# BANK OF CANADA

Annual Report
1 9 9 7

# HIGHLIGHTS
# 1997

- With inflation remaining low for the sixth consecutive year, the Canadian economy recorded a strong expansion of about 4 per cent through 1997.

- The Bank increased its contacts with individuals, groups, and provincial governments through its regional representatives in Vancouver, Calgary, Toronto, Montreal, and Halifax.

- An independent study on the Bank of Canada's handling of gold during World War II established that the Bank had no involvement in Nazi gold transactions.

- The Bank launched a new program to promote awareness of the anti-counterfeiting features of Canadian bank notes.

- An assessment of the Year 2000 challenge for the Bank's automated systems was completed, and a central project office is ensuring that critical internal systems will continue to function properly.

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893-49-90-652

CN ISSN 0067-3587

Printed in Canada on recycled paper

Bank of Canada • Banque du Canada
Gordon G. Thiessen
Governor - Gouverneur
Ottawa K1A 0G9

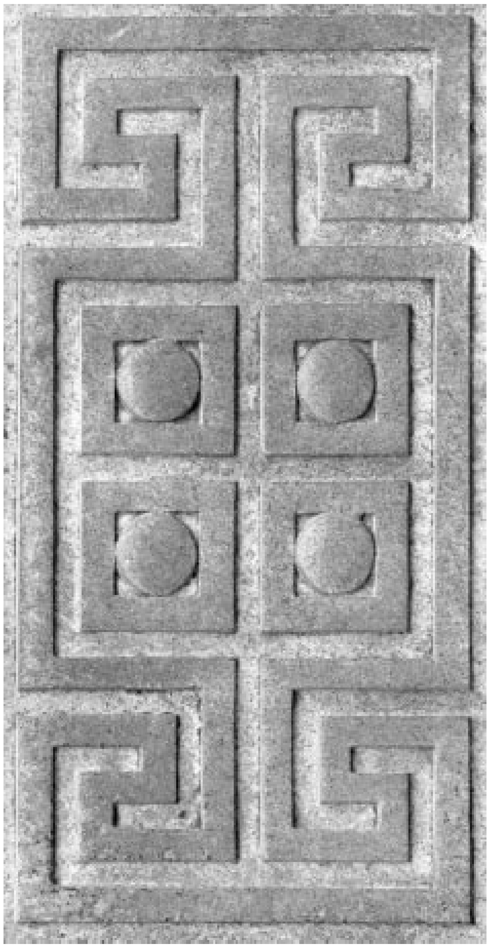
27 February 1998

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

Dear Mr. Martin,

In accordance with the provisions of the Bank of Canada Act, I am submitting the Bank of Canada's *Annual Report* for the year 1997 and the Bank's audited financial statements as at 31 December 1997.

Yours sincerely,



*Cover: Macedon, Antigonos Gonatas, tetradrachm, 277-239 BC*

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

*Photo: James Zagon*

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## Our Commitment to Canadians

- To contribute to the economic well-being of Canadians by

  - conducting monetary policy in a way that fosters confidence in the value of money

  - promoting the safety and soundness of Canada’s financial system

  - supplying bank notes that are readily accepted without concerns about counterfeiting

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

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

# STATEMENT FROM THE GOVERNOR

I want to begin this year's report by commenting on some of the economic developments that are on the minds of Canadians. After that, I would like to highlight a few of the events that show how the Bank of Canada fulfilled its commitments to Canadians during 1997.

**Gordon Thiessen**

## Canada's economic prospects

The problems being faced by the countries of Southeast Asia, South Korea, and Japan are leading to estimates of slower growth in the world economy and to predictions of downward pressures on international inflation rates. Canada has found itself caught up by some of the reactions to these Asian problems in international financial markets and in markets for the primary commodities that we export. Lower commodity prices and nervous investors turning to the U.S. dollar in search of a safe haven have contributed to the recent weakness in the Canadian dollar.

