Premises Committee, and Pension Trust Funds

Lawyer

- Partner, Hinds and Sinclair

J. Spencer Lanthier

Chair, Audit Committee and Advisory Group on Currency, and member, Executive Committee and Corporate Governance Committee

Chartered Accountant

- Vice-Chair and Board Member, TSX Group Inc.
- Member, Board of Directors, Gerdau AmeriSteel Inc.
- Member, Board of Directors, Ellis-Don Inc.
- Member, Board of Directors, Bruce Power Inc.
- Member, Board of Directors, Intertape Polymer Group Inc.
- Member, Board of Directors, The Canada Life Assurance Company and Canada Life Financial Corporation
- Member, Board of Directors, TorStar Corporation

Winston Baker

Member, Audit Committee and Human Resources and Compensation Committee

Former educator and politician

- President, WB Holdings Ltd.

Kit Chan

Chair, Premises Committee, and member, Human Resources and Compensation Committee and Advisory Group on Currency

- Principal, KBC Enterprises Ltd.
- Co-Chair, 2003 United Way Campaign for United Way of Calgary and Area
- Director and Corporate Secretary of ACT Cinemage Group Ltd.
- Partner, Canada Education Inc.
- Partner, Good Earth Art

Walter Dubowec

Member, Human Resources and Compensation Committee and Premises Committee

Chartered Accountant

- Former Office Managing Partner, Deloitte & Touche LLP
- Chairman and President, The Joe Brain Foundation Inc. and its subsidiary, J.M.B. Canadian Explorations Ltd.
- Treasurer, Foundation for Health Inc.
- Director, Manitoba Medical College Foundation
- Director and Treasurer, The Antonia Kotowich Foundation Inc.
- Member, The Associates, Asper School of Business
- Member and Advisor, Saint John's Haven Inc.
- Member of the Canadian Club of Winnipeg
- Lay member of the Financial Council of the Ukrainian Catholic Archeparchy of Winnipeg

Daniel F. Gallivan

Member, Audit Committee, Premises Committee, and Advisory Group on Currency

Lawyer

- Partner, Cox Hanson O'Reilly Matheson
- Director, Ombudsman for Banking Services and Investments
- Director, ASCO Canada Ltd. and ASCO (K&D) Ltd.
- Secretary, NovaScotian Crystal Limited
- Director, Nova Scotia Sports Hall of Fame

Barbara Hislop

Member, Executive Committee, Corporate Governance Committee, and Human Resources and Compensation Committee

- Officer, Canfor Corporation
- President and CEO, Genus Resource Management Technologies Inc.
- Director, Forintek Canada Corporation
- Director, Hudson's Bay Company
- Director, Vancouver Board of Trade

Aldéa Landry

Chair, Planning and Budget Committee and Nominating Committee (Fellowship Program), and member, Executive Committee and Corporate Governance Committee

Lawyer

- President, Landal Inc.
- President, J.F.L. Arbitration Services Inc.
- Director, The Shaw Group of Halifax
- Chair, TVA National Advisory Group (National Television Network)
- Vice-Chair, Atlantic Venture Network Group
- Director, Beauséjour Medical Research Institute
- Member, Atlantic Provinces Economic Council
- Member of the Board, YMCA

Barbara Stevenson

Chair, Human Resources and Compensation Committee, and member, Audit Committee

Lawyer

- Partner, Carr, Stevenson & MacKay
- Director, CSM Holdings Company Ltd.
- Director, Island Home & Mortgage Services Ltd.
- First Vice-President, Heart and Stroke Foundation of Prince Edward Island

Kevin Lynch

Deputy Minister of Finance

(Ex officio)

- Member, Executive Committee

area of succession planning. Other initiatives of interest to the Board included the enhancement of research and analytical capabilities over the medium term and a review of the Bank's pension plan.

The Board's broad oversight responsibility includes monitoring the effectiveness of the process by which monetary policy is conducted, including the standards applied in gathering information, the quality of the staff, and the analysis they provide. To gain an independent, expert perspective on the Bank's work, the Board met in private sessions with representatives of the International Monetary Fund and with Special Adviser, John Chant, an academic who worked with the Bank's management team for a one-year period ending in July 2002.

Board Governance Practices

The Board continually monitors best governance practices appropriate to the Bank. After reviewing the Saucier report, *Beyond Compliance: Building a Governance Culture,* the Board made minor changes to the responsibilities of the Lead Director. Following this review, the Board was reassured that its current governance practices were in line with the best practices reflected in the report.

The Board has six standing committees and one advisory group to deal with the issues brought to it for consultation or decision:

- Executive Committee
- Corporate Governance Committee
- Human Resources and Compensation Committee
- Audit Committee
- Planning and Budget Committee
- Premises Committee
- Advisory Group on Currency

The Lead Director and the Chair of the Human Resources and Compensation Committee meet annually with the Governor and Senior Deputy Governor to review their performance and to discuss objectives for the coming year. The Corporate Governance Committee and the Board as a whole also contribute to the annual performance evaluations of the Deputy Governors, the General Counsel/Corporate Secretary, and the Chief Administrative Officer.

To ensure that the Board can operate independently of management, the Lead Director chairs private sessions of outside Directors at the conclusion of each Board meeting. In 2002, the Board continued the annual practice of evaluating its stewardship to ensure that best practices of corporate governance have been followed.

Directors are paid according to a fee structure recommended by the government and approved by Order-in-Council. For 2002, the total remuneration to outside Directors was $260,400.

Governing Council

The Governor, the Senior Deputy Governor, and four Deputy Governors sit on the Governing Council, which takes responsibility for monetary policy and decisions concerning financial systems. The Council operates on a consensus basis when reaching policy decisions on the setting of the target for the overnight interest rate. These decisions are normally announced on eight scheduled dates each year.

GOVERNING COUNCIL (From left to right) ›

PIERRE DUGUAY
Deputy Governor
Domestic economic issues/Bank notes

SHERYL KENNEDY
Deputy Governor
Financial markets

CHARLES FREEDMAN
Deputy Governor
Financial institutions/Clearing and settlement systems

PAUL JENKINS
Deputy Governor
International economic and financial issues/Public communications

MALCOLM KNIGHT
Senior Deputy Governor
Chief Operating Officer

DAVID DODGE
Governor
Chairman of the Board of Directors

Executive Management Committee (left to right): Standing: Mark Jewett, Malcolm Knight, Sheryl Kennedy, Dan MacDonald, David Dodge, Paul Jenkins. Seated: Charles Freedman, Janet Cosier, Pierre Duguay, Gerry Gaetz

Executive Management Committee

The Executive Management Committee ensures that matters related to strategic direction and management receive close attention at the executive level. This Committee also supports a delegated and coordinated approach to decision-making. The Executive Management Committee includes the members of the Governing Council, the General Counsel/Corporate Secretary, the Chief Administrative Officer, the Adviser on Strategic Planning and Risk Management, and the Chief of the Corporate Services Department.

The Bank's operations are organized into ten departments. Department chiefs are responsible for the operations in their own areas and for ensuring that the policies and priorities of the Bank are implemented. Each department chief has an agreement with a member of the Executive Management Committee that outlines the department's overall objectives and financial authority for the coming year.

Management Forum

Consisting of the Executive Management Committee, advisers, department chiefs, and the directors of human resources and finance, the Management Forum meets regularly to exchange information on management issues and to review corporate policy proposals.

BANK OF CANADA REGIONAL OFFICES

Regional Representatives

The Bank's regional offices strengthen its ties with industry, government, educational institutions, and other organizations and associations across the country. They make an important contribution to the Bank's understanding of financial markets and regional economic developments and to promoting awareness of bank note security features. Representatives in the Toronto and Montréal offices consult regularly with financial market participants across the country. In 2002, the Bank established a post in New York to enhance communication with the financial community there.

AN ACCOUNT OF OUR **STEWARDSHIP**

MONETARY POLICY

"The economy's strong performance owes much to the sound policy framework and its skillful implementation. Inflation targets have helped to anchor expectations and permitted a forceful injection of monetary stimulus in the face of last year's shocks."

2003 Article IV Consultation, Statement of the IMF Mission (15 November 2002)

By keeping inflation low, stable, and predictable, the Bank of Canada's monetary policy contributes to solid economic performance and rising living standards for Canadians.

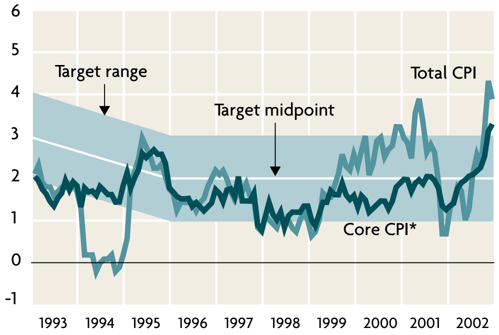
The keystone of our framework for monetary policy is an inflation-control target range for the consumer price index (CPI) centred on a 2 per cent target midpoint. This target has resulted not only in stable and more predictable inflation, but in a stronger and more stable economic environment in general.

Monetary policy is implemented by changing the target for the overnight interest rate. This target rate influences other interest rates and other rates of return, as well as the exchange rate for the Canadian dollar. Over time, these rates affect total spending, which in turn, eventually has an impact on inflation. Thus, the influence of the Bank's action on inflation typically builds up slowly over a period of 18 months to 2 years.

Inflation-Control Targets and Economic Stability

A major source of pressure on inflation is the degree of overutilization or underutilization of the country's production capacity. Monetary policy aimed at stabilizing inflation will therefore tend to stabilize capacity pressures as well. Since capacity evolves only slowly through time, this means that output growth will also tend to be steadier. This is, indeed, what has been observed in Canada since the adoption of inflation-control targets in 1991. Output growth has been much more stable than it was in the 1980s, and capacity pressures have been steadier as well.

