AN ACCOUNT OF OUR STEWARDSHIP

Monetary Policy

The goal of Canadian monetary policy is to contribute to solid economic performance and rising living standards for all Canadians by keeping inflation low and stable. Specifically, the Bank aims to keep the trend of inflation, as measured by the consumer price index (CPI), inside a target range of 1 to 3 per cent. This target range, established jointly with the government, was extended in February 1998 to the end of 2001. A long-term target consistent with price stability will be established by the end of 2001.

> ***"Inflation has been maintained at very low levels as a result of the Bank of Canada's successful inflation targeting policy."***
>
> ***Statement of IMF Mission to Canada, 16 November 1999***

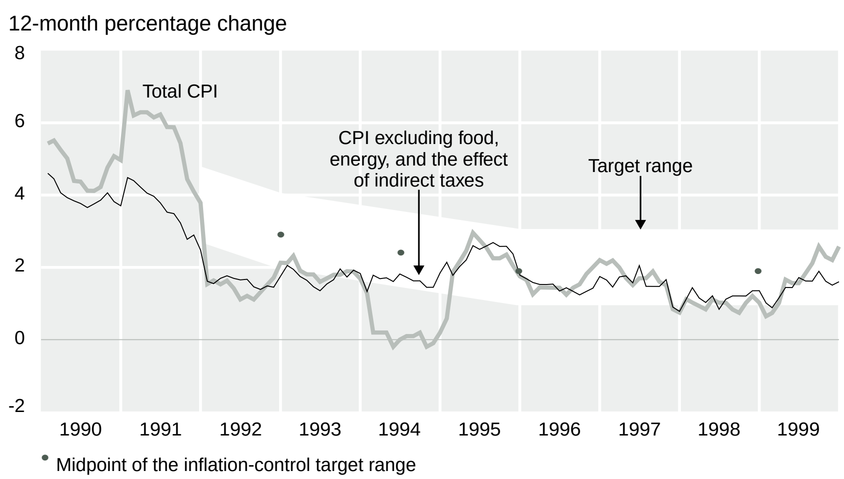
The Bank carries out monetary policy through its influence on short-term interest rates and thereby on the whole range of rates of return and on the exchange rate for the Canadian dollar. Monetary policy actions affect inflation only indirectly and are usually felt over a period of 18 months to two years. Therefore, the Bank focuses on the trend of inflation, using a measure of core consumer prices that excludes volatile food and energy prices and the effect of changes in indirect taxes.

Meeting the Inflation Target

The Bank's core measure of inflation, which had fallen to the bottom of the target range in 1998, moved up towards the middle of the range by the second half of 1999. At the end of the year, core inflation was 1.6 per cent. This movement largely reflected the reduction of excess capacity brought about by Canada's strong economic expansion. It also reflected some temporary factors, such as the lagged effects of the depreciation of the Canadian dollar in 1998, which pushed up the prices of imported goods and services. The overall consumer price index rose 2.6 per cent through the year, significantly higher than core inflation because of sharp increases in fuel oil and gasoline prices.

The average private sector forecast for the CPI has remained near the centre of the Bank's inflation-control target range. For example, the Conference Board's latest *Survey of Forecasters* calls for an average of 2.2 per cent this year and 2.0 per cent in 2001.

Consumer Price Index



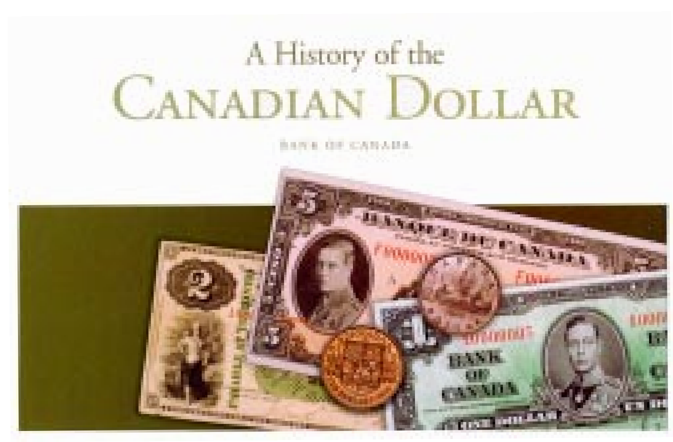
Longer-term expectations of inflation, as reported in surveys of business forecasters, also remained at the midpoint of the Bank's target range. The yield spread between conventional and inflation-indexed bonds, which also tends to reflect longer-term inflation expectations, narrowed significantly in the autumn of 1998 amid talk of global deflation. During 1999, it widened again to settle near the centre of the Bank's target range for inflation.