In such a period of uncertainty and nervousness, it is useful to look again at the basic situation of the Canadian economy. In fact, that situation remains remarkably positive. For much of the last 25 years, the Canadian economy has suffered from three major shortcomings: a high inflation rate, persistent budget deficits that led to very high levels of public debt, and a private business sector that had managed only relatively small gains in productivity over the period and was slow to gear up to the increasing competition being generated by new technology and more open international markets. Recently, Canada has made remarkable progress in all three areas. Our inflation rate has been 2 per cent or less for the past six years. The fiscal situation of the federal government and most provinces is close to balance or in surplus. The ratio of accumulated government debt relative to the size of our economy is finally starting to fall. As well, Canadian companies have made major adjustments over recent years, adopting new technologies and becoming more internationally competitive.

*For the economy as a whole, prospects remain bright.*

*Canadian companies have made major adjustments over recent years, adopting new technologies and becoming more internationally competitive.*

There is no doubt that the impact of events in Asia will be felt more strongly in those industries and regions with the closest trade links to Asia and those associated with primary commodities. As well, the ice storm that hit eastern Ontario, Quebec, and parts of the Maritimes in January 1998 has had a short-term impact on economic activity. Nonetheless, for the economy as a whole, prospects remain bright. The combination of internationally competitive Canadian firms and a robust U.S. economy should mean that most export industries will continue to prosper. At the same time, the low interest rates in Canada, made possible by low inflation and improved government finances, will continue to support spending by businesses on new technology, machinery, and equipment and by households on housing, motor vehicles, and other durable goods. The improved fundamentals underlying our economy enable Canada to absorb and adjust to international shocks, like the events in Asia, more easily than in the past.

The Canadian economy expanded strongly, at a rate of about 4 per cent through 1997. I expect that, despite the negative effects from Asia, our economy will still grow at a healthy pace in 1998. During 1997, there was a net increase of nearly 380,000 full-time jobs in the private sector, and the employment picture should continue to improve in 1998.

Although the unemployment rate fell by a full percentage point in 1997, for many Canadians our unemployment rate of 8.6 per cent at year-end is still an indicator of a tough job market. Public opinion polls suggest that many parents expect that their children will have a harder time than they did finding and keeping jobs.

There is no question that the Canadian economy has been going through a major and difficult period of adjustment. Many jobs have been eliminated and others have changed dramatically. Employees are increasingly expected to acquire new skills. But many of them fear that rapidly changing technology will soon render even those new skills obsolete.

But beneath all these changes and uncertainties are signs of more promising employment prospects. Recent economic developments in the United States provide a concrete illustration of what is possible. The U.S. economy has been ahead of us in adjusting to the changing world economy that I have been describing. The United States is in its seventh year of economic expansion with sustained gains in employment and an unemployment rate that is the lowest since 1973.

This kind of performance has been possible because U.S. firms have become highly competitive internationally and have been quick to adjust to changing markets and technologies. But translating these advantages into a low unemployment rate has required a reasonably stable growth path for the economy because that makes employers more confident about investing in their workforce and hiring new employees.

*Inflation is low, and by pursuing a monetary policy designed to keep inflation under control, the Bank of Canada is contributing to making the economic expansion in Canada as long-lasting as possible.*

I cannot stress too strongly just how important the policy of low inflation pursued by the U.S. central bank has been in achieving that economic stability. History shows that once inflation begins to take hold, the seeds of a recession are sown. The worse the inflation, the worse the subsequent recession.

All this leads me to be rather optimistic about the prospects for an improved employment situation in Canada. Inflation is low, and by pursuing a monetary policy designed to keep inflation under control, the Bank of Canada is contributing to making the economic expansion in Canada as long-lasting as possible. If the Canadian economy continues to demonstrate a capacity to become more efficient and more flexible in responding to change, and once we get through the effects of the problems in Asia, we should be looking at better prospects for economic growth and employment than we have seen for some time.

## Fulfilling the Bank’s commitment

The Bank’s commitments to Canadians are set out on page four. I want to say a few words about how the Bank worked to fulfil these objectives in 1997. A more detailed account of our stewardship is provided in the subsequent sections of this report.

The first commitment, to conduct monetary policy in a way that fosters confidence in the value of money, is translated into concrete terms through our inflation-control target range of 1 to 3 per cent. Chronic inflation erodes the value of money. In February 1998, the Government of Canada and the Bank of Canada jointly agreed that this current target would be extended through to the end of the year 2001. The press release issued by the Bank to explain this decision is reproduced on page 56.