Consumer Price Index
Year-over-year percentage change



* CPI excluding the eight most volatile components and the effect of changes in indirect taxes on the remaining components

Meeting the Inflation Target

The Bank's core measure of inflation, which is used as an operating guide, began the year just below the 2 per cent target and then hovered around 2.2 per cent from February to July. It subsequently rose, reaching a peak of 3.1 per cent in November, largely because of a number of one-time factors related to electricity prices, automobile insurance premiums, and a rebound from temporarily low prices for certain goods a year earlier. Total CPI inflation increased more rapidly, to rates above the target range in the last three months of the year, because of rising petroleum prices and tobacco tax hikes coming on top of the increase in core inflation.

The increases in both measures of inflation in late 2002 were, however, larger than the Bank had been anticipating. This reflected both more persistence in insurance premium increases and some broadening of price pressures. By January 2003, the Bank concluded that the higher-than-expected rates of inflation, together with various measures of capacity pressures, were indicating that the Canadian economy was likely operating closer to capacity than previously assessed.

However, expectations of inflation over the medium term and for longer time horizons, whether based on average private sector forecasts or on the spread between the yields on conventional and inflation-indexed bonds, remained near 2 per cent.

Early in 2002, concerns persisted as to how rapidly the Canadian and U.S. economies would recover from the 2001 slowdown and the decline in consumer and business confidence following the September 2001 terrorist attacks. As a result, the Bank lowered its target for the overnight interest rate by 25 basis points to 2 per cent on its January fixed announcement date. Over the next three months, it became apparent not only that there had been no increase in economic slack in the Canadian economy in the fourth quarter of 2001, but that both the Canadian and U.S. economies had grown strongly in the first quarter of 2002. On its April fixed announcement date, the Bank therefore began to gradually reduce the large amount of economic stimulus in the system. A 25-basis-point increase in the target overnight rate on that date was followed by two similar moves in June and July, taking the target rate to 2.75 per cent, as Canadian economic growth remained strong in the second quarter.

In subsequent months, uncertainty regarding the pace of recovery in the U.S. and global economies increased. Uncertainty also rose in financial markets, connected partly with U.S. scandals in corporate governance and accounting. As well, there were growing geopolitical risks related to the situation in the Middle East. Largely as a result of these factors, the rate of economic expansion slowed in the second half of 2002 to close to the Bank's estimate of potential growth of 3 per cent, and the Bank held its target rate constant through the last five months of the year and into early 2003. As we go forward, with an appropriate reduction in the amount of monetary stimulus, the *level* of output is expected to remain close to capacity during 2003 and into 2004, and core inflation is projected to return to the 2 per cent target over this time horizon.

Volatile Energy Prices and the CPI

Energy prices have been the major source of volatility in the total CPI in recent years. From late 1997 to early 1999, declining energy prices kept CPI inflation at or below the bottom of its target range of 1 to 3 per cent for much of that period. Then, from mid-1999 to mid-2001, a significant rise in energy prices pushed total CPI inflation well above core inflation for two years. The most recent cycle in energy prices drove total CPI inflation below target in late 2001 and above target in late 2002. Because of the lags between policy actions and their effects on inflation, such largely unpredictable and typically short-lived movements in energy prices cannot be offset by monetary policy. These movements illustrate why the Bank focuses on a core inflation measure—which excludes volatile price components—as its operating guide.

Assessing International Developments

As in 2001, most of the shocks affecting the Canadian economy in 2002 had their origins abroad, particularly in the United States. The exchange of information within the international groups in which Bank officials participate continued to be invaluable. These include meetings of G-10 central bank governors, other regular meetings held at the Bank for International Settlements, working parties and committees of the Organisation for Economic Co-operation and Development, and meetings of the International Monetary and Financial Committee of the International Monetary Fund, the G-20, the G-10, and the G-7. Canada chaired the meetings of G-7 finance ministers and central bank governors in 2002, hosting a meeting in the National Capital Region in

November 2002 Research Conference Speakers: (top) Michael Devereux, University of British Columbia; (bottom, left to right) Martin Eichenbaum, Northwestern University; Beverly Lapham, Queen's University; Sharon Kozicki, Federal Reserve Bank of Kansas City

February. The Bank also initiated the use of video teleconferencing for selected international meetings, including discussions among G-7 central bank deputies.

Bank staff continue to provide insights and advice on the use of inflation targeting in the context of a flexible exchange rate regime through international meetings in which emerging-market countries participate, as well as through technical assistance offered at the Bank and abroad.

Promoting an Understanding of Monetary Policy

In 2002, the Bank continued to expand communications regarding its conduct of monetary policy and the roles of the exchange rate and Canada's floating exchange rate regime. It used speeches, presentations, and numerous *Review* articles to explain the Bank's procedures and continuing research in these areas.

The Bank places a high priority on an ongoing dialogue with industry, government, and academia about economic and monetary policy issues. Regional staff are actively involved in this process. They also assist the Governing Council and the Directors with their communications activities across Canada.

Fellowship Program Announced

Launched in 2002, the Bank of Canada Fellowship Program will contribute importantly to the Bank's objective of fostering leading-edge research through partnerships with outside organizations and individuals. Fellowships will be offered to academics with a proven track record of excellence in a field of research critical to the Bank's mandate and who have the potential to continue to make an outstanding contribution in their area of research. A Fellowship consists of a salary stipend, as well as funds for research assistants and related expenses. The first fellowships will be awarded early in 2003. The Bank's new Fellowship Program will bring Fellowship recipients to the Bank for three days each year to discuss their research findings with Bank researchers and policy-makers.

(For further information, see www.bankofcanada.ca/fellowship)

Communications Conference: Manfred Körber, European Central Bank, and David Hawley, International Monetary Fund

Bank Hosts Communications Conference

The first international central bank communications conference was hosted by the Bank in October 2002. It brought together communications professionals from major central banks around the globe. The conference addressed a number of themes that in one way or another occupy all central banks in communicating monetary policy: strategic communications, dealing with the media, communicating with the general public, public education, crisis communications, current and future uses of central bank Web sites, and performance measurement. The presentations and discussion confirmed the common challenges communicators face in an environment of increasing openness and transparency, as well as different views on how to approach these challenges.

Carrying Out Research and Analysis

Research and analysis are key to formulating and implementing monetary policy. Bank researchers actively took part in some 90 academic and central bank seminars and conferences in 2002. During the year, the Bank participated in a number of formal partnerships with foreign central banks,

academic research institutes, and individual academics. There were also about 40 informal relationships with academic researchers who made presentations at Bank-sponsored seminars, workshops, and conferences.

The Bank's annual research conference in 2002 assessed the current state of knowledge on how price- and wage-setting decisions are affected by monetary policy and vice versa. As an inflation-targeter, the Bank continues to place a high priority on this area of research. In this context, the Bank has begun a survey of the price-setting behaviour of firms in Canada.

A listing of the Bank's economic research, published both internally and externally, appears in the annual booklet, *Bank of Canada Publications Catalogue,* introduced in 2002. During the year, the Bank published a record 42 working papers.

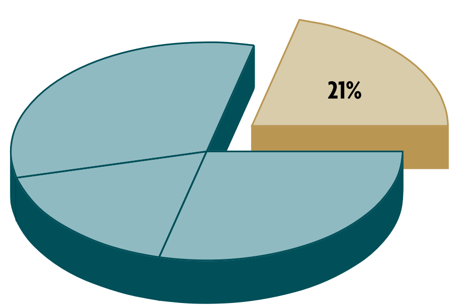
With the adoption of its new medium-term plan, the Bank began to broaden its research on the structural and sectoral issues that affect the Canadian macroeconomy. These include issues related to aggregate productivity and labour markets. The plan also placed a high priority on research to assess the implications of the changing structure of credit markets in the transmission of monetary policy.

In the medium term, the Bank's regional staff will be expanded to strengthen the research and analysis related to regional surveys, as well as to other regional and industrial topics.

Operating Expenses

Operating expenses for monetary policy in 2002 increased from 2001 levels, consistent with plans for this function. The Bank spent $51.1 million in 2002, approximately 21 per cent of its total operating expenses (before restructuring and related expenses) on formulating and implementing monetary policy, compared with $43.4 million in 2001. Part of the increase in expenses relates to planned increases in staff resources associated with increased research on structural and sectoral issues, as well as enhanced communications efforts.

