



BANK OF CANADA  
BANQUE DU CANADA

ANNUAL **2006** REPORT

# THE BANK'S COMPASS

As a public institution  
and a workplace, we  
take our bearings from  
our commitment to  
Canadians, to excellence,  
and to one another.

## **Our commitment to Canadians**

To promote the economic and financial welfare of Canada, we

- ▶ conduct monetary policy in a way that fosters confidence in the value of money
- ▶ supply quality bank notes that are readily accepted and secure against counterfeiting
- ▶ promote the safety and efficiency of Canada's financial system
- ▶ provide efficient and effective funds-management services
- ▶ communicate our objectives openly and effectively and stand accountable for our actions

## **Our commitment to excellence**

Building on our strengths, we aim to meet our commitment to Canadians through performance that is second to none among the central banks of the world.

We strive for excellence through leading-edge research and analysis, through partnerships within the Bank and with outside organizations, and through

- ▶ innovation in all aspects of our work
- ▶ leadership that spurs us on to new success
- ▶ integrity in our business and in our actions
- ▶ diversity of people and ideas

## **Our commitment to one another**

We aim to achieve our best in a workplace where we

- ▶ communicate clearly and openly
- ▶ share knowledge and experience
- ▶ develop our talents and careers
- ▶ recognize those who live up to our commitments
- ▶ respect one another and our lives outside work





BANK OF CANADA  
BANQUE DU CANADA

**David A. Dodge**  
Governor - Gouverneur

27 February 2007

The Honourable James Michael Flaherty, PC, MP  
Minister of Finance  
140 O'Connor Street  
21st Floor  
Ottawa, Ontario  
K1A 0G5

Dear Minister,

In accordance with the provisions of the Bank of Canada Act, I am submitting the Bank of Canada's Annual Report for the year 2006 and the Bank's audited financial statements as at 31 December 2006.

Yours sincerely,

A handwritten signature in black ink, appearing to read "D.A. Dodge".



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## MESSAGE FROM THE GOVERNOR

*The year 2006 marked a turning point for the Bank of Canada. We successfully completed our medium-term plan, The Way Forward, and began writing a fresh chapter in the Bank's history based on a new three-year plan. In this annual report, we do more than give an accounting of past achievements.*

*We also provide forward-looking information on the plans and priorities in our new medium-term plan. And as we advance, we are always mindful of the Bank's original mandate, set out more than 70 years ago, to "promote the economic and financial welfare of Canada."*



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*David Dodge, Governor*

## Policy Developments: 2006

Maintaining low, stable, and predictable inflation remains central to how the Bank meets its core responsibility of promoting the economic and financial welfare of Canadians. Our commitment to this goal was reaffirmed through the renewal of the inflation-targeting agreement, which was announced jointly with the federal government in November.

Over the past year, global economic forces continued to necessitate considerable adjustment across regions and sectors of the Canadian economy. At the same time, variability in energy prices meant some sizable swings in the consumer price index. Inflation moved from a high of 2.8 per cent in January to a low of only 0.7 per cent in September. The core rate of inflation opened 2006 somewhat below 2 per cent, but by the autumn, had moved just above 2 per cent. This rise in core inflation was consistent with an overall economy that was operating slightly above the limits of its capacity. Against a background of increasing pressures on capacity through the first half of the year, the Bank raised its policy interest rate (the target for the overnight interest rate) on four occasions. That brought the target rate to 4.25 per cent by July, where it

remained through the balance of the year. In the second half of the year, we judged that the principal upside risks to our outlook for inflation were related to the momentum in household spending and housing prices, while the main downside risk was a sharper slowdown in the U.S. economy than was previously expected. These risks were seen to be roughly balanced.

In 2006, we also completed the rollout of the new *Canadian Journey* series of bank notes, which carry such up-to-date security features as a metallic holographic stripe, a watermark portrait, a windowed colour-shifting thread woven into the paper, and a see-through number. With this new series of notes and the benefits of the partnerships described below, we saw real progress in the fight against counterfeiting, as the value and number of counterfeit notes dropped for the second year in a row.

Given the importance of well-functioning Canadian and international financial systems in today's global economy, the Bank put a great deal of effort this past year into researching and promoting financial system efficiency and in advocating for a stronger and more effective International Monetary Fund.

## “The Way Forward” 2003–06

As 2006 came to a close, so, too, did work under the medium-term plan launched in 2002: *The Way Forward*. Over the past four years, we have achieved the significant objectives set out under this program. These objectives were designed to help us better fulfill our commitments to Canadians, while striving to be at the forefront of the world’s central banks. Our objectives were organized into three broad themes – research, partnerships, and communications – that cut across all the Bank’s functions.

Our commitment to *research* was apparent in our efforts to bolster the Bank’s analytical capacity. With our emphasis on attracting and retaining the best personnel, we have been able to deliver high-quality research and current analysis of the rapidly changing global and Canadian economies. This has been invaluable in supporting our conduct of monetary policy. Our enhanced research efforts have also included financial sector policies and how best to promote the stability and efficiency of our financial system.

This long-standing commitment to research also applies to longer-term projects. Research and analysis were crucial in the renewal of the inflation-control agreement. In the renewal, the Bank clarified several aspects of the inflation-targeting system and set out a research program to determine whether and how it might be possible to further improve

our inflation-control framework for the decades ahead.

Our emphasis on research can be seen through the breadth of other research themes discussed later in this report. Here I would like to particularly note the development and implementation of a new model for economic projections and policy analysis, known as the Terms-of-Trade Economic Model (ToTEM). This model builds on the strength of the Bank’s earlier model for the Canadian economy. But ToTEM, by taking advantage of the leaps in technological progress in economics and computing power made over the past decade, provides a richer description of the Canadian economy.