Late in 1997, the inflation rate, as measured by the consumer price index, fell just below the Bank’s target range. This was the result of a number of temporary influences and does not reflect the underlying trend of inflation in Canada. Nonetheless, the fact that the trend of inflation is near the bottom of the 1 to 3 per cent range highlights the point I made earlier that there is plenty of room for our economy to expand.

The Bank’s commitment to promoting the safety and soundness of the financial system acquired a legislative mandate in 1996, when the Payment Clearing and Settlement Act came into force. This means that much of the work that the Bank had been doing to increase the


PHOTO: HELEN MEUBUS, COMMUNICATIONS SERVICES DEPT.

*L-R: Bernard Bonin, Gordon Thiessen, and Charles Freedman at an appearance before the House of Commons Finance Committee*

security of our financial system now becomes a legal obligation on the Bank. This past year we began to implement the legislation by issuing a guideline on how we would carry out our oversight responsibilities.

Our commitment to supplying bank notes that are readily accepted without concerns about counterfeiting has led the Bank to increase its investment in research and development of anti-counterfeiting features and production methods in preparation for the next generation of bank notes. While counterfeiting is not a serious problem in Canada, it has been rising, making it all the more important that we make use of the most effective anti-counterfeiting devices available.

The commitment to providing efficient and effective central banking and debt-management services has been bolstered by the new financial arrangements put in place between the Bank and Canada Investment and Savings, an agency of the Department of Finance set up to manage the sale of federal government debt to individual savers. Beginning in 1997, the Bank has been able to charge the agency for the services the Bank provides to support the issue of Canada Savings Bonds and other “retail” debt. This change will improve accountability.

*The Bank continued its efforts to meet its commitment to communicate openly with Canadians and to be accountable for its actions.*

The Bank continued its efforts to meet its commitment to communicate openly with Canadians and to be accountable for its actions. An important step was taken in 1997 to increase the Bank’s contact with individuals, groups, and provincial governments through new regional offices in Calgary and Halifax and expanded operations in Vancouver, Toronto, and Montreal. Our officers in these locations are responsible for promoting dialogue on monetary policy issues and on various operational aspects of the Bank’s work in the regions. Experience has shown that both the economy and monetary policy work better when Canadians are well informed about current economic issues and about the focus of monetary policy. And to do our job well, we at the Bank need to gather information from a wide range of sources and to listen to the views and concerns of Canadians.

The commitment to communicate openly faced a major challenge this year when evidence came to light that the Bank might have been involved in wartime gold transactions undertaken to help neutral countries make use of gold looted by Nazi Germany from other countries and from individuals. The finding of the investigation—that the Bank was not involved in such transactions—is described on page 31. What I would like to record here is that the Bank responded promptly and openly to the allegations and that our staff worked long and hard to ensure that the historian engaged by the Bank to assess the information had ready access to all the material on the subject, allowing him to complete his work quickly and with confidence in his sources.

* * *

Finally, I would like to add a word on the Bank of Canada as an institution. The Bank continues to undergo major adjustments. Although the review of our core responsibilities—what is crucial to the institution and what is not—is now largely behind us, some of the implications for the internal organization of the Bank and its staff are still being worked through. As well, like many other institutions, the Bank has been investing in technology to bring new efficiencies to its operations. We have also engaged in early identification of what we need to do to address the problems that the year 2000 creates for our automated systems.

The Bank had about 20 per cent fewer staff in 1997 than in 1994. At the same time, the skills required on the part of our employees and the types of positions needed in the Bank have changed enormously. This has demanded a large degree of flexibility and a willingness to acquire new skills. The staff has responded in a remarkable fashion. I want to take this opportunity to thank them all for their commitment to the process of change, their extra effort to make the changes work, and their patience in living with all the uncertainties and frustrations as well as the excitement that change brings.

Gordon Thiessen

# THE BANK AT A GLANCE

## What the Bank Does

The Bank of Canada's primary responsibilities, as set out in the Bank of Canada Act, can be grouped into four broad areas. Amendments to the act in 1997 (see page 54) do not in any way alter these primary responsibilities.

