AN ACCOUNT OF OUR STEWARDSHIP

Monetary Policy

The goal of Canadian monetary policy is to contribute to rising living standards for all Canadians through low and stable inflation. Specifically, the Bank aims to keep the rate of inflation, as measured by the annual rate of increase in the consumer price index, inside a target range established jointly with the government. Since 1995, the target range has been 1 to 3 per cent.

The Bank implements monetary policy through its influence on short-term interest rates and thereby on monetary conditions. The concept of monetary conditions incorporates the effects on the economy of both short-term interest rates and the exchange rate for the Canadian dollar. Changes in monetary conditions affect inflation only indirectly and are usually felt over a period of 18 months to two years.

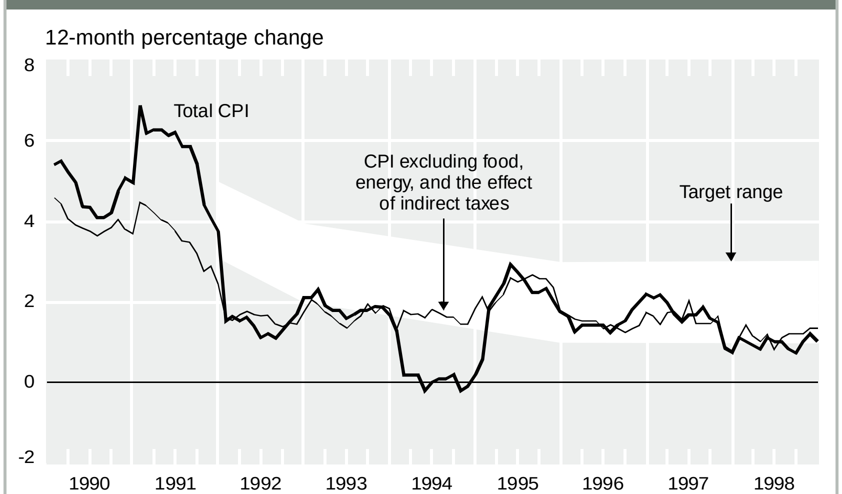
One of the most important results of the targets has been an increase in the internal discipline of the policy-making process.

Gordon Thiessen
The Canadian Experience with Targets for Inflation Control
The 1998 Gibson Lecture

Extending the inflation targets

In early 1998, the government and the Bank agreed to maintain the current target range for inflation to the end of 2001. Both judged that it would be useful to have a longer period in which the economy could demonstrate its ability to perform well under conditions of low inflation before determining the appropriate long-run target that would be consistent with price stability. The Bank reiterated that, because of the lags in the effect of monetary policy on inflation, it will continue to focus on bringing the *trend* rate of inflation (gauged by a measure of core consumer prices, which excludes volatile food and energy prices and the effect of indirect tax changes) towards the centre of the range over a period of about two years.

Consumer Price Index



Meeting the target

The Bank's core measure of inflation fluctuated around the lower end of the target range throughout 1998, ending the year at 1.4 per cent. It was held down because adverse global economic developments led to a more pronounced slowing in the pace of domestic economic expansion than had been anticipated and to downward pressures on import prices. The fall in the external value of the Canadian dollar provided an offsetting influence by raising prices in certain sectors. The overall consumer price index rose more slowly—only 1 per cent—because of declines in oil prices.

Over the past year, global developments resulted in an exceptionally high degree of economic and financial uncertainty. The most significant consequences of these developments for the Canadian economy have been reduced world prices of primary commodities and the unsettling effect of financial market instability on business and consumer confidence.

Because Canada has a floating exchange rate, much of the adjustment has taken place through a decline in the external value of the Canadian dollar, rather than through deflationary pressure on output, employment, and wages. While that adjustment was taking place, the Bank had to guard against any potential loss of confidence in Canadian dollar investments. That task became more exacting in late summer, when global financial markets became increasingly edgy following the Russian debt moratorium. In this unsettled environment, the inflation-control targets provided an essential medium-term focus for the conduct of monetary policy.