Monetary Policy Activities as a Proportion of Total Bank Expenses

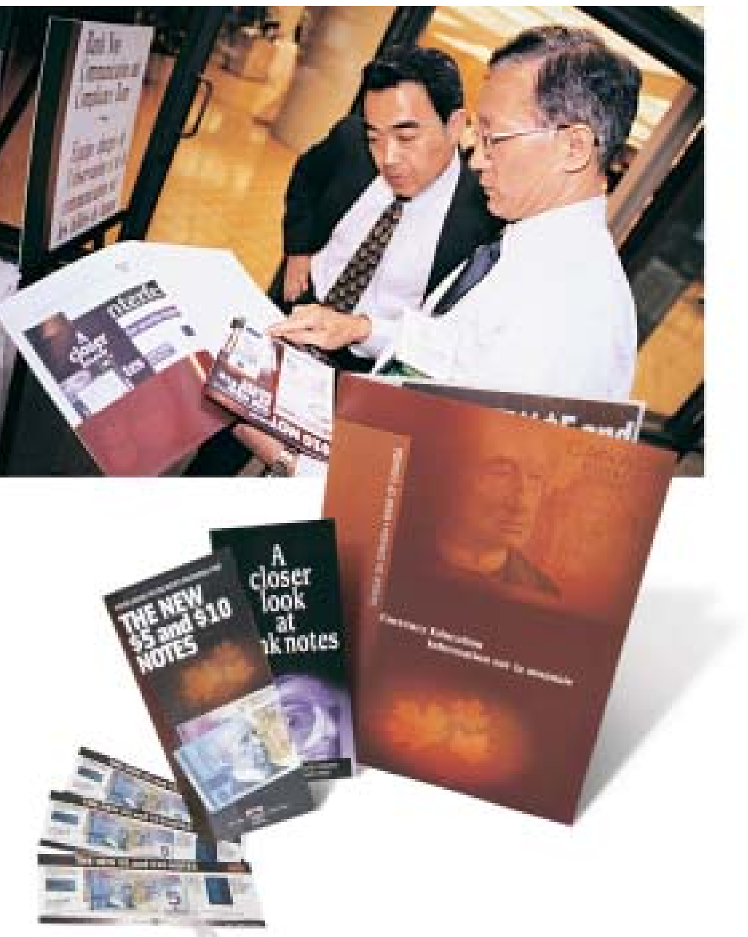


Launch of the new $5 note: Celebrated Canadian author, Roch Carrier, with excerpt from his well-loved tale, *The Hockey Sweater.* Inset: Hockey legend, Jean Béliveau and Kim St. Pierre, goalie of Canada's gold medal women's hockey team.

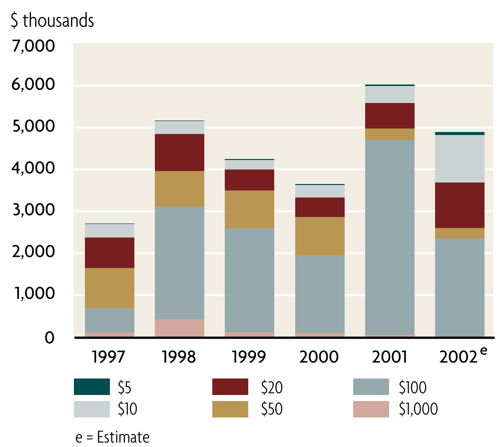
CURRENCY

Canadians depend on the Bank of Canada to supply bank notes in which they can have confidence and to make these notes available readily and economically. An ongoing challenge facing the Bank is counterfeiting, which has increased in recent years with the use of new and more sophisticated technologies.

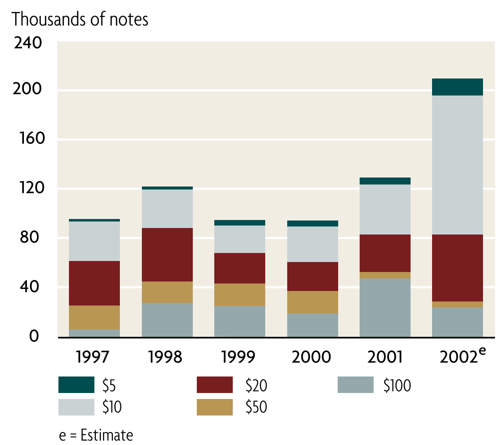
The Bank has responded aggressively to this threat by investing in programs aimed at raising public awareness of counterfeit-detection practices, deterring counterfeiting through initiatives with enforcement agencies, and enhancing the security features in bank notes.



Value of Counterfeit Bank Notes Found in Circulation



Number of Counterfeit Bank Notes Found in Circulation



The Incidence of Counterfeiting

The *number* of counterfeit notes increased from 130,000 in 2001 to an estimated 210,000 in 2002, driven by a substantial rise in the number of counterfeit $10 notes.

At the same time, the *value* of counterfeit notes fell from $6.0 million in 2001 to an estimated $5 million in 2002. This decline is due to a drop in the number of counterfeit $100 notes detected in circulation, following the arrest, in July 2001, of those responsible for a major counterfeiting operation.

Although the number of counterfeit notes found in circulation is very small relative to the 1.4 billion genuine notes, the cost to Canadians from counterfeiting can be significant. It goes beyond the direct loss borne by those accepting counterfeit notes. Most important is the potential loss of trust in bank notes as a means of payment if individuals worry that the bank notes they are using are not genuine or will not be readily accepted.

Raising Public Awareness

One of the best defences against counterfeiting is a well-informed public. Bank notes include many security features, but these are effective only if the public recognizes them and knows how to use them.

In March 2002, the Bank issued its new $5 note, the second denomination in the *Canadian Journey* series launched in January 2001. The introduction of the $5 note, titled *Children at Play,* provided an opportunity to further promote public awareness and understanding of the security features on all existing notes. A national media launch, held in Montréal, was supported by same-day technical briefings for the media in various regions, followed by post-launch education seminars across the country.

Over the course of the year, some 450 presentations on counterfeit-detection techniques were made to cash handlers in the retail and financial services sectors, as well as to business and civic groups, educational institutions, and law-enforcement agencies. This represents a 50 per cent increase over 2001.

These presentations were complemented by other initiatives: media interviews; responses to public inquiries; and the distribution of posters, leaflets, training videos, information kits, DVDs, and CD-ROMs. The Bank also introduced an Internet-based training video as an alternative method of delivering information about bank note security.

Partnerships were also formed with national and regional associations that have a particular interest in counterfeit detection, such as the Retail Council of Canada and the Conseil québécois du commerce de détail. A coordinated public awareness and compliance campaign was successfully implemented in collaboration with the Calgary Police Service through their Downtown Business Liaison Program. Work is underway to expand such partnerships into a more integrated national program.

The Currency Museum

The Currency Museum's travelling exhibit, *The Colour of Your Money,* introduced in 2001, opened in Montréal concurrently with the launch of the new $5 note, before moving to Kenora and Fort Frances. Since December 2002, part of the Museum's collection can be accessed on-line, through the Bank's Web site. This is expected to significantly expand the Museum's reach beyond the 40,000 visitors to its Ottawa location each year.

Promoting Improved Deterrence and Compliance

In 2002, the Bank began to work more closely with agencies that enforce Canada's anti-counterfeiting laws. This involved presentations to Crown prosecutors on the social and economic significance of counterfeiting and the provision of information to police officers to help them in effectively pressing charges.

The Bank also increased its contacts with provincial and municipal law-enforcement agencies to monitor local counterfeiting, support enforcement initiatives, and coordinate education activities. We continued to work closely with the Royal Canadian Mounted Police to monitor and analyze counterfeiting across the country.

Checking out exhibits at the Bank's Currency Museum

Improving Security

As the threat of counterfeiting continues to grow, the Bank is moving to a higher level of security for higher-denomination notes — the $20, $50, and $100. A reassessment of possible security features for these notes was undertaken during 2002, drawing upon expertise from other central banks and developers of bank note security products. These efforts led to the selection of a suite of new and more sophisticated security features that will be easier for the public to recognize and that will make it more difficult to counterfeit genuine notes.

The design of the high-denomination notes of the *Canadian Journey* series is now well underway, with the launch of one denomination planned for the first half of 2004 and the remaining two over the subsequent 12 months.

As an international threat, counterfeiting demands a coordinated international response. Accordingly, the Bank is actively involved in several initiatives with other central banks, note-issuing authorities, and equipment manufacturers and suppliers. These initiatives range from providing a forum for the exchange of views on all aspects of the design, production, and distribution of bank notes to active co-operation in developing, assessing, and implementing new bank note technology.

One example of such involvement is the Central Bank Counterfeit Deterrence Group (CBCDG), established in 1993 by the governors of the G-10 central banks and chaired by a senior officer of the Bank of Canada. The group's main task has been the development of a system to defeat computer-based counterfeiting. In 2002, there was significant deployment of the system in digital reprographic equipment and software.

Meeting the Demand for Bank Notes

It is not enough for bank notes to be secure; they must also be available when and where Canadians need them. For the Bank, this means anticipating demand, managing inventories, and dealing with the complexities of distributing a new series of notes. We work closely with financial institutions to ensure that the national bank note distribution system operates efficiently. By the end of 2002, there were $41.1 billion of notes in circulation, a 6 per cent increase over the previous year.

In 2002, the Bank initiated a review of its bank note inventory strategy with an academic from the University of Alberta. We also conducted research that confirmed that the public is better able to use the security features, and thus to ascertain if a bank note is genuine, when the note is in good condition. As a result, we plan to replace worn notes more quickly in order to improve the overall condition of notes in circulation. The effects of this change in strategy will be seen over the next few years.

How to Reach the Bank Note Communication and Compliance Program

OTTAWA:

Bank Note Communication and Compliance Team

Tel: 1-888-513-8212
Fax: (613) 782-7533
e-mail: education@bankofcanada.ca
Web site: www.bankofcanada.ca

Currency Museum

Tel: (613) 782-8914
Fax: (613) 782-7761
e-mail: museum-musee@bankofcanada.ca

Contact information for the Bank's regional offices can be found on page 70.

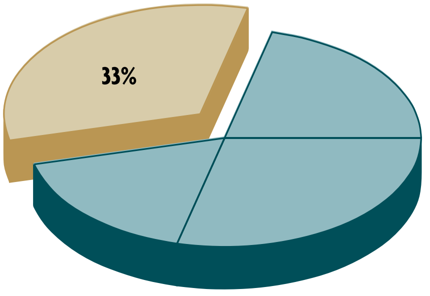
Operating Expenses

Operating expenses for the currency function in 2002 were $78.8 million, about 33 per cent of the Bank's total operating expenses (before restructuring and related expenses). This represents an increase of $13.2 million from 2001.