### *Monetary policy*

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

### *Central banking services*

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

### *Currency*

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

### *Debt-management services*

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

### International activities

On the international front, Bank staff participate in regular meetings and conferences of major international organizations, where the emphasis is on sharing and gathering information to assist in domestic policy deliberations. In addition, the Bank works closely with government departments on international economic and financial issues. Bank employees also take part in technical assistance programs to developing countries under the auspices of the International Monetary Fund (IMF) and the World Bank and in co-operation with the Canadian International Development Agency (CIDA).

## How the Bank Works

The Bank's responsibilities were carried out by a highly professional staff of about 1,500 regular employees and 300 temporary and contract staff as at year-end. Staff are organized into eleven departments—six directly involved in the Bank's four main areas of activity and five corporate service departments, including an internal audit department.

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

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

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

PHOTO: ANDREW BALFOUR

*Members of the Governing Council, L-R, seated: Charles Freedman, Sheryl Kennedy, Gordon Thiessen; standing: Bernard Bonin, Paul Jenkins, Tim Noël*

## Corporate Governance

There has recently been increased public interest in the effectiveness of the control exercised by boards of directors. In 1995, the Bank's Board of Directors began a review of its corporate governance. In doing so, it looked to the recommendations made by both private and public sector committees.

The Board clarified its responsibilities in a Terms of Reference document. The terms recognized that the Bank of Canada Act gives the Governor the responsibility for monetary policy and other businesses of the Bank, while conferring on the Board general oversight responsibility for the Bank as well as certain specific duties. These specific obligations are in the area of internal financial management and general administration. The Board appoints the Governor and Senior Deputy Governor (subject to approval by order-in-council) as well as the deputy governors. The Board also monitors members of senior management, participates in the strategic planning process, approves the Bank's budget and accounting practices, and reviews staffing practices and internal controls.

The Board is also responsible for reviewing all the significant activities of the Bank and evaluating the manner in which the Governor carries out his responsibilities. In addition, the Board may contribute advice on what it sees as the public interest regarding matters that are the responsibility of the Bank.

To help in discharging its mandate, the Board created a Corporate Governance Committee. This committee is composed solely of directors from outside the Bank and is chaired by a lead director (currently Judith Maxwell). The specific duties of the committee include reviewing the frequency and timing of meetings, reviewing the yearly cycle of decisions brought to the Board's attention, assessing the presentations made to the Board, and determining whether the Board is receiving the information it needs from management. In addition to chairing the committee, the lead director also presides at regular informal meetings of the Board at which management is not present.

The Board also decided to conduct an annual self-assessment. The first of these, completed in 1997, determined that the Board believes it is appropriately exercising its stewardship of the Bank's affairs, that the Board has access to the information it needs to exercise its mandate, and that the Board interacts effectively with management.

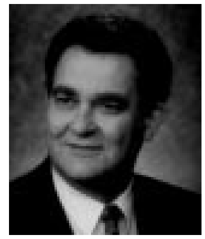
## The Board of Directors

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

As indicated on the previous page, the main role of the Board is one of general oversight with more specific responsibilities in the areas of financial management and general administration.

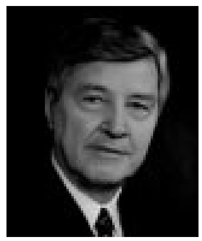
The Board of Directors meets at least seven times a year. In addition, the Board exercises its stewardship through a series of committees. The Executive Committee, which is composed of four directors as well as the Governor, Senior Deputy Governor, and the Deputy Minister of Finance, may deal with any matter within the competence of the Board and meets to deal with special matters when it is impractical to assemble the full Board. In 1996, the Board created the position of lead

Judith Maxwell, CM *
Ottawa, Ontario
Lead Director



Winston Baker
St. John's, Newfoundland

Walter Dubowec, FCA
Winnipeg, Manitoba



Raymond Garneau, OC
Westmount, Quebec

James S. Hinds, QC
Sudbury, Ontario

Aldéa Landry, QC
Moncton, New Brunswick

Harold H. MacKay, QC†
Regina, Saskatchewan

Paul Massicotte *
St-Laurent, Quebec

James S. Palmer, QC *
Calgary, Alberta

Joseph Segal, CM
Vancouver,
British Columbia

Barbara Stevenson, QC *
Charlottetown,
Prince Edward Island

C. Scott Clark **
Deputy Minister of Finance
(Ex officio)

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

Two positions were vacant on 31 December 1997.