Longer-term expectations of inflation, as reported by surveys of business forecasters, remained slightly below the midpoint of the target range. The yield spread between conventional and inflation-indexed government bonds narrowed further, indicating that investors are increasingly confident that inflation will remain low over the long run.

Promoting understanding of monetary policy

In the face of substantial economic and financial uncertainty, the Bank's regional offices, which opened in 1997, played a key role in explaining the issues confronting monetary policy. Staff from these offices assisted directors and members of the Governing Council with their communications activities across the country. They made numerous presentations to business, academic, and community groups; established contact with provincial government officials; and greatly expanded the number of companies and industry associations visited and the geographic area covered. These visits provide valuable opportunities to discuss monetary policy and to gather information on economic developments.

The inflation-targeting approach used by the Bank of Canada to implement monetary policy has been very successful in lowering inflation and maintaining it at a low level.

Statement of
IMF Mission to Canada
30 November 1998

Assessing international developments

Because international developments influence the Canadian economy and financial markets, the Bank devotes considerable time and energy to understanding and anticipating events in other countries. This involves close contacts with international economic and financial organizations, where information is shared and views are debated.

Also in 1998, the Bank of Canada hosted the fifth annual meeting of central bank governors of francophone countries. The participants, who came from 18 countries and from the International Monetary Fund, were invited to compare their respective challenges under different exchange rate regimes.

Research and analysis

The formulation of monetary policy rests on research and analysis. To ensure sound research, the Bank maintains contact with academics and other researchers in Canada and abroad. This involves networking, participating in and hosting conferences, and publishing research. To bring additional views on monetary policy from outside the Bank, a new visiting Special Adviser position was created in 1998. The one-year term position was filled in August by Professor David Laidler from the University of Western Ontario. Professor Laidler is one of Canada's most distinguished economic scholars and a world authority on monetary economics.

Research in 1998 focused on policy-making under uncertainty, the consequences of downward nominal wage rigidity for the choice of a long-run inflation target, and the explanation and prevention of international currency crises. The Bank also hosted a conference at which market practitioners and researchers from universities and other central banks discussed the information that can be derived from financial market prices. The proceedings of that conference will be published in the spring of 1999. The next conference, in the autumn of 1999, will examine

Foreign Exchange Markets

A survey of foreign exchange markets conducted in 1998 by central banks in 43 countries shows that Canada's foreign exchange market is the 11th largest in the world, with a daily turnover of about US$37 billion and that the Canadian dollar was the 7th-most-traded currency in the world.

The Exchange Rate and Price Stability

The exchange rate is an important price in the Canadian economy. It affects how much Canadians pay for imported goods and services and how much Canadian producers receive for goods that are exported, including primary commodities. Import and export prices in turn influence our purchasing patterns as consumers as well as the production and pricing decisions of Canadian producers.

A floating exchange rate can help keep inflation in check—inside the target range—by sheltering domestic prices from foreign inflation and by enabling monetary policy to stimulate or slow demand for Canadian products as needed. Without a floating exchange rate, the adjustment to shocks—internal or external—would fall upon wages and prices and would involve larger fluctuations in output and employment.

At the same time, Canada's inflation-control targets provide an essential anchor for the floating exchange rate. Without this anchor, the freedom of the currency to float could potentially undermine confidence in its value, both in world markets and at home.

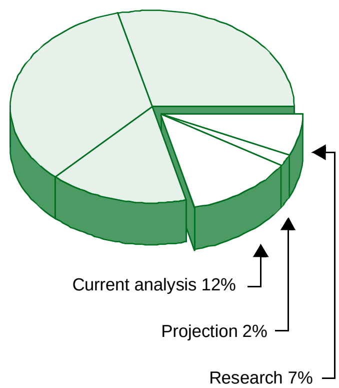
Maintaining price stability is the best way that monetary policy can help improve economic performance, and the flexible exchange rate is a vital component in that process.

the role of monetary aggregates in the transmission of monetary policy.