The Canadian economy posted an impressive performance in 1999. It grew by close to 4 per cent, and the unemployment rate fell to a 23-year low of 6.8 per cent at year-end. The economy benefited greatly from the remarkable strength of the U.S. economy. The pickup in Europe and the recovery of some of the Asian economies that had been most hurt by the financial crisis also helped, as did the turnaround in the prices of the key primary commodities that we export. The economy was also buoyed by relatively low interest rates, rising employment, and a growing sense of consumer confidence, which supported stronger domestic spending. In light of the strong momentum of the Canadian economy, the Bank Rate was raised on 17 November 1999 and 3 February 2000, to preserve the low rate of inflation needed for a sustainable economic expansion.

Assessing International Developments

International developments influence the Canadian economy and our financial markets. The Bank therefore devotes considerable time and energy to understanding and anticipating events in other countries. It also advises the Government of Canada on international financial and economic issues. The Bank works closely with other central banks on matters of monetary policy and financial stability. It also maintains close contacts with international economic and financial institutions, sharing information and debating current issues.

There were significant changes in world currency arrangements during 1999. The year began with the launching of the European single currency (the euro), an event that generated increased interest in the feasibility of common currency arrangements for other areas of the world. The merits of currency boards and "dollarization"—the adoption of the U.S. dollar as currency—were also widely debated, particularly in Latin America. Equally significant was the adoption of floating exchange rates and inflation targets in a number of emerging-market countries. In 1999, Brazil and Colombia joined this group. The Bank responded to calls from a number of countries for technical advice on the conduct of monetary policy based on its experience with inflation targeting.



In the past, it was illegal to reproduce images of bank notes. Changes to the legislation in 1999 made it possible for the Bank to use bank notes as illustrations in this new publication by James Powell, Chief of the International Department.

With the global economy recovering from the turmoil of 1997–98, the international community investigated new and better ways to prevent and resolve financial crises. Flexible exchange rates figured prominently in these discussions about how to prevent financial crises and minimize the damage they cause. It became apparent that, in general, those countries with floating exchange rates were able to adjust more promptly to disturbances and achieve a stronger economic turnaround.

Carrying Out Research and Analysis

The formulation of monetary policy rests primarily on analysis and research. To ensure that its research is sound, the Bank cultivates relationships with academics and other researchers through conferences, seminars, informal contacts, and publication of staff research.

In 1999, the Bank hosted a conference dealing with the role of monetary aggregates in policy deliberations. The conference proceedings will be published later this year and will also be posted on the Bank's Web site. A seminar will be held in the spring of 2000 to discuss research on the issues involved in designing a long-term target for price stability.

A significant amount of research has been carried out on the merits of flexible exchange rates for Canada and on the consequences of alternative currency arrangements. Some of this work was discussed in national and international forums in 1999 and will be the central theme of the Bank's next conference in the autumn of 2000. Also featuring prominently in the Bank's research program were the conduct of monetary policy under uncertain conditions and the identification of a broad set of indicators of capacity and inflation pressures when the economy is operating near its potential. Efforts continued to be devoted to deepening the Bank's understanding of how Canadian financial markets function and how the evolving structure of these markets affects the behaviour of the Canadian economy.

PHOTO: JAMES ZAGON

Bank of Canada conference on Money, Monetary Policy, and Transmission Mechanisms, November 1999

Promoting Understanding of Monetary Policy

With the Canadian economy approaching its production capacity, the Bank's external communications have focused on the risks facing monetary policy. They also stressed the need for timely adjustment of the Bank Rate to preserve the low trend of inflation and thus support sustainable economic expansion in Canada.

In 1999, the Bank reviewed its communications activities to ensure a continuous and well-integrated approach. To further this objective, the Bank will now publish a formal update of its semi-annual (May and November) *Monetary Policy Report* each February and August.