The theme of *partnerships* was illustrated by our achievements in the currency function.

We developed a comprehensive education and awareness program to help retailers and the public to distinguish genuine notes from counterfeits. The Bank has also collaborated closely with law-enforcement agencies and other central banks to combat computer-based counterfeiting. An information network has been created to enhance federal, provincial, and territorial prosecutors’ awareness of counterfeiting and to promote the tools available for successful prosecution of counterfeiting crimes.

The Bank’s emphasis on partnerships also supported our funds-management function. As fiscal agent to the federal government, we worked with both the government and



financial market participants to improve the functioning of markets for government debt. We also improved the efficiency of the auction process for government bonds and treasury bills.

Partnerships with the academic world were also bolstered by the establishment of the Bank of Canada Fellowship Program, a program that aims to recognize and encourage research in areas of particular importance to the functions of the Bank.

We have worked hard to make our work more transparent, recognizing that policies are most effective when they are well communicated and widely understood. The medium-term plan's theme of fostering *clear communication* emphasized that commitment. Our *Monetary Policy Report* and press releases issued at the time of our interest rate announcements have provided more details about our assumptions, analyses, and economic projections. Members of our Governing Council have continued to speak on monetary policy issues generally, to better explain such topics as changes in the global economy, the impact of emerging markets in Asia, and exchange rate movements, to cite just a few examples.

Our commitment to communication has also underpinned our achievements in the financial system function, where we have provided more in-depth analysis of financial stability and efficiency issues through our *Financial System Review*. Over the past four years, we have

expanded our knowledge of financial system issues, and have communicated this to Canadians. We have also enhanced transparency by improving our website to make a wide variety of information more readily available to all Canadians.

Our medium-term plan, *The Way Forward*, was extended to four years from the original three to deal with a number of issues that arose. For example, we identified a need to strengthen our planning for continuity of operations and to renew several aspects of our infrastructure. We continue to work on these issues, and they form part of the foundation of our new medium-term plan.

## “Moving Forward”: The New Medium-Term Plan 2007–09

Over the next three years, we will continue to conduct monetary policy with the goal of keeping inflation at 2 per cent. At the same time, we will embark on a research program to see whether our very successful inflation-control framework can be made even better. We will be asking researchers to focus on two main questions. First, what would be the costs and benefits of an inflation target lower than 2 per cent? Second, what would be the costs and benefits of replacing the current inflation target with a longer-term, price-level target? We hope others will join us in this effort with the goal of completing this research well before the current agreement expires in 2011. We will

try to improve our understanding of the impact of globalization on the Canadian economy, examine the effects of demographic changes on productivity and the economy, and look for ways to improve the effectiveness of the Bank's monetary policy.

We will work to bolster public confidence in Canada's bank notes through further reductions in counterfeiting. The Bank has set as a goal reducing the number of counterfeits by over 50 per cent by 2009. Research will be conducted on new security features, themes, and designs for the next generation of bank notes. We will continue to strengthen our relationships with merchants, police, and prosecutors. And because counterfeiting is a worldwide problem, work on these goals will continue with other central banks and security specialists.

Over the span of the next medium-term plan, the Bank intends to continue improving its capacity to oversee major clearing and settlement systems and improve the collection and use of financial data. We will develop better ways to assess the stability of the financial system and the efficiency of the Canadian financial sector. Efforts to help reform the International Monetary Fund will continue, to make it more relevant and important in today's global economy.

To continue to effectively manage the Government of Canada's debt, cash, and foreign exchange reserves, as well as the Bank of Canada's own financial assets, we will aim

in the coming three years to renew our funds-management systems and to enhance our analytic capabilities.

In carrying out this new plan, there are three bank-wide priorities involving investments over the three years of the plan. The priorities are: renewing our infrastructure; creating a superior work environment; and staying at the forefront of good governance to preserve the trust of Canadians in our ongoing stewardship of the Bank. To attract and retain qualified and talented staff, the Bank's human resource strategy encompasses offering distinctive challenges and development opportunities, competitive total compensation, and a distinctive work environment.

You can find the medium-term plan on our website at *About the Bank* under *Management and Administration*.

## Concluding Comments

As I said earlier, this annual report goes beyond a recounting of past achievements in our four functions: monetary policy; currency; financial system; and funds management. It also sets out our goals and priorities for the medium term. Further details and strategies for achieving these goals can be found within this annual report.

The Bank of Canada's strong reputation and its ability to continue to succeed rely on the skills and professionalism of its entire staff. I want

to personally thank the employees of the Bank for their hard work in 2006 and throughout *The Way Forward*. I am grateful for their efforts and for their commitment to excellence. I also wish to thank the members of the Board of Directors for their continuing support. I especially wish to express my appreciation to the Directors whose terms expired in 2006 for their dedicated service to the Bank and to Canadians. They are Ronald Keefe, Daniel Gallivan, J. Spencer Lanthier, Kit Chan, and Jim Hinds. Sadly, Jim Hinds of Sudbury,

Ontario, passed away shortly after leaving our Board. We all benefited greatly over the years from Jim's wise counsel.

I welcome our new Board members and look forward to working with them. Canada's central bank will continue to be accountable to all Canadians and to fulfill its mandate to promote the economic and financial welfare of Canada and its citizens.

A handwritten signature in black ink, appearing to read "C. A. Dodge". The signature is fluid and cursive, with a long horizontal stroke at the end.