Operating expenses

The Bank spent nearly $41 million, or approximately 21 per cent of its total operating expenses, on the formulation and implementation of monetary policy. This represents an increase of about $3 million or 8 per cent from 1997. Contributing to this increase were the higher costs of information technology and an expansion of communication programs, particularly at the Bank's new regional offices.

Operating Expenses Related to Monetary Policy Formulation



Currency

Every year, Canadians make billions of payments using bank notes and coins. They rely on the Bank of Canada to furnish notes that are well protected from counterfeiting and to manage the supply of bank notes as economically as possible. The Bank took several steps in 1998 to accomplish these objectives. It broadened and intensified a public education program about the security features of genuine bank notes; it continued to pursue research and development on bank note technology and security; and it completed the implementation of a new distribution system for bank notes.

The best guarantee of bank note security is a public that readily recognizes the security features in bank notes.

Protecting bank notes from counterfeiting

Counterfeiting remains at relatively low levels in Canada—only a small fraction of one per cent of the total value of notes in circulation. It has, however, increased recently. The value of counterfeit notes found in circulation in 1998 was double that of the previous year, mainly because of a sharp increase in the number of counterfeit $100 notes. A number of these high-quality counterfeit $100 notes appeared for the first time during the second half of 1998 and are believed to have originated from a single source. Their most notable characteristic is the excellent reproduction of the micro-printing found on genuine bank notes.

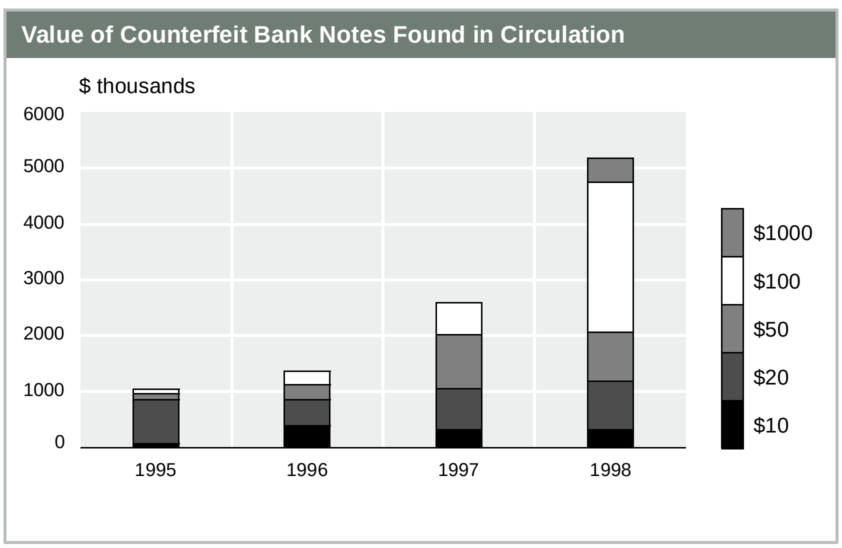
Counterfeit notes can still be distinguished by the absence of the gold-to-green colour shift in the Optical Security Device—the shiny rectangle in the upper left-hand corner of $20, $50, $100, and $1,000 notes. Counterfeits also lack the distinctive look and feel of other security features such as the raised ink in the portrait on genuine notes.

The best guarantee of bank note security is a public that readily recognizes the security features in bank notes. During 1998, the Bank added a new training video to its currency education program. This complemented the poster and leaflet introduced in 1997. Bank staff made presentations to cash handlers in the retail and financial services sectors and to police forces, to increase their awareness of the key security features of bank notes. Nearly one million leaflets were also distributed to the general public through financial institutions and provincial tourist bureaus.

The public can get more information about identifying counterfeit bank notes by calling 1-888-513-8212.

The Bank also keeps Canadians informed about the features of genuine bank notes through presentations by its regional representatives and through the Currency Museum in Ottawa.