Staff in the Bank's regional offices assisted Directors and Governing Council members with their communications activities across Canada. They maintained contact with provincial governments, industries, educational institutions, and the general public. They also continued to refine their methodology for gathering information on current and prospective economic developments. Each quarter, the regional offices presented the Governing Council with the results of a survey of about 100 firms and associations—a "grassroots" assessment of the state of the economy and a complement to the economic projection prepared by Bank staff.

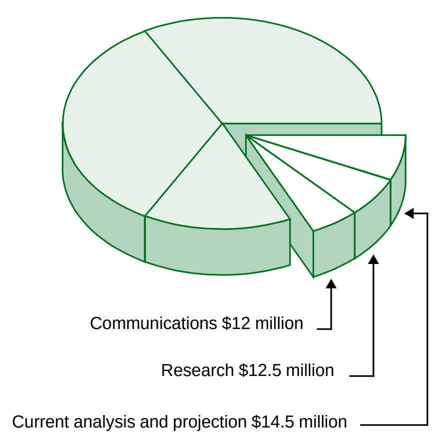
The Bank's Web site has become a convenient source of information, offering an ever-widening range of financial statistics, publications, and Bank-related material. A module illustrating the transmission of monetary policy was added in 1999, as well as an interactive inflation calculator that demonstrates the effects of inflation on the value of money over the past 85 years.

Operating Expenses

The Bank spent $39 million in 1999 (approximately 18 per cent of its total operating expenses) on formulating and implementing monetary policy. This represents a decrease of nearly $1.7 million from 1998. Two main factors explain this decline: the completion in 1998 of the redevelopment of the Bank's system for processing data collected from financial institutions; and the collection of fees under a cost-sharing agreement with the Office of the Superintendent of Financial Institutions and the Canada Deposit Insurance Corporation for the processing of these data.

As pointed out earlier, communication is an important aspect of the conduct of monetary policy. External communications activities accounted for 31 per cent of monetary policy expenses. This includes the time spent by all members of the Governing Council on speeches and regional outreach, the preparation and production costs of publications, and the activities of regional representatives.

Monetary Policy Activities as a Proportion of Total Bank Expenses



Currency

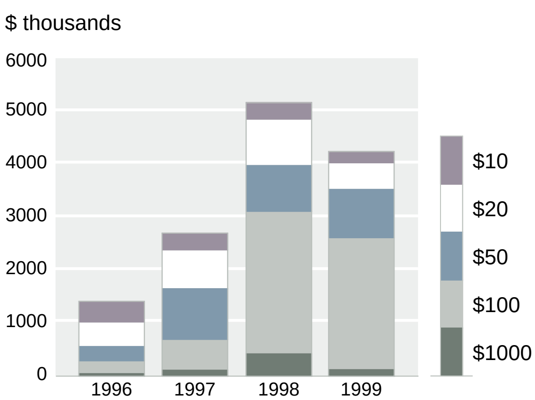
Every day, Canadians make hundreds of millions of transactions using bank notes. They rely on the Bank of Canada to provide an adequate supply of quality bank notes that are secure against counterfeiting.

During 1999, the Bank broadened and intensified its program of public education about the security features of genuine bank notes. It continued to pursue research and development work on bank note technology and security. It carried on with activities related to the issuance of a new series of bank notes and, together with its partners in the Bank Note Distribution System, completed thorough and extensive preparations for the year 2000.

The Incidence of Counterfeiting

Counterfeiting remains at relatively low levels in Canada. Counterfeits make up only a small fraction of one per cent of the total value of notes in circulation. Nevertheless, counterfeiting has increased in recent years.

Value of Counterfeit Bank Notes Found in Circulation



The value of counterfeit notes found in circulation doubled between 1997 and 1998, owing mainly to a sharp increase in the number of counterfeit $100 notes. In contrast, the value of counterfeit notes found in circulation fell during 1999. The change from 1998 to 1999 can be attributed chiefly to declines in the counterfeiting of $10, $20, and $1,000 notes.

Counterfeit bank notes can be readily distinguished by the absence of the gold-to-green colour shift in the Optical Security Device—the shiny rectangle in the upper left-hand corner of genuine $20, $50, $100, and $1,000 notes. Counterfeit notes also lack the other security features found on genuine notes, such as the raised ink in the portraits and the green dots or planchettes that can be peeled off.