Much of this increase relates to the production and distribution of bank notes to meet demand and to increase inventory levels ahead of the launch of the new $5 note.

Additional funds were also allocated to the expansion of public education initiatives to deter counterfeiting and to the development of improved security features to protect the integrity of our currency.

Currency Activities as a Proportion of Total Bank Expenses



The Bank's Trading Room

CENTRAL BANKING **SERVICES**

This function involves two major activities: promoting financial stability and providing efficient funds-management services to the federal government.

Promoting Financial Stability

Widespread confidence in financial institutions, markets, and clearing and settlement systems is essential to support economic activity in Canada and abroad. Promoting the safe and efficient operation of these key parts of the financial system is an important activity of the Bank of Canada and other public sector bodies.

Financial Stability Initiatives in 2002

As part of its promotion of financial stability, the Bank

- began publication of its *Financial System Review*. This new semi-annual publication is intended to increase public knowledge of, and discussion about, changes and developments in the Canadian financial system.
- increased the resources devoted to issues concerning financial stability and started organizing a conference on these issues to be held in the second half of 2003.

Clearing and Settlement Systems*

Overseeing major systems

The Bank of Canada contributes to financial stability through its oversight of major clearing and settlement systems under the Payment Clearing and Settlement Act (PCSA). The Bank was particularly active in this role during 2002. Perhaps most important was the commencement of operations by the CLS (Continuous Linked Settlement) Bank. The CLS Bank is a special-purpose bank designed to virtually eliminate the risk associated with the settlement of foreign exchange trades.

Since the Canadian dollar is one of the currencies initially settling in the CLS Bank, the Bank of Canada was part of a group of central banks that examined the proposed risk-control measures. In early September 2002, the Governor of the Bank of Canada designated the CLS Bank as subject to oversight under the PCSA. The Bank of Canada's primary responsibility is to satisfy itself that all risks associated with the settlement of transactions involving the Canadian dollar are adequately addressed.

During 2002, The Canadian Depository for Securities Ltd. (CDS) continued its work to create an enhanced securities clearing and settlement system that would settle virtually all securities trades in Canada, including exchange-traded equities. Built on the sound risk-control arrangements of the Debt Clearing Service (DCS), the new system, called CDSX, is likely to become operational in the first half of 2003 and is expected to be designated for oversight under the PCSA.

The Canadian Payments Association (CPA) operates two payments systems, the Large Value Transfer System (LVTS) and the Automated Clearing Settlement System (ACSS). The ACSS now processes and settles primarily retail payments, since most of the large-value payments that used to be processed through this system have migrated to the LVTS. After extensive analysis by Bank staff, the Governor decided that the operation of the ACSS does not pose systemic risk. Thus, the ACSS will not be designated for oversight under the PCSA. The Bank is continuing to encourage CPA members to move any remaining large-value payments settling through the ACSS to the LVTS. In this regard, effective February 2003, the CPA will prohibit paper cheques with a value of $25 million or more from settling in the ACSS.

* The Bank's Web site (www.bankofcanada.ca) provides detailed information on payments and other clearing and settlement systems.

Updating guidelines for clearing and settlement systems

In 2002, the Bank updated its guidelines and minimum standards for payment and other clearing and settlement systems that are subject to oversight under the PCSA. The new minimum standards incorporate international standards published recently by the Bank for International Settlements and the International Organization of Securities Commissions.

Providing operational support for clearing and settlement systems

The Bank makes a unique contribution to the safe and efficient operation of clearing and settlement systems by providing them with various services, including accounts to settle obligations among participants in these systems and liquidity to system operators and their participants. Thus, the Bank has agreed to act as banker for the CLS Bank, receiving and making payments on its behalf. In addition, the Bank has worked with the CLS Bank and its Canadian participants to provide contingency arrangements should there be operational disruptions in the LVTS or at LVTS participants. Since the CLS Bank began operations, the Bank of Canada, along with the CPA and the CDS, has begun its operational day just after midnight—seven hours earlier than previously.

Examining Systemwide Business-Continuity Planning

The ability of the Canadian financial system to withstand and recover from disruptions in its operations is important not just for system participants, but also for other agents in the economy. Events such as the 1998 ice storm in Eastern Ontario and Quebec, Y2K, and the terrorist attacks of 11 September 2001 in the United States have highlighted the significant degree of interdependence among participants in the financial system with regard to business-continuity plans. In 2002, the Bank began to facilitate discussions among certain financial sector participants regarding the robustness of business-continuity planning in those parts of the financial system that are critically important to the operation of the system and to the economy as a whole. The Bank has also re-examined and enhanced its own contingency arrangements and business-continuity plans.

Promoting International Financial Stability

The Bank continued to be actively involved in developing a framework for the resolution of international financial crises. Of note, an Action Plan published by the G-7 in the spring aimed at increasing the predictability of official policy actions to address problems in emerging-market economies. In the Action Plan, agreement was reached on the need to limit official-sector lending unless clear criteria and procedures are met that justify an exception. The Action Plan also proposed that a two-track approach to facilitate crisis resolution be pursued. One approach would include collective-action clauses in contracts between borrowing countries and lenders, while the second approach would see the adoption of a more formal process, the proposed Sovereign Debt Restructuring Mechanism.

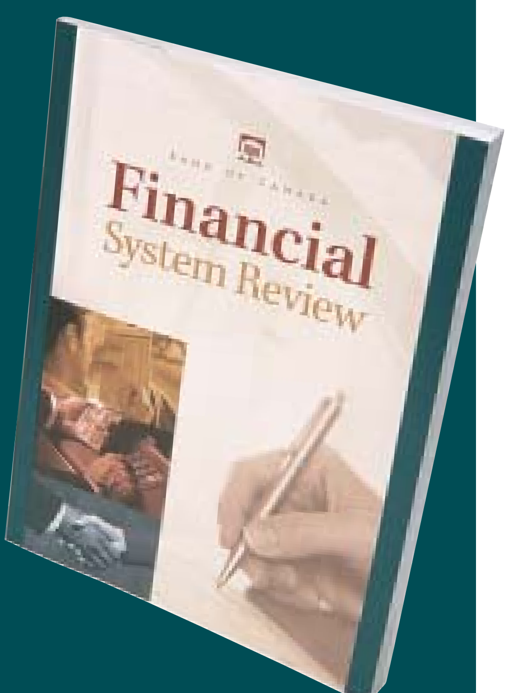
The Bank participates in several international groups that work on international financial-stability issues, including the G-20 and the Financial Stability Forum (FSF). In 2002, the G-20, which met in India in November, focused on globalization issues, as well as on crisis resolution and combatting terrorist financing. The Bank co-hosted the autumn FSF meeting in Toronto. The FSF promotes international financial stability, the improved

Financial System Research

To meet the objectives of the medium-term plan, the Bank continues to build its capacity to conduct research into financial system issues. In some cases, this work is conducted with researchers from outside the Bank. Recent work has included

- developing models on financial contracting and contagion
- considering the effects of consolidation within the financial sector on market liquidity and systemic risk
- developing models of payments systems that can be used to assess the possibility of systemic-risk events
- examining the behaviour of participants and operational-risk issues in clearing and settlement systems
- documenting and analyzing recent trends in capital markets

One particular focal point has been work aimed at improving data related to Canadian capital markets and research examining the efficiency of Canadian capital markets.



functioning of markets, and the reduction of systemic risk through information exchange and international co-operation in financial supervision and surveillance.

As in previous years, Bank staff provided technical assistance to a number of countries in 2002, and participated in selected Financial System Assessment Programs conducted by the IMF.

Financial Markets

One of the main issues facing financial markets during 2002 was the restoration of confidence in their integrity following the collapse of Enron and other corporate scandals in the United States. The Bank contributed to discussions of this issue through speeches by the Governor and participation in a number of public policy forums.

The Bank also works in partnership with other government agencies and market participants to enhance the functioning of Canadian markets, particularly fixed-income markets. For instance, in 2002, the Bank worked with the Investment Dealers Association of Canada, the Montréal Exchange, and other market participants to enhance the methodology for determining daily interest rate settings. These interest rate settings are, in turn, used to price interest rate derivatives and other financial instruments. The Bank also assisted the Canadian Securities Administrators in their efforts to develop appropriate regulation of alternative trading systems in fixed-income markets and supported the Canadian Capital Markets Association in its efforts to promote straight-through processing in Canadian financial markets.

Funds Management

In its role as fiscal agent, the Bank provides the government with treasury and banking services and also advises the government on the management of the federal public debt. These services aim to meet the government's debt-management objective of stable, low-cost funding.

Providing Treasury and Banking Services and Advice

Debt-management initiatives in 2002 centred on improving the Bank's analytic capabilities in this field and further refining the bond-buyback program. Research was conducted to support a sophisticated simulation-based approach for analyzing debt structure cost and risk trade-offs. Refinements to the bond-buyback program were implemented, following consultations with market participants. These refinements included the introduction of measures enabling investors to exchange outstanding debt issues for new issues of current benchmark securities, as well as an expansion of the basket of eligible bonds in the buyback program. In addition, the time between the deadline for the submission of bids and the release of regular auction results was further reduced this year—from 15 minutes to 10 minutes. This followed a reduction from 30 minutes in 2001.

Investing Government Funds

The Bank manages the investment of the government's Canadian-dollar cash balances and its foreign exchange reserves.

Domestic cash balances range between $1 billion and $15 billion, typically rising to the upper end of this range prior to quarterly principal and interest payments. A new investment framework for morning auctions of government cash balances was implemented in 2002. It involves the use of collateral to facilitate broader participation in the auctions and to reduce exposure to credit risk.