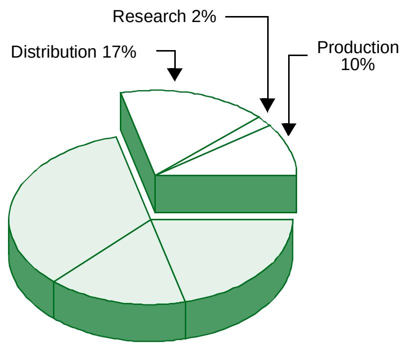
The Bank works closely with police forces, especially the RCMP, which is responsible for the enforcement of counterfeiting laws across the country.



Research and development

The Bank's program of research and development in bank note technology and security is a key defence against counterfeiting. This program focuses on developing technology to combat counterfeiting threats from advances in reproduction technology and on improving bank note production and distribution techniques. During 1998, the Bank's program centred on new anti-counterfeiting devices and the materials on which bank notes are printed. The current phase of this research and development will extend over the next two to three years, culminating in the issue of the first note in a new series. The goal is to develop new notes with better protection against counterfeiting technologies—notes that can be modified over time in response to new technological threats. The Bank is using expertise from the bank note printing companies, from law-enforcement agencies, and from leading note-issuing authorities around the world. It is also consulting with the public, the visually impaired, and with government officials. Consideration is being given to printing bank notes on polymer or polymer-based materials. These new materials could offer both increased security and longer note life, which would result in important savings.

Operating Expenses Related to Currency



Implementing the new bank note distribution system

During January 1998, the Bank of Canada and participating major Canadian deposit-taking institutions finished implementing a new system for the distribution of bank notes. It is more efficient and less costly than the old system, which was based on the Bank's nine agencies across the country. Under the new system, the participating institutions manage the flow of notes among themselves in co-operation with the Bank. The Bank is responsible for distributing the notes when they are first issued, maintaining records of note inventories in the system, withdrawing notes when they are no longer fit for circulation, and overseeing note quality and authenticity. The latter is an important responsibility of staff in the Bank's regional offices in Halifax, Montreal, Toronto, Calgary, and Vancouver.

The Bank also consults with the Royal Canadian Mint (which is responsible for the production and distribution of coins) on issues of mutual concern, particularly the distribution of coins to financial institutions.

Operating expenses

Expenses for currency operations were $56 million, or about 29 per cent of the Bank's total operating expenses. This represents a decrease of almost $10 million or about 15 per cent compared with 1997. The decline is the result of the implementation of the new bank note distribution system and lower requirements for notes.

Central Banking Services

Central banking services encompass a wide range of activities. Many involve the Bank and other government agencies working with the financial industry to promote a safe and sound financial system. Others include services provided to clients, including the federal government, financial institutions, and the general public. The Bank's goal is to provide these services as efficiently and effectively as possible.

Promoting a safe and sound financial system

Payment Clearing and Settlement Act

The Payment Clearing and Settlement Act (PCSA) gives the Bank of Canada responsibility for overseeing major clearing and settlement systems in Canada. These systems play a crucial role in the Canadian economy. The Bank's task is to ensure that appropriate arrangements are in place to manage and control risk so that if a participant in one of these systems should fail, the financial system would not be seriously disrupted.

Early in 1998, the Debt Clearing Service (DCS) was designated as subject to the Bank's oversight under the PCSA. In early 1999, similar action was taken with the Large Value Transfer System (LVTS). This did not result in any significant change in the risk-control arrangements of these systems because the Bank had been closely involved in their design. But the designation has provided greater legal certainty that the obligations of the system's participants would be settled according to the rules of the system even if one of the participants were to fail.

LVTS begins full operations

Canada's payments system became safer and more efficient early in 1999 when, after some unanticipated delays, the LVTS became fully operational. This new electronic payments system forms the core of the national payments system, providing a crucial central mechanism for reducing and controlling systemic risk. Other major clearing and settlement systems, such as the DCS, will use the LVTS to settle payment obligations among participants.

Bringing money market securities into DCS

The safety and efficiency of the financial sector was further enhanced in 1998 when over $150 billion of corporate money market securities were brought into the DCS. These securities are now traded, and the payment obligations arising from the trades are settled, in a system that is risk-proofed. Efficiency has been improved by eliminating the need for physical delivery of the securities and the exchange of the physical payment items.