For more information, telephone **1-888-513-8212** or visit the Bank's Web site (**http://www.bank-banque-canada.ca**).

The Bank works closely with the Royal Canadian Mounted Police (who are responsible for enforcing Canada's anti-counterfeiting laws) to monitor and analyze counterfeiting in Canada. This provides valuable support both to counterfeiting investigators and to the Bank's currency education program.

Bob Dolomont, from our Atlantic regional office, in a presentation to the Canadian Society for Industrial Security, Moncton, New Brunswick

Currency Education

The best defence against counterfeiting is an informed public that readily recognizes the security features of genuine bank notes.

Throughout 1999, the Bank continued to broaden its currency-education program. Bank staff made some 280 presentations to cash handlers in the retail and financial services sectors, business groups, educational institutions, and law enforcement agencies to increase their awareness of the key security features of genuine bank notes. Those presentations were complemented by the distribution of posters, leaflets, and training videos and by the programs of the Currency Museum.

Over the next two to three years, the Museum will develop Web-based programs and exhibits on Canada's numismatic heritage and on the roles and responsibilities of the Bank.

Research and Development

New bank note technology and security are a powerful defence against counterfeiting.

The Bank's research and development program focuses on combating counterfeiting threats from advances in copier and computer technologies and on improving bank note production methods.

During 1999, the Bank studied new anti-counterfeit ing devices as well as the material on which bank notes are printed. The overall aim of the program is to develop a new type of Canadian bank note, one that can be modified over time in response to new technological threats. Accordingly, the Bank is drawing upon expertise from bank note printing companies, law enforcement agencies, and leading note-issuing authorities around the world. The Bank is also consulting the general public, government officials, and visually impaired Canadians about design themes and features for the new notes.

The New Note Series

The Bank is planning to begin to issue the first notes in the new series during 2001. The introduction of the new notes would continue over the next two to three years.

During 1999, efforts were focused on integrating advanced security features into an overall note design. The new notes will incorporate a suite of security features using improvements in bank note technology, production techniques, and durability. In addition to enhancing security, the improvements are expected to reduce the costs of bank note production. As a result of work with financial institutions and equipment manufacturers, the introduction of the new series is not likely to require significant changes to current note-handling facilities and equipment.

Going . . . going . . .

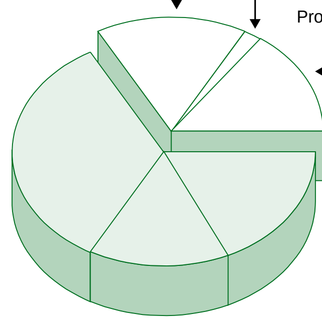
In November 1999, for the first time in its history, the Bank of Canada auctioned off surplus bank note material to collectors. None of this material was part of the National Currency Collection. The public auction route was chosen to ensure that the sale was open to all Canadians.

Specimen bank notes of earlier series and low serial number notes from the 1969–79 series were offered at an auction in Toronto and through fax and e-mail bids. The sale generated considerable interest among collectors and the general public, and lots sold well above their expected values.

Operating Expenses

Expenses for currency operations were $72.7 million during 1999, or about 33 per cent of the Bank's total operating expenses during the year. These expenses represent

Currency Activities as a Proportion of Total Bank Expenses



an increase of $15.2 million, or some 26 per cent, over 1998. This significant increase is attributable to year-2000 preparations. New notes that would have been printed in 2000 and 2001 were printed in 1999 and were also distributed across the country.

Currency expenses are reduced by revenue from the sale of optical security material. For many years, the Bank has been producing the optical security material for its own use in the rectangular gold-green security patch on high-value Canadian notes. Other versions of the material have been made available for sale on a commercial basis to official issuers of bank notes in other countries. In 1999, revenue from these sales increased significantly.

Without expenses related to the year-2000 date change, expenses for currency operations during 1999 would have been $56 million, still a significant percentage of the Bank's total operating expenses during the year, but some 3 per cent below actual expenditures during 1998.

Central Banking Services

The Bank's central banking services function has two main objectives: to promote a safe and sound financial system in Canada and to provide efficient funds-management services to the federal government.