Unclaimed Balances

Chartered banks and federally chartered trust and loan companies are required to transfer to the Bank of Canada all unclaimed balances maintained in Canada in Canadian currency that have been inactive for a period of ten years.

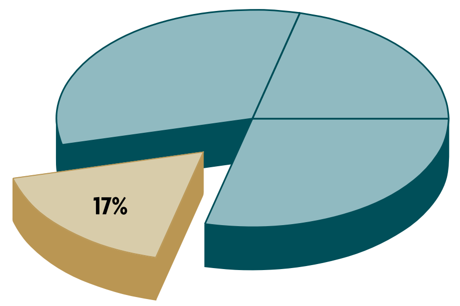
Members of the public can use the search facility on the Bank's Web site at www. bankofcanada.ca to find out if there is an unclaimed balance to which they may be entitled and for information on making a claim. Information on unclaimed balances can also be obtained from any of the Bank's regional offices (see page 70 for addresses), by calling the Bank's toll-free line at 1-888-891-6398, or by e-mail at ucbalances@bankofcanada.ca.

During 2002, financial institutions transferred $31.0 million in unclaimed balances to the Bank. In addition, the Bank handled more than 21,100 general inquiries, completed more than 43,000 searches, and paid a total of $7.5 million to satisfy 6,900 claims.

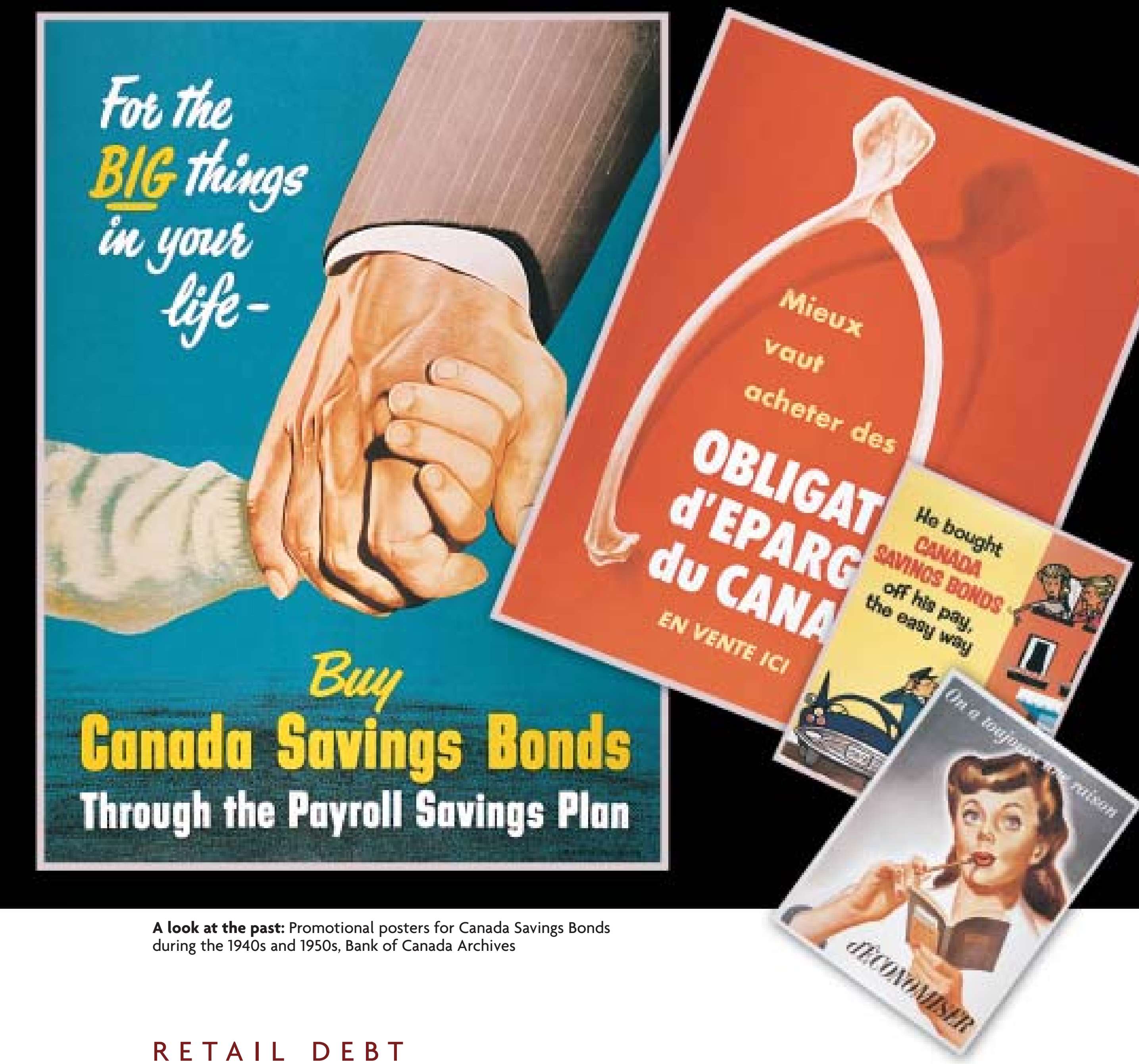
Foreign exchange reserves are held to provide general liquidity for the government and to provide funds to help promote orderly conditions in the Canadian-dollar foreign exchange market. Foreign exchange reserves stood at US$37.2 billion at the end of 2002, up from US$34.2 billion at the end of 2001, primarily owing to a revaluation resulting from the appreciation of the euro against the U.S. dollar. Work in this area was directed at three large initiatives. The first was the renewal of the government's standby arrangements with foreign banks. The others were aimed at improving risk management in the portfolio of the Exchange Fund Account. One project involved implementing a new collateral-management framework, including the development of a repo program, to better manage the credit risk associated with the government's exposure to financial institution counterparties in its cross-currency swaps, forward contracts, and deposit investments. The other project saw the start-up of a new system for trading, portfolio management, risk management, and accounting in the Exchange Fund Account.

Operating Expenses

Central Banking Services Activities as a Proportion of Total Bank Expenses



Operating expenses for central banking services were $41.0 million in 2002, or about 17 per cent of the Bank's total operating expenses (before restructuring and related expenses). This represents an increase of $9.9 million from 2001, resulting from a number of factors. In 2002, the Bank experienced the first full year of costs arising from improved disaster-recovery arrangements for Bank systems that support the clearing and settlement of financial transactions. Staff resources devoted to financial stability also increased in 2002, and the Bank began publication of the *Financial System Review*. In the area of funds management, the Bank improved its analytic and operational capabilities and expanded its research related to the government's debt-management strategy.



A look at the past: Promotional posters for Canada Savings Bonds during the 1940s and 1950s, Bank of Canada Archives

RETAIL DEBT **SERVICES**

Under its retail debt program, the government issues traditional Canada Savings Bonds (CSBs), which are redeemable at any time, and Canada Premium Bonds (CPBs), which are issued at a higher interest rate than CSBs but are redeemable only annually. Bonds are available through a network of sales agents, as well as organizations sponsoring the Payroll Savings Program, and through direct sales by telephone or via the Internet.

Outsourcing Objectives

- Lower overall costs for the retail debt program, while providing the same high-quality service
- Increased flexibility to respond to the changing needs of the program and marketplace, particularly emerging e-business opportunities
- Effective management of all risks associated with the outsourced retail debt operations
- Continued employment and improved job opportunities for most retail-debt-operations staff

As the government's fiscal agent, the Bank is responsible for providing operations and systems-support services, accounting, and advice for the retail debt program. The program is directed by the Department of Finance through its agency, Canada Investment and Savings, which is responsible for product offerings and sales and marketing strategies.

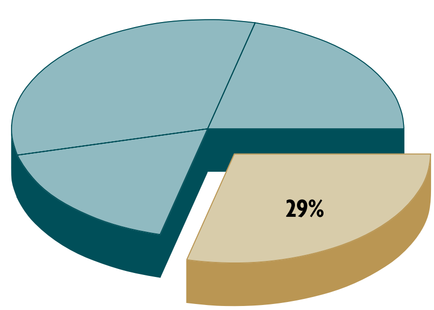
In 2001, the Bank outsourced the operations and systems-support services to EDS Canada Inc. This move was seen as providing more flexible and cost-effective "back-office" services for the retail debt program, while allowing the Bank to maintain its responsibilities as fiscal agent. And indeed, these outcomes were observed through the first full year of the contractual arrangement. Costs decreased by over 4 per cent, while the stipulated service levels were consistently met. Telephone and Internet infrastructure technologies were enhanced, making it possible to handle increased customer contacts cost-effectively, and a number of initiatives were begun to position the operations to take advantage of the emerging e-business opportunities.

The partnership developed between the Bank and EDS has set the stage for continued success. The risks typically associated with an outsourcing arrangement of this nature have been closely managed, and a significant percentage of the Bank's former staff continue to work for the retail debt business, ensuring the same high-quality service. The outsourcing objectives will continue to provide a road map for measuring the success of this business.

Operating Expenses

Operating expenses for retail debt services were $70.3 million, or 29 per cent of the Bank's total operating expenses (before restructuring and related expenses). The Bank's retail debt operations were outsourced in September of 2001 to EDS Canada Inc. Expenses in 2002 decreased by $3.3 million from 2001, reflecting savings generated from the new arrangement. All the expenditures required to support the retail debt program are recovered from the federal government.

Retail Debt Activities as a Proportion of Total Bank Expenses



FINANCIAL
SUMMARY

Stone currency from the South Pacific island of Yap, Bank of Canada Garden Court

REVENUE AND EXPENSES

Revenue from Investments

Total revenue from investments declined in 2002 by 6 per cent, to $2.0 billion, because of a lower rate of interest on the Bank's securities holdings. With overall expenses of $0.2 billion, net revenue paid to the Government of Canada in 2002 was $1.8 billion, compared with $2.0 billion in 2001.