In addition to these corporate securities, over $380 billion in Government of Canada securities were in this system at the end of 1998.

Acting as settlement agent

To further reduce the risk in the financial system, the Bank of Canada has agreed to act as settlement agent for the DCS. This role eliminates the so-called "banker risk" in the system—the risk arising from the possible failure of a private sector institution acting as the settlement agent.

Clearing and Settlement

A clearing and settlement system processes and discharges payment obligations among its participants (usually financial institutions). For example, the Debt Clearing Service, operated by The Canadian Depository for Securities Limited, is an electronic clearing and settlement system involving Canadian dollar bonds and money market securities. The Large Value Transfer System, operated by the Canadian Payments Association, is a real-time funds transfer system that handles large-value or time-critical Canadian dollar payments.

Clearing and settlement systems for foreign exchange

The Bank continues to have discussions with the operators and participants of clearing and settlement systems designed to reduce or eliminate the settlement risk in foreign exchange transactions. The discussions concern the development of arrangements for settling the Canadian dollar portion of these transactions and the Bank's role as settlement agent for these systems. One proposal would have the Bank, the LVTS, and the DCS 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 method for implementing monetary policy is tied to the way payments are cleared and settled each day. In 1998, the Bank determined the method that it would employ under the new LVTS. Details can be found in the autumn issue of the Bank of Canada Review.

Services to the federal government

Managing the public debt and the government's cash balances

As fiscal agent for the federal government, the Bank provides advice on managing the public debt and handles new borrowings in the domestic treasury bill and bond markets. Borrowings are done through auctions. Over 50 were run by the Bank during the year. As the government's banker, the Bank also manages the government's cash balances. This too involves auctions. To maximize the government's revenue, portions of the cash balances are offered almost daily as term deposits and are bid for by financial institutions. In the autumn of 1998, a new automated system was introduced for handling all of these auctions.

Improving financial market efficiency

The Bank has an interest in the development of Canadian financial markets and actively supports measures to improve their efficiency. In 1998, after extensive consultations with market participants, the Bank and the Department of Finance introduced new rules governing dealer and client bidding at Government of Canada treasury bill and bond auctions. The Bank also co-operated with the Investment Dealers Association of Canada in developing a new code of conduct governing trading in wholesale markets for outstanding domestic debt. To support the liquidity of the bond market, the Bank undertook, on behalf of the government, a pilot operation that involved buying amounts of smaller outstanding government issues that are not actively traded. This allows for larger issues of more-liquid debt maturities.

Managing the government's foreign reserves and financial risk

The Bank manages the government's foreign exchange reserves. It invests the assets of the Exchange Fund Account and is involved with borrowings when necessary to maintain an adequate level of reserves. The Bank also intervenes in the foreign exchange market, on behalf of the government, to influence trading in the Canadian dollar. Because of the dollar's weakness, intervention was heavy at times during 1998, as were foreign currency borrowings to increase reserve holdings.

To reflect the growth of the exchange market in Canada, the Bank and

MacKay Report

The *Report of the Task Force on the Future of the Canadian Financial Services Sector* (the MacKay report) was released in September. The report proposes significant changes to the current arrangements in the Canadian financial sector. The Bank is working closely with the Department of Finance to ensure that these important issues are given careful consideration.

the Department of Finance established a new intervention policy in September. This approach is less automatic and allows more discretion in the timing and amount of intervention. The Bank also participated with other industrialized countries in efforts to standardize and improve the quality of the information on reserve holdings that is reported to the public.

In addition, the Bank measures and monitors the government's exposure to financial risk. In 1998, a joint committee of the Department of Finance and the Bank of Canada was established to oversee this operation.