Promoting a Safe Financial System

Oversight of major clearing and settlement systems

Under the Payment Clearing and Settlement Act (PCSA), the Bank of Canada is responsible for the oversight of Canada's major clearing and settlement systems. These are the systems through which financial institutions transfer funds or process and discharge payment obligations from the purchase and sale of financial instruments such as debt, equity, foreign exchange, or derivatives. The Bank reviews the arrangements that are used to manage and control risks in these systems to ensure that the financial system would not be seriously disrupted if a participant failed.

LVTS begins full operations

On 4 February 1999, the Large Value Transfer System (LVTS) began full operations. It was designed and built by the Canadian Payments Association, which is made up of deposit-taking institutions and the Bank of Canada. The LVTS now forms the core of the national payments system, processing large-value or time-critical payments quickly and continuously throughout the day. The LVTS plays a particularly important role in the settlement of Canadian dollar payment obligations arising from securities and foreign

The LVTS and the Bank of Canada

Once it began operations, the LVTS was designated under the Payment Clearing and Settlement Act as subject to Bank of Canada oversight. This ensures ongoing monitoring of the arrangements to control potential risks. It also provides greater legal certainty that payments will be settled even if one or more participants should fail. To address any remaining concerns about risk in the existing payments system—the Automated Clearing Settlement System—the Bank of Canada and LVTS participants are working to bring most large-value payments into the LVTS.

The LVTS has also enabled the Bank to act as settlement agent for the Debt Clearing Service (DCS) without incurring significant risk. The DCS is an electronic clearing and settlement system that handles transactions involving Canadian dollar bonds and money market securities. With the Bank acting as settlement agent, so-called "banker risk" has been eliminated for the DCS and its participants. Banker risk refers to the possible failure of a private sector institution acting as settlement agent.

exchange transactions. By providing certainty of settlement for each payment message it accepts, the LVTS significantly reduces risk in Canada's payments system. Its introduction has brought Canada in line with the best international practices for handling large-value payments. The system currently processes an average of 13,500 payments each day for a total daily average of just over $100 billion.

Clearing and settlement systems for foreign exchange

The LVTS will permit the Canadian dollar to be included in cross-border, multi-currency clearing and settlement systems, such as arrangements to be operated by the CLS Bank International. This arrangement is designed to significantly reduce and control the risks associated with the settlement of foreign exchange transactions. To do this, the CLS Bank requires the co-operation of central banks whose currencies (such as the Canadian dollar) will be part of this service. The Bank of Canada has indicated that it will provide a settlement account and act as the settlement agent for the CLS Bank. Under this arrangement, the Bank of Canada, the LVTS, and the DCS will be required to open at 12:30 a.m. each business day to overlap with the business hours of payments systems in Europe and the Far East.

The Bank of Canada is part of a group of central banks that is discussing with CLS Services the exact nature of its risk-containment and settlement arrangements. While a firm start-up date has not yet been determined, the service is likely to start operations in 2001.

Core principles for major payments systems

The Bank of Canada is a member of a task force made up of 23 central banks, the International Monetary Fund (IMF), and the World Bank. The task force is developing a set of core principles that major payments systems should satisfy to be considered safe and efficient by public sector authorities. It has also addressed the responsibilities of a central bank in applying these principles. A draft of the core principles was released for comment in December 1999. After publication of the final report, the Bank intends to incorporate the core principles into the guidelines issued under the PCSA and to apply them to systems designated under the Act.

As part of its recent review of Canada's financial sector stability, the IMF agreed with the Bank of Canada's assessment that the LVTS is in full compliance with the draft core principles.

> The CLS Bank will be a special-purpose bank under U.S. federal law and will be supervised by the Federal Reserve. Headquartered in New York, it will have operations in London and New York. The Bank is wholly owned by CLS Services (CLSS), a holding company with headquarters in London. CLSS currently has over 60 shareholders from 14 countries (including a number of Canadian banks). Ownership is open to qualified financial institutions.

IMF Assesses the Stability of Canada's Financial Sector

In the autumn of 1999, as part of a pilot project, the IMF conducted an assessment of the Canadian financial system. Formally called a Financial System Stability Assessment, the exercise is aimed at helping governments make improvements to increase the resilience of the financial sector. The IMF noted that Canada has a financial system that is sound and stable and that its regulatory framework shows a high degree of compliance with major international standards.