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 these revenues are highly dependent on interest rates. For these reasons, the level of operating expenses is a better indicator of the Bank's stewardship of public resources.

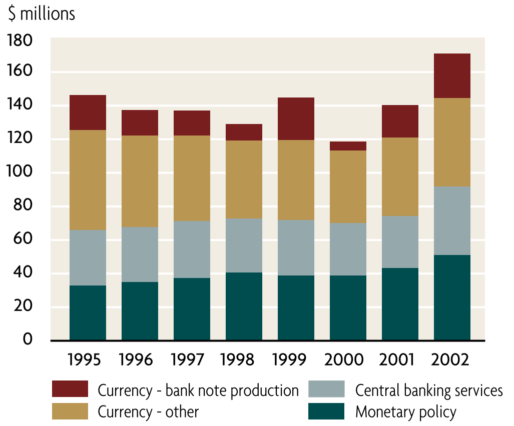
Operating Expenses

Monetary Policy, Currency, and Central Banking Services

Activities involving the Bank's main functions—monetary policy, currency, and central banking services—are regularly reviewed from the perspective of the Bank's role as a public policy organization, the needs of its clients, and the efficiency and effectiveness of its operations. From 1994 to 2000, operating expenses in each of these areas were reduced, with the exception of 1999, when additional expenditures were incurred in preparation for the year-2000 changeover. In 2001, and again in 2002, operating expenses in these core functions rose in response to the new demands and priorities described in previous sections of this *Annual Report*.

Total operating expenses for the Bank's main functions rose by $30.8 million, or 22 per cent, in 2002. As discussed in the previous stewardship sections of this *Report,* the Bank has begun to implement several new strategic priorities: broadening its research on issues affecting the macroeconomy; expanding its regional offices; implementing the new strategy for the currency function; enhancing its involvement in financial market development; and investing in new initiatives and technology to continue to provide operational

Operating Expenses
Monetary policy, currency, and central banking services



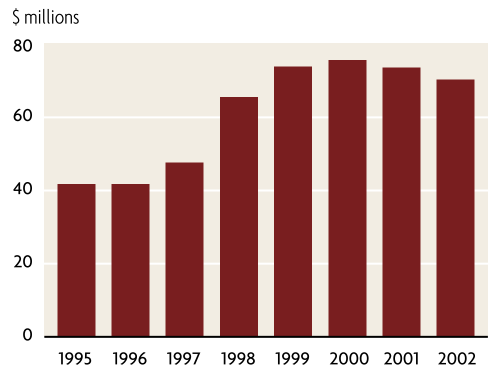
excellence and risk management for funds-management activities. Support costs associated with these initiatives increased in 2002 as did the costs for employee benefits. Increases in the Bank's expenses were partially offset by savings resulting from the restructuring of the Bank's corporate services, which will continue in 2003.

Given the Bank's medium-term plan for the period 2003 to 2005, a further increase in operating expenses for these core functions is expected in 2003.

Retail Debt Services

The Bank has provided "back-office" services to Canada Investment and Savings—the agency of the Department of Finance responsible for the government's retail debt program—since the agency's inception in 1996. In September 2001, the Bank outsourced retail debt operations to EDS Canada Inc. (EDS) and established an internal Debt Administration Office to oversee contracts with third-party suppliers and to ensure that all responsibilities are fulfilled. In 2002, despite an increase in processing volumes, expenses for retail debt declined by $3.3 million, or over 4 per cent, as a result of efficiency gains from outsourced operations. Direct expenditures required to support the retail debt program, as well as those invoiced by EDS, are recovered from the federal government. Coincident with the outsourcing of retail debt operations, a portion of general corporate administration expenses previously recovered from the federal government is now borne by the Bank. Also associated with the outsourcing was a shift in Bank expenses from salaries to service costs.

Operating Expenses
Retail debt services



Corporate Services Restructuring

Following the outsourcing of retail debt operations, the Bank launched a restructuring initiative focused on creating an integrated approach to corporate services in order to deliver these services cost-effectively to a smaller Bank. One-time expenses for restructuring were $14.3 million in 2002, bringing the total costs over the past two years to $28.2 million. Operational savings from this initiative began in 2002 and are expected to exceed the project investment by 2005.

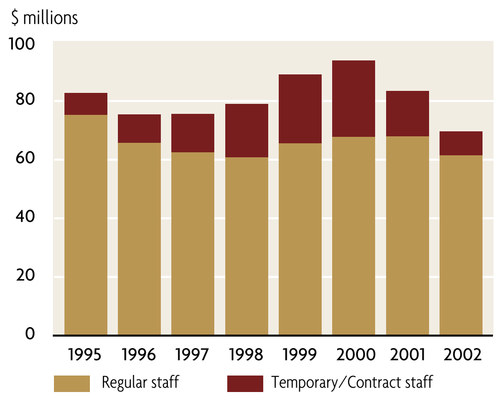
Salaries and Benefits

The Bank's total salary expenses decreased by over 16 per cent in 2002. This decline reflected a reduced number of staff because of retail debt outsourcing and corporate services restructuring. The decline in salary expenses from these sources was partially offset by additional staff hired to support the Bank's new strategic priorities and by salary-range adjustments to maintain market competitiveness. With these program changes, the composition of the Bank's staff has shifted significantly towards analytic and research professionals.

The Bank provides its staff with defined-benefit pension plans, to which employees contribute at specified rates, and a flexible benefits program covering medical and insurance benefits. The total cost of these benefits increased in 2002, largely because of changes to keep the pension plans market competitive and the rising cost of medical and other insurance plans.

The assets of the Bank's pension plans exceed the accrued benefit obligation. Under the guidelines of the Canadian Institute of Chartered Accountants, the amount of the pension surplus can vary considerably from year to year. On this basis, as shown in the Bank's financial statements, the surplus at the end of 2002 was about $27 million compared with $204 million the previous year. To assess the pension plan on a long-term-funding basis, the Bank concentrates on periodic actuarial valuations. The most recent valuation showed a surplus of approximately $180 million at the end of 2001, and the surplus is estimated to be about $130 million at the end of 2002.

Salary Expenses
Monetary policy, currency, central banking services, and retail debt services



FINANCIAL **STATEMENTS**

(Year ended 31 December 2002)

BANK OF CANADA

FINANCIAL REPORTING RESPONSIBILITY

The accompanying financial statements of the Bank of Canada have been prepared by management in accordance with Canadian generally accepted accounting principles and, if necessary, contain certain items that reflect best estimates and judgment of management. The integrity and objectivity of the data in these financial statements are management's responsibility. Management is responsible for ensuring that all information in the Annual Report is consistent with the financial statements.

In support of its responsibility, management has developed and maintains financial and management control systems and practices to provide reasonable assurance that transactions are properly authorized and recorded, that financial information is reliable, that the assets are safeguarded and liabilities recognized, and that the operations are carried out effectively. The Bank has an internal Audit Department, whose functions include reviewing internal controls and their application on an ongoing basis.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control and exercises this responsibility through the Audit Committee of the Board. The Audit Committee is composed of members who are neither officers nor employees of the Bank and who are financially literate, with at least one member who is a financial expert. The Audit Committee is therefore qualified to review the Bank's annual financial statements and to recommend their approval by the Board of Directors. The Audit Committee meets with management, the Internal Auditor, and the Bank's external auditors appointed by Order-in-Council. The Audit Committee has established processes to evaluate the independence of the Bank's external auditors and reviews all services provided by them. The Audit Committee has a duty to review the adoption of, and changes in, accounting principles and procedures that have material effect on the financial statements, and to review and assess key management judgment and estimates material to the reported financial information.

These financial statements have been audited by the Bank's external auditors, Raymond Chabot Grant Thornton, General Partnership and Deloitte & Touche LLP, and their report is presented herein.

D.A. Dodge, Governor

S. Vokey, CA, Chief Accountant

Ottawa, Canada

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

AUDITORS' REPORT

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

We have audited the balance sheet of the Bank of Canada as at 31 December 2002 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 Canadian 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 2002 and the results of its operations for the year then ended in accordance with Canadian generally accepted accounting principles.

The financial statements as at 31 December 2001 and for the year then ended were audited by Raymond Chabot Grant Thornton, General Partnership and Arthur Andersen LLP who expressed an opinion without reservation in their report dated 18 January 2002.

Raymond Chabot Grant Thornton

RAYMOND CHABOT GRANT THORNTON
General Partnership
Chartered Accountants

Deloitte & Touche LLP

DELOITTE & TOUCHE LLP
Chartered Accountants

Ottawa, Canada
17 January 2003

BANK OF CANADA

STATEMENT OF REVENUE AND EXPENSE
Year ended 31 December 2002

	2002	2001
	Millions of dollars	
REVENUE		
Revenue from investments, net of interest paid on deposits of $8.3 million ($23.2 million in 2001)	**2,016.6**	2,149.2
EXPENSE by function (notes 1 and 3)		
Monetary policy	**51.1**	43.4
Currency	**78.8**	65.6
Central banking services	**41.0**	31.1
	170.9	140.1
Retail debt services expenses	**70.3**	73.6
Retail debt services outsourcing costs	**–**	23.2
Retail debt services recoveries	**(70.3)**	(96.8)
	170.9	140.1
OTHER EXPENSE		
Restructuring and related costs (note 11)	**23.3**	28.7
	194.2	168.8
NET REVENUE PAID TO RECEIVER GENERAL FOR CANADA	**1,822.4**	1,980.4

(See accompanying notes to the financial statements.)