International activities on behalf of the government

Throughout 1998, the Bank of Canada advised and assisted the government concerning Canada's participation in several multilateral financial assistance packages arranged for emerging-market economies. Early in the year, a group of countries, led by the Group of Seven (G-7), agreed to establish bilateral credit lines for South Korea in support of a large financial package that had been arranged for them in December 1997 by the International Monetary Fund (IMF). Canada's contribution was an amount up to US$1 billion. South Korea did not need to draw on the facility.

In July, for the first time in 20 years, the IMF activated the General Arrangements to Borrow (GAB) to help finance a loan to Russia. Similarly, in December, the New Arrangements to Borrow (NAB), which are similar to the GAB, were activated to support an IMF financial package for Brazil. Canadian loans extended to the IMF under both the GAB and the NAB form part of Canada's international reserves.

In addition to the IMF arrangement, a multilateral credit facility was provided to the Brazilian central bank by a group of 20 industrialized countries. Canada's share in this facility was US$500 million.

GAB and NAB

The General Arrangements to Borrow (GAB) were established by the Group of Ten (G-10) countries in 1962 to supplement the regular quota-based resources of the International Monetary Fund.

The New Arrangements to Borrow (NAB) came into force in November 1998. Like the GAB, they provide additional resources to the IMF to forestall or cope with emergencies that threaten the stability of the international financial system. There are 25 participants in this new arrangement, including the G-10 countries.

Although the GAB remains in existence, the NAB is the facility of first and principal recourse. Together, they provide the IMF with supplementary resources roughly equivalent to US$48 billion, of which Canada's share is currently about US$2 billion.

Services to financial institutions

Federal legislation requires the Bank of Canada to provide a security registry service in all provinces. Lenders register with the Bank their intention to take collateral from borrowers in the form of certain financial assets as security against loans. This registry can be searched for prior registrations.

For more than a year, the Bank has been looking at alternative ways of delivering this service. It decided to contract out the development and operation of a new computer-based system, which was in place by mid-1998. Under the new arrangements, lenders register their intention to take security directly with the operator of the system at various points throughout the country. As before, the registry can be searched in response to requests submitted by mail, facsimile, and

Strengthening the International Financial System

Over the past year, a number of important initiatives were taken to strengthen the international financial system.

Particularly important was the work of three groups that were set up in April to look at a range of issues to reform the financial system. The working groups were made up of representatives of 22 industrial and emerging-market economies. Their reports were published in October and are available on the Web sites of the Bank for International Settlements and the International Monetary Fund (IMF).

The first group considered how transparency and accountability can improve economic performance. The second group studied the principles and policies that foster the development of a stable and efficient financial system. Highlighting this study was a Canadian initiative supporting "peer reviews" of national supervisory systems. The third group focused on policies that would help prevent international financial crises and contribute to their orderly resolution. It stressed the importance of appropriate exchange rate regimes, better risk management by lenders, limits on guarantees provided by governments, and effective insolvency regimes. The third group's report also set out a framework that would allow debt obligations to be worked out in a co-operative and orderly way to serve the interests of both debtors and creditors.

The Bank of Canada was represented on the first and third of these working groups, while the Department of Finance participated in the second.

At the end of October, G-7 finance ministers and central bank governors issued a communiqué in which they made a commitment to implement many of the reforms recommended by these three groups. The objective, they said, is to create "an international financial system for the twenty first century that captures the full benefits of global markets and capital flows, minimizes the risk of disruption, and better protects the most vulnerable while promoting the international monetary stability which is an element of a stable international financial system." They also pledged to work with other countries to promote the adoption of these reforms.

Two other developments that have helped to strengthen the international financial system were the establishment of the New Arrangements to Borrow in November, and the general increase in IMF quotas that came into effect in January 1999.

courier. In the future, searches by authorized users will be possible through remote Internet access.

Services to the general public

Chartered banks are required to transfer to the Bank of Canada all unclaimed bank balances maintained in Canada in Canadian currency that have been inactive for a period of 10 years. In 1998, for the first time, the Bank's Web site provided direct public access to information about these unclaimed bank balances. There were more than 300,000 visits to the site after it became operational in November. This service supplements the 1-800 telephone service and Internet e-mail address introduced in 1997.