† Mr. MacKay resigned in July 1997 to chair the federal government Task Force on the Future of the Canadian Financial Services Sector.

director and formed a Corporate Governance Committee to ensure that the Bank has good governance practices in place. Other committees of the Board are the Planning and Budget Committee, the Audit Committee, the Human Resources and Compensation Committee, and the Premises Committee. These meet several times a year according to the requirements of their subject areas. The Audit Committee, like the Corporate Governance Committee, is composed of non-management members only.

## The Year 2000 Challenge

The Bank of Canada, like most other users of computers, is faced with a need to modify many of its computer systems to deal with what has become known as the Year 2000 challenge. The challenge arises from the inability of automated systems to distinguish the year 2000 from the year 1900 because, until very recently, computers were programmed to recognize only the last two digits of the year.

The Bank recognizes that the Year 2000 challenge has the potential to cause disruptions throughout the economy and requires the attention and action of most organizations in Canada and around the world. For its part, the Bank has been working actively for over a year to address the issue as it relates to its own internal systems, to those of its main external suppliers of goods and services, and to the overall functioning of the Canadian financial system.

In April 1997, the Bank completed an internal Year 2000 Impact Assessment and presented the findings to the Board of Directors. This study highlighted the need to verify that critical internal systems will function properly, to co-ordinate testing with business partners of shared systems, and to ensure that appropriate contingency plans are in place in the event of malfunction or failure. A dedicated team was formed and is currently engaged in these tasks across the organization, led by a central project office that provides management, direction, and support. The key objectives are to complete the internal work program by the end of 1998, and in 1999 to focus on testing with our business partners and developing the necessary contingency plans.

In support of the overall functioning of the Canadian financial system, the Bank is participating in discussions with federal government departments, and with Industry Canada's Year 2000 Task Force. It is also working with domestic and international financial communities to raise awareness, encourage resolution, share best practices, and monitor the state of readiness.

# AN ACCOUNT OF OUR STEWARDSHIP

## Monetary Policy

*Inflation expectations have become increasingly consistent with the Bank's target for inflation control. This has given monetary policy more flexibility to respond to economic developments in Canada.*

The goal of Canadian monetary policy is to help the economy reach its full potential and thus contribute to rising living standards for all Canadians. The means for achieving this goal is to maintain stability in the value of money, because this will help businesses and individuals make sounder economic decisions and will moderate cyclical fluctuations in income and employment.

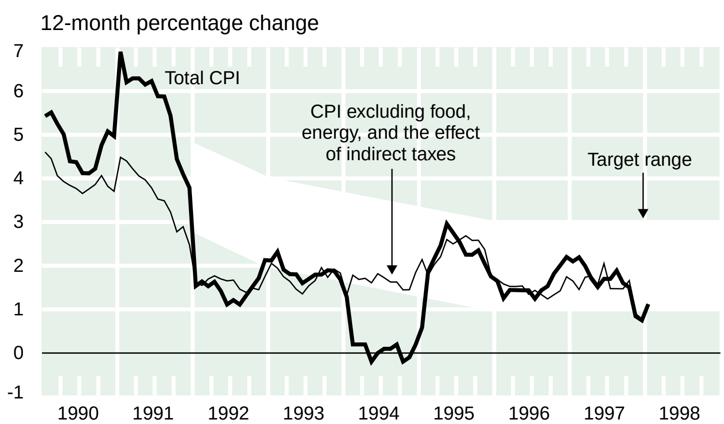
To make this objective more concrete, the Bank of Canada and the federal government have adopted an explicit target range for the rate of inflation, as measured by the annual rate of change in the consumer price index. For the period since 1995, the target range has been 1 to 3 per cent. In early 1998, this target was extended to the end of 2001 (see page 56).