BANK OF CANADA

BALANCE SHEET
As at 31 December 2002

ASSETS	2002	2001
	Millions of dollars	
Deposits in foreign currencies		
U.S. dollars	**674.2**	391.9
Other currencies	**4.4**	3.8
	678.6	395.7
Advances to members of the Canadian Payments Association	**534.9**	647.5
Investments (note 4)		
Treasury bills of Canada	**13,113.1**	12,605.6
Other securities issued or guaranteed by Canada maturing within three years	**8,571.3**	8,799.8
Other securities issued or guaranteed by Canada not maturing within three years	**18,648.7**	16,976.7
Other bills	**–**	428.8
Other investments	**2.6**	2.6
	40,335.7	38,813.5
Bank premises (note 5)	**135.1**	149.2
Other assets		
Securities purchased under resale agreements	**1,904.8**	1,410.7
All other assets (note 6)	**369.7**	387.9
	2,274.5	1,798.6
	43,958.8	41,804.5

(See accompanying notes to the financial statements.)

LIABILITIES AND CAPITAL

	2002	2001
	Millions of dollars	
Bank notes in circulation	**41,146.7**	38,820.6
Deposits		
Government of Canada	**534.6**	1,005.2
Banks	**1,065.5**	1,307.1
Other members of the Canadian Payments Association	**125.8**	23.8
Other deposits	**415.0**	289.6
	2,140.9	2,625.7
Liabilities in foreign currencies		
Government of Canada	**516.2**	224.6
Other liabilities		
All other liabilities	**125.0**	103.6
	43,928.8	41,774.5
Capital		
Share capital (note 7)	**5.0**	5.0
Statutory reserve (note 8)	**25.0**	25.0
	30.0	30.0
	43,958.8	41,804.5

D.A. Dodge, Governor

S. Vokey, CA, Chief Accountant

On behalf of the Board

J.S. Lanthier, CM, FCA, Chair, Audit Committee

P. Massicotte, Lead Director

(See accompanying notes to the financial statements.)

BANK OF CANADA

NOTES TO THE FINANCIAL STATEMENTS
Year ended 31 December 2002

1. The business of the Bank

The Bank of Canada's responsibilities focus on the goals of low and stable inflation, a safe and secure currency, financial stability, and the efficient management of government funds and public debt. These responsibilities are carried out as part of the broad functions described below. Expenses in the *Statement of revenue and expense* are reported on the basis of these four corporate functions as derived through the Bank's allocation model.

Monetary policy

Contributes to solid economic performance and rising living standards for Canadians by keeping inflation low, stable, and predictable.

Currency

Designs Canada's bank notes (including anti-counterfeiting features), issues and distributes new bank notes, and replaces worn notes.

Central banking services

Promotes financial system stability and provides efficient funds-management services to the federal government.

Retail debt services

Ensures that all holders of Canada Savings Bonds and Canada Premium Bonds have their information registered and their accounts serviced through efficient operations and systems support. The Bank recovers the cost of retail debt operations on a full-cost basis.

2. Significant accounting policies

The financial statements of the Bank are in accordance with Canadian generally accepted accounting principles and conform to the disclosure and accounting requirements of the Bank of Canada Act and the Bank's bylaws. A *Statement of cash flows* has not been prepared as the liquidity and cash position of the Bank are not of primary concern to users of these financial statements. Other information regarding the Bank's activities may be derived from the *Statement of revenue and expense* and the *Balance sheet*.

The significant accounting policies of the Bank are:

a) Accounting estimates

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts recorded in the financial statements and notes to financial statements. These estimates are based on management's best knowledge of current events and actions that the Bank may undertake in the future. Actual results may differ from those estimates.

b) Revenues and expenses

Revenues and expenses are accounted for on the accrual basis.

c) Employee benefit plans

The Bank sponsors a number of defined-benefit plans that provide pension and other post-retirement and post-employment benefits to most of its employees. The Bank accrues its obligations under these benefit plans and the related costs, net of plan assets. The costs of the plans are actuarially determined using the projected benefit method to determine the current service costs. Past service costs resulting from plan amendments, and the transitional balances are amortized on a straight-line basis over the average remaining service period of active plan members (12 years). The excess of the net actuarial gain (loss) over 10 per cent of the greater of the benefit obligation and the fair value of plan assets is amortized over the average remaining service period of active plan members (12 years). For the purpose of calculating the expected return on plan assets, assets are valued at fair value.

d) Translation of foreign currencies

Assets and liabilities in foreign currencies are translated to Canadian dollars at the rates of exchange prevailing at year-end. Investment income is translated at the rate in effect at the date of the transaction. The resulting gains and losses are included in the *Statement of revenue and expense*.

e) Advances

Advances to members of the Canadian Payments Association are liquidity loans that are fully collateralized and generally overnight in duration. The Bank charges interest on advances under the Large Value Transfer System (LVTS) at the Bank Rate. For advances under the Automated Clearing Settlement System (ACSS), the Bank charges the Bank Rate plus a margin, which was 125 basis points at 31 December 2002 (150 basis points in 2001).

f) Investments

Investments, consisting mainly of Government of Canada treasury bills and bonds, are recorded at cost and are adjusted for amortization of purchase discounts and premiums using the constant-yield method for treasury bills and bankers' acceptances and the straight-line method for bonds. The amortization, as well as gains and losses on disposition, are included in the *Statement of revenue and expense*.

g) Bank premises

Bank premises, consisting of land, buildings, computer hardware/software and other equipment, are recorded at cost less accumulated depreciation. Computer software is capitalized only when its cost exceeds $2 million. 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 hardware/software	3 to 7 years
Other equipment	5 to 15 years

h) Special purchase and resale agreements (SPRAs)

SPRAs are repo-type transactions in which the Bank offers to purchase Government of Canada securities from designated counterparties with an agreement to sell them back at a predetermined price on the agreed resale date, generally the next business day. The Bank is prepared to enter into SPRAs at the policy target rate, defined as the midpoint of the operating band for the overnight interest rate (i.e., 25 basis points below the Bank Rate), if overnight funds are generally trading above the indicated target level. SPRAs are transacted with primary dealers, a subgroup of government securities distributors that have reached a threshold level of activity in the Government of Canada debt markets.

The balance sheet category *Securities purchased under resale agreements* represents the value receivable by the Bank. As such, this amount includes the purchase of treasury bills and bonds, the purchase of accrued interest on bonds, and the interest earned by the Bank. The treasury bills and bonds purchased under resale agreements are not recorded as investment assets.

i) Deposits

The liabilities within this category are Canadian-dollar demand deposits. For members of the Canadian Payments Association, the Bank pays interest on positive balances associated with the LVTS at the lower end of the operating band for the overnight interest rate (50 basis points below the Bank Rate), and on positive balances related to the ACSS at the lower end of the operating band for the overnight interest rate less a margin, which was 125 basis points at 31 December 2002 (150 basis points in 2001). On Special Deposit Accounts, which serve as collateral for LVTS participants, the Bank pays interest at the published overnight rate less a margin, which was 6.25 basis points at 31 December 2002 (6.25 basis points in 2001).

j) Sale and repurchase agreements (SRAs)

SRAs are reverse repo-type transactions in which the Bank offers to sell Government of Canada securities to designated counterparties with an agreement to buy them back at a predetermined price the next business day. The Bank is prepared to enter into SRAs at the policy target rate, defined as the midpoint of the operating band for the overnight interest rate (i.e., 25 basis points below the Bank Rate), if overnight funds are generally trading below the indicated target level. SRAs are transacted with primary dealers, a subgroup of government securities distributors that have reached a threshold level of activity in the Government of Canada debt markets.

k) Securities Lending Program

In 2002, the Bank implemented a Securities Lending Program to support the liquidity of Government of Canada securities by providing a secondary and temporary source of these securities to the market. These securities-lending transactions are fully collateralized and are generally overnight in duration. The securities loaned continue to be accounted for as investment assets. Lending fees charged by the Bank on these transactions are included in revenue at the date of the transaction.

l) 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 classes of expenditure

	2002	2001
	Millions of dollars	
Salaries	**69.9**	83.4
Benefits and other staff expenses	**15.3**	13.8
Currency costs	**31.9**	24.6
Premises maintenance	**17.9**	18.9
Services and supplies	**90.5**	54.3
Depreciation	**24.3**	26.3
	249.8	221.3
Outsourcing costs	–	23.2
Recoveries		
Retail debt services	**(70.3)**	(96.8)
Other	**(8.6)**	(7.6)
	170.9	140.1
Restructuring and related costs	**23.3**	28.7
Total	**194.2**	168.8

Recoveries represent the fees charged by the Bank for a variety of services. Retail debt services recoveries for 2001 include outsourcing costs.

4. Investments

Securities	2002 Millions of dollars Amortized cost	Fair market value	Average yield %	2001 Amortized cost	Fair market value	Average yield %
Treasury bills of Canada	**13,113.1**	**13,126.3**	**3.0**	12,605.6	12,655.3	3.3
Other securities issued or guaranteed by Canada maturing within 3 years	**8,571.3**	**8,883.8**	**5.6**	8,799.8	9,133.9	6.0
Other securities issued or guaranteed by Canada not maturing within 3 years	**18,648.7**	**20,407.1**	**6.0**	16,976.7	18,165.0	6.3
Other bills	**–**	**–**		428.8	428.8	2.3
	40,333.1	**42,417.2**		38,810.9	40,383.0	
Other investments	**2.6**	**2.6**		2.6	2.6	
	40,335.7	**42,419.8**		38,813.5	40,385.6	

The Bank typically holds its investments in treasury bills and bonds until maturity. The amortized book values of these investments approximate their par values.There were no securities loaned under the Securities Lending Program at 31 December 2002.