In 1998, the Bank responded to 10,500 general inquiries (46 per cent more than in 1997), completed more than 50,000 searches (79 per cent more than in 1997), and paid a total of $4.7 million (36 per cent more than in 1997) to settle approximately 9,800 claims (61 per cent more than in 1997).

Further rapid growth in claim settlements is expected now that the Web site is up and running.

Unclaimed Bank Balances

The public can search for unclaimed bank balances on the Bank's Web site at

http://www.bank-banque-canada.ca/

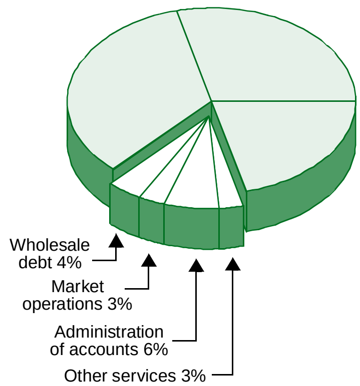
For those without Internet access, many public libraries are equipped with Internet stations. The public can also access information on unclaimed bank balances at the Bank's five regional offices.

Information is also available by calling 1-888-891-6398.

Operating expenses

Expenses for central banking services were $32 million in 1998, or just under 17 per cent of the Bank's total operating expenses. This represents a decline of about $1.5 million or 4.5 per cent from 1997, mainly attributable to more efficient delivery of these services. Revenues received for services provided totalled just under $1 million.

Operating Expenses Related to Central Banking Services



Retail Debt Services

In its role as fiscal agent, the Bank provides many services related to handling the federal government's debt. Those that relate to debt held mainly by large institutional investors were described under Central Banking Services. The remainder relate to the government's retail debt, which includes Canada Savings Bonds (CSBs) and other debt held by individ-uals.

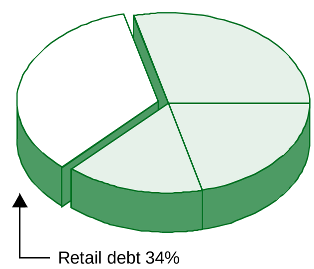
The Bank's retail debt services are distinct from its other operations. The Bank provides these services for Canada Investment and Savings, an agency of the Department of Finance, and recovers its costs from the federal government. Canada Investment and Savings is responsible for directing the retail debt program, while the Bank's role is to provide operational and systems support. (The annual report of Canada Investment and Savings is available from the Department of Finance.)

Because millions of Canadians hold the government's debt, extensive computer systems and call-centre facilities are needed to service the accounts. As a result, the resources committed to retail debt are considerable, and they have been growing in recent years, as key underlying computer systems have been redesigned to allow the introduction of new services.

Activities in 1998

During 1998, a new computer-based system for handling the retail debt register was brought on stream after four years of development. This was a major overhaul of a system that had been built in the 1970s. Over the year, progress was made on another multi-year undertaking—a complete revamping of the process for handling the CSB payroll savings plan. This plan is offered across the country through more than 15,000 employers. Many of these employers had complained about the administrative work involved in being part of the payroll savings plan. The new process sharply reduces their work and eliminates fees paid by the government for services from financial institutions. It adds to the Bank's activities, however, and was a significant part of the increase in retail debt operating expenses in 1998.

Operating Expenses Related to Retail Debt Services



The Bank also provided operational support as new features were added to the government's retail debt program during the year. This included the introduction of the Canada Premium Bond, which offers a higher interest rate but can be redeemed only annually. It also included an extension of the sales period, beyond the traditional autumn campaign, for both Canada Premium Bonds and CSBs.

During 1998, the Bank completed the consolidation in Ottawa of services to bondholders that were previously offered through the Bank's agencies.

Operating expenses

Expenses for retail debt services were $65.5 million in 1998, or 34 per cent of the Bank's total operating expenses. This represents an increase of about $18 million or 37 per cent over 1997. The increase is due to new computer systems and support for the expanded retail debt program. All of these costs are recovered from the federal government.