Entry of foreign bank branches into Canada

In June 1999, the federal government amended banking legislation to permit foreign banks to operate in Canada through branch offices. This raised a number of risk issues for clearing and settlement systems because foreign banks will be subject to the legal regime of their incorporating jurisdiction as well as to Canadian law. To address these issues, the PCSA was amended to allow the Governor of the Bank of Canada to judge whether the direct participation of a foreign bank branch in a clearing and settlement system designated under the Act would pose an unacceptable risk. Where the Governor concludes that such risks exist, the Governor can prohibit or place conditions on the participation of a foreign bank branch in the designated system.

Policy development for the financial sector

Following the September 1998 report by the Task Force on the Future of the Canadian Financial Services Sector, the federal government published a policy paper in June 1999 outlining a modified policy framework for the Canadian financial sector.

The Bank played a significant role in the work leading up to the policy paper, providing analysis and advice to the Department of Finance on many issues affecting the safety and efficiency of the financial sector. Of particular importance to the Bank were proposals to give life insurance companies, securities dealers, and money market mutual funds access to the payments system. And, given the Bank's oversight responsibilities under the PCSA, another area of considerable interest was greater public oversight of the operations of the Canadian Payments Association and possibly other payments systems.

Publication of policies, standards, and procedures

During 1999, as part of its activities aimed at promoting the stability of Canada's financial system, the Bank developed policies, standards, and procedures governing the purchase and sale by the Bank of certain securities and other financial instruments under conditions of severe and unusual financial market or financial sector stress. The Bank of Canada Act gives the Bank the discretionary power to carry out such transactions, and the policies, standards, and procedures clarify the types of securities that would be eligible and the circumstances under which such transactions might be considered. As required by the Act, the policies, standards, and procedures were published in the *Canada Gazette*; they are also posted on the Bank's Web site.

Funds-Management Services

Government borrowing

As fiscal agent for the federal government, the Bank manages the government's borrowings through treasury bill and bond offerings and advises on the structure of the public debt. Initiatives in 1999 were directed towards enhancing the liquidity of the government's outstanding debt. For example, the pilot bond buyback program, designed to increase the supply of more actively traded benchmark issues and to encourage broader participation in the market, was improved to permit faster turnaround of buyback results to market participants. Almost $2.8 billion was repurchased from the market in five buyback operations.

International Financial Stability

In 1999, two new international forums began work to promote financial stability.

- **The Financial Stability Forum (FSF)** was established by the Group of Seven (G-7) countries to promote information exchange and to coordinate the activities of national authorities (including central banks), international institutions, and international regulatory or expert groups with responsibilities for various aspects of financial stability. Canada is represented on the Forum by the Department of Finance, the Bank of Canada, and the Office of the Superintendent of Financial Institutions. Among the FSF's first initiatives was the establishment of three working groups to recommend policy actions in the areas of highly leveraged institutions, international capital flows, and offshore financial centres. More recently, work has begun on two further topics: the implementation of standards relevant to the strengthening of financial systems and a review of recent experience with deposit insurance schemes.

- **The Group of Twenty (G-20)** was also established by the G-7 countries to encourage informal dialogue on important economic and financial policy issues among systemically important economies. Canada's Minister of Finance, Paul Martin, was chosen to chair the G-20 for the first two years. At their first meeting in December, ministers of finance and central bank governors from the 20 countries discussed ways to reduce the vulnerability of economies to international developments, including the role played by an appropriate exchange rate regime and a strong and stable financial sector.

Investing government funds

Last year, the Bank worked with the government to formulate new investment guidelines for Canada's foreign exchange reserves. These guidelines will help the Bank minimize the cost of holding reserves while continuing to practise prudent risk management. During the year, reserves increased by US$5.2 billion, largely through market operations conducted by the Bank, as fiscal agent, including purchases of foreign currency. Adjustments to reserves became more transparent when Canada became one of the first countries to comply with a new international format for reporting foreign exchange reserves. These data are released regularly on the Bank's Web site. The Bank will also publicly confirm any official intervention in the foreign exchange market by an announcement on the same day. There were no interventions during 1999.

Since February 1999, the Bank has been using the Large Value Transfer System to settle most of the government's payment and revenue flows.

Other Banking Services

Security registry services

Federal legislation requires the Bank of Canada to provide security registry services in all provinces. Since mid-1998, the Bank has provided this service through a privately owned and operated company. Not only has the response time for searches improved, but authorized users are now able to conduct searches via the Internet.