5. Bank premises

	2002 Millions of dollars Cost	Accumulated depreciation	Net book value	2001 Cost	Accumulated depreciation	Net book value
Land and buildings	**167.5**	**78.3**	**89.2**	167.5	74.9	92.6
Computer hardware/ software	**53.5**	**42.7**	**10.8**	55.2	37.4	17.8
Other equipment	**135.5**	**105.9**	**29.6**	139.4	102.4	37.0
	356.5	**226.9**	**129.6**	362.1	214.7	147.4
Project in progress	**5.5**	**–**	**5.5**	1.8	–	1.8
	362.0	**226.9**	**135.1**	363.9	214.7	149.2

The project in progress consists of the replacement of the Bank’s Automated Systems that form the core of foreign reserves management. Depreciation, on a straight-line basis over 5 years, will commence in 2003 upon completion of the project.

6. All other assets

This category includes accrued interest on investments of $267.9 million ($279.0 million in 2001). It also includes the pension accrued benefit asset of $70.7 million ($55.6 million in 2001).

7. Share capital

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.

8. Statutory reserve

The rest fund was established in accordance with the Bank of Canada Act and represents the statutory reserve of the Bank. The statutory reserve was accumulated out of net revenue until it reached the stipulated maximum amount of $25.0 million in 1955.

9. Employee benefit plans

The Bank sponsors a number of defined-benefit plans that provide pension and other post-retirement and post-employment benefits to most of its employees. The pension plans provide benefits under a Registered Pension Plan and a Supplementary Pension Arrangement. The following table provides information about these plans.

	Pension benefit plan		Other benefit plans	
	2002	2001	2002	2001
	Millions of dollars		Millions of dollars	
For the year				
Bank contributions	**2.7**	2.0	**5.4**	5.7
Employees' contributions	**5.1**	0.4	**–**	–
Benefits paid	**22.0**	20.8	**5.4**	5.7
Benefit plan expense (revenue)	**(12.4)**	(15.1)	**13.3**	14.7
Curtailment loss	–	–	**2.7**	8.9

	Pension benefit plan		Other benefit plans	
	2002	2001	2002	2001
	Millions of dollars		Millions of dollars	
As at 31 December				
Accrued benefit obligation	**612.1**	486.4	**106.4**	87.4
Fair value of plan assets	**639.2**	690.6[a]	**–**	–
Plans' surplus (deficit)	**27.1**	204.2	**(106.4)**	(87.4)
Accrued benefit asset (liability)	**70.7**	55.6	**(51.5)**	(41.0)

a. The valuation of the plan assets disclosed in the 2001 Financial Statements was determined as of 4 October 2001. The prior year comparative numbers have been amended to reflect the valuation as at 31 December 2001.

The increase in the pension plans' accrued benefit obligation of $125.7 million ($40.2 million in 2001) from 2001 to 2002 is primarily a result of the following factors: a decrease in the discount rate used for accounting purposes $24.2 million ($26.0 million in 2001); updating of economic and demographic assumptions $30.1 million (nil in 2001); and changes to member benefits $31.0 million (nil in 2001).

The significant actuarial assumptions (weighted averages as of 31 December) used in calculating the accrued benefit obligations are as follows.

	Pension benefit plans		Other benefit plans	
	2002	**2001**	**2002**	**2001**
Discount rates	**5.50%**	5.75%	**5.30%**	5.99%
Expected rates of return on plan assets for the year	**6.00%**	5.70%	**N/A**	N/A
Rate of compensation increase	**4.00% + merit**	3.00% + merit	**4.00% + merit**	3.00% + merit

Interest rates for Government of Canada marketable bonds are used. These rates are lower than those used by the Bank for funding valuations of the pension benefit plans and hence show a lower surplus.

For measurement purposes, a 9.0 per cent annual rate of increase in the per capita cost of covered hospital and drug benefits was assumed. The rate was assumed to decrease gradually to 4.5 per cent over 10 years and remain at that level thereafter. The per capita cost of other health care benefits was assumed to increase at 3.0 per cent per annum.

10. Commitments

a) Operations

In 2001, the Bank entered into a long-term support agreement for retail debt services, expiring in 2011. As at 31 December 2002, fixed payments totalling $119.2 million remained, plus a variable component based on the volume of transactions. The Bank recovers the cost of retail debt services from the Canada Investment and Savings Agency.

Commitments related to other support services are $5.3 million over the next two years.

b) Foreign currency contracts

The Bank is a participant in foreign currency swap facilities with the U.S. Federal Reserve for US$2 billion, the Banco de México for Can$1 billion and with the Exchange Fund Account of the Government of Canada. There were no drawings under any of those facilities in 2002 or 2001 and, therefore, there were no commitments outstanding at 31 December 2002.

c) Investment contracts

In the ordinary course of business, the Bank enters into commitments involving the purchase and sale of securities. All commitments outstanding at 31 December are settled in the subsequent year. A summary of these outstanding commitments follows.

		2002	2001
		Millions of dollars	
Investment contracts	– sales	**1,906.1**	1,411.1

Outstanding sale investment contracts of $1,906.1 million, at an interest rate of 2.74 per cent under special purchase and resale agreements, were settled by 17 January 2003 ($1,411.1 at the end of 2001 at an interest rate of 2.25 per cent).

11. Restructuring and related costs

Outsourcing

In 2000, the Bank launched a major initiative to outsource the administration of the retail debt program to a private sector supplier, while maintaining its role as fiscal agent for retail debt. Under the terms of a contract with EDS Canada for the provision of operations and system support, Bank staff joined EDS in its Ottawa offices. This contract is for a term of 9.5 years and commenced 1 September 2001. The total one- time cost of outsourcing associated with this initiative was $23.2 million in 2001, all of which was recoverable from the Canada Investment and Savings Agency of the federal government.

Restructuring

With the outsourcing initiative completed, the Bank has undertaken to restructure its corporate services to align them with the needs of a smaller organization. This restructuring program is scheduled for completion in 2003. The following table provides information about the non-recurring costs associated with this program.

	2002	2001
	Millions of dollars	
Restructuring project costs	**14.3**	8.1
Staff redundancies	–	5.8
Curtailment loss from post-retirement benefits (note 9)	**2.7**	8.9
Unallocated corporate administration costs	**6.3**	5.9
Total	**23.3**	28.7

In 2001, a liability of $5.8 million was established to meet future obligations related to staff redundancies. During 2002, no increase to this established liability was recorded and $1.4 million of the liability was utilized. The amount outstanding as at 31 December 2002 is $4.4 million and is included in All Other Liabilities.

GOVERNING COUNCIL

David A. Dodge, Governor*
Malcolm D. Knight, Senior Deputy Governor*

Deputy Governors

Pierre Duguay* **W. Paul Jenkins***
Charles Freedman* **Sheryl Kennedy***

Marcus L. Jewett, QC, General Counsel and Corporate Secretary*
Daniel W. MacDonald, Chief Administrative Officer*

Advisers

Janet Cosier,*[1] Clyde A. Goodlet, David J. Longworth
John D. Murray, Ronald M. Parker, Andrew Spence[2]

Financial Markets

George Pickering	Chief
Ross MacKinnon	Director, Toronto Division
Miville Tremblay	Director, Montréal Division
Agathe Côté	Deputy Chief
Donna Howard	Director—Debt Management and Foreign Reserves
Ron Morrow	Director—Data Services and Market Operations

Research

Tiff Macklem	Chief
Paul Fenton	Deputy Chief
Robert Amano	Research Director
Allan Crawford	Research Director

Monetary and Financial Analysis

John G. Selody	Chief
Pierre St-Amant	Deputy Chief
James F. Dingle	Director[3]
Walter N. Engert	Director
Brian O'Reilly	Director

International

James E. Powell	Chief
Sheila Niven	Deputy Chief
Robert Lafrance	Research Director
Lawrence L. Schembri	Research Director

Banking Operations

Bonnie J. Schwab	Chief
Jim Reain	Director
Charles Spencer	Director
Lorna Thomas	Director

Executive and Legal Services

Marcus L. Jewett	General Counsel and Corporate Sectretary*
Colleen G. Leighton	Director of Executive Services
Elayne Terrence	Special Assistant to the Governor

Pension Plan Review

L. Theodore Requard	Executive Director

Communications

Denis Schuthe	Chief
Jocelyne Charron	Deputy Chief and Director, Operations

Corporate Services

Gerald T. Gaetz	Chief*
John Otterspoor	Director, IT Services
Frances Boire-Carrière	Director, Human Resources Services
Sheila Vokey	Chief Accountant and Director, Accounting and Financial Services
Chris J. Hemstead	Director, Knowledge and Information Services
Janice Gabie	Director, Business Planning and Support

Debt Administration Office

Dale Fleck	Director

Audit

David Sullivan	Internal Auditor
Frank J. Mahoney	Director, Advisory Services

* Member of Executive Management Committee
1. Also Chair of the Board of Directors of the Canadian Payments Association
2. Visiting economist
3. Also Deputy Chairman of the Board of Directors of the Canadian Payments Association

Note: Positions as of 31 January 2003

FOR FURTHER INFORMATION ABOUT THE BANK OF CANADA

PUBLICATIONS

Monetary Policy Report* and *Update

A detailed summary of the Bank's policies and strategies, as well as a look at the current economic climate and its implications for inflation. *Reports* published in April and October; *Updates* published in January and July. Without charge.

Financial System Review

Brings together the Bank's research, analyses, and judgments on various issues and developments concerning the financial system. Published semi-annually. Without charge.

Bank of Canada Review

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Note: Positions as of 31 January 2003