Multilateral financial assistance packages

The Bank of Canada advises and assists the government when it participates in multilateral financial assistance packages for emerging-market economies. Only one such arrangement involving Canada was active in 1999—a facility provided to the Brazilian central bank by a group of industrial countries in December 1998. Canada's share of the credit facility was US$500 million. The Brazilian authorities made several drawings and repayments on this facility during the year.

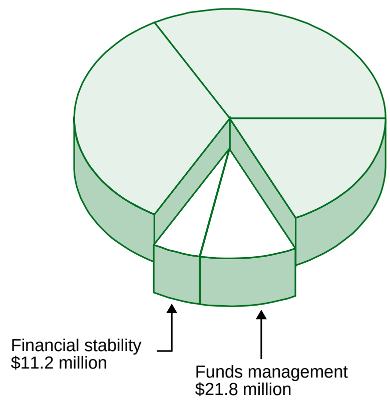
Unclaimed balances

Chartered banks are required to transfer to the Bank of Canada all unclaimed bank balances maintained in Canada in Canadian currency that have been inactive for a period of 10 years. New methods of access that have been introduced in recent years have had a dramatic impact on the levels of service provided by the Bank. During 1999, the Bank responded to over 17,400 general inquiries, completed more than 61,600 searches, and paid a total of $6.4 million to satisfy approximately 11,700 claims.

Unclaimed Bank Balances

To increase public access to information on unclaimed bank balances, the Bank operates a toll-free telephone service (**1-888-891-6398**) and maintains an e-mail address (**ucbalances@bank-banque-canada.ca**). Individuals can also use a search facility on the Bank's Web site (**http://www.bank-banque-canada.ca**) to find out if there is an unclaimed balance to which they may be entitled. They will also be told how to claim a balance. For those without Internet access, most public libraries are now equipped with Internet stations. The public can also access information on unclaimed bank balances at any of the Bank's five regional offices. The addresses of these offices can be found on page 60.

Central Banking Services Activities as a Proportion of Total Bank Expenses



Operating Expenses

Expenses for central banking services were $33 million, or 15 per cent of the Bank's total operating expenses in 1999. This is an increase of $2.3 million over the 1998 levels, attributable mainly to increased staff and systems-development costs in the function's two main service areas—particularly in government funds management. Revenues received for services totalled $750,000, down 19 per cent from 1998 due to a revised fee schedule for custodial services to The Canadian Depository for Securities Limited.

Retail Debt Services

The Bank provides services for the federal government's retail debt program. Under this program, the government issues traditional Canada Savings Bonds (CSBs), Canada Premium Bonds offering a higher interest rate than CSBs but redeemable only annually, and other debt held by individuals.

The program is directed by the Department of Finance and its agency Canada Investment and Savings, who determine products to be offered, interest rates to be paid, and strategies for sales and marketing. The Bank provides operational and systems support for these activities. This is a major undertaking, involving millions of accounts and extensive computer systems and call centre facilities.

Activities

During 1999, a key focus was the consolidation of the new business processes introduced for the retail debt program in recent years. These processes related to

- a new computer-based system developed over four years to handle the retail debt register
- a multi-year project to completely revamp the handling of the CSB Payroll Savings Plan offered through more than 15,000 companies
- support for the concurrent offering of two products—CSBs and Canada Premium Bonds

A new Payroll Savings Plan is being phased in. Some 200,000 participants were added in 1999. A pilot was run to accommodate smaller employers who are unable to meet the standard requirements of the program for transmitting data. Satisfaction with the new plan remains high with both sponsoring employers and participating employees.

Improving service to the public was a high priority in 1999. Customer service demands have increased in line with the expanded range of retail debt products and an extended sales period of six consecutive months. As a result, the call centre has been expanded and reorganized to handle the increased volume—more than 1 million calls were received in 1999.

Operating Expenses

Expenses for retail debt services were $73.9 million in 1999, or 34 per cent of the Bank's total operating expenses. Reflecting the increased activities noted above, retail debt expenditures were up $8.4 million from the previous year. The government reimburses the Bank for all of these costs.

Retail Debt Services Activities as a Proportion of Total Bank Expenses