The Bank implements monetary policy through its influence on monetary conditions—the combined pressures exerted on the economy by the level of short-term interest rates and the exchange rate for the Canadian dollar. The effect of changes in monetary conditions on inflation is usually felt over a period of 18 months to two years.

### Year in review

Inflation stayed between 1 1/2 per cent and 2 per cent for the first 10 months of the year, before dropping slightly below the target range late in the year, partly because of temporary discounts by retailers. In December, the total consumer price index (CPI) was up by 0.7 per cent from a year earlier; *core* CPI, which excludes volatile food and energy prices and the effect of changes in indirect taxes, was up by 0.8 per cent. Inflation is expected to move back inside the target range in the early part of 1998, once the effect of these temporary factors unwinds. (In January, both the total and core CPI were up 1.1 per cent on a year-over-year basis.)

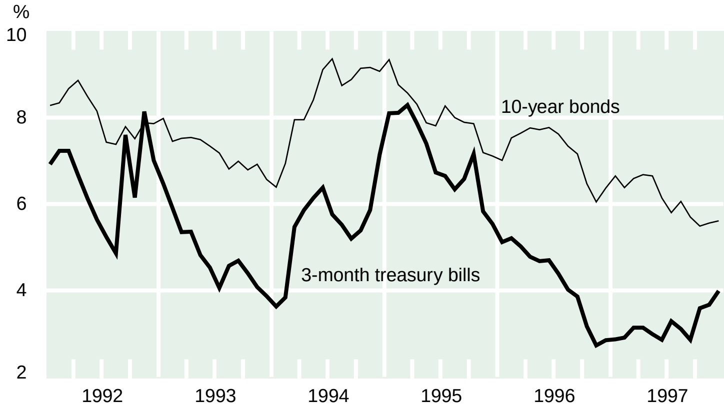
**Consumer price index**




With a dramatically improved fiscal situation, the Canadian economy has continued to derive increasing benefits from a low and stable inflation environment. In 1996, interest rates fell to their lowest levels in decades. Long-term interest rates declined further in 1997, as expectations of inflation and interest rate premiums generated by inflation uncertainty continued to come down.

Over the past year, inflation expectations have become increasingly consistent with the Bank's target for inflation control. This has given monetary policy more flexibility to respond to economic developments in Canada.

**Canadian interest rates**




In the last several years, the Bank has taken a number of initiatives to improve and enhance communications on monetary policy. In 1997, it took another major step in that direction by opening new offices in Halifax and Calgary and by expanding existing regional offices in Vancouver, Toronto, and Montreal. Representatives from these offices accompanied members of the Governing Council and of the Board of Directors in their outreach activities across the country. They also participated in briefing sessions held to discuss the *Monetary Policy Report*. The report, which is published in May and November, has itself become more open in its assessment of the economic outlook and in its discussion of the implications for monetary policy.

The Bank is also engaged in an ongoing dialogue with academics and other researchers to ensure that the formulation of monetary policy rests on high-quality analysis and research. Communication takes many forms—networking, participation at conferences, publication of research by Bank staff, and the hosting of conferences. The opening of regional offices is adding new opportunities for dialogue. The Halifax office, for example, has initiated joint projects with local researchers.

The Bank published a record number of research papers in 1997. It also published the proceedings of its 1996 annual economics conference, which dealt with the exchange rate and monetary policy. Research in 1997 focussed on the definition of price stability and the design of inflation-control targets—the topic of the 1997 conference hosted in May. The conference featured research by Bank economists and Canadian academics and also included a round-table discussion by officials of three other central banks on their experience with inflation-control targets. The conference proceedings were published in early 1998.

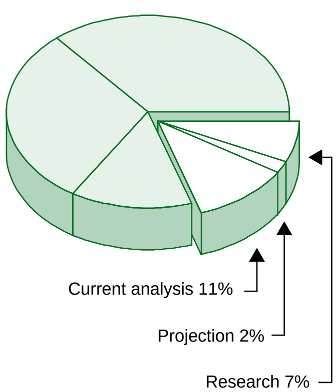
The 1998 conference, planned for this spring, will present results from recent research undertaken to extract information from financial market prices about market expectations and risk premiums. The 1999 conference will return to the role of monetary aggregates in the conduct of monetary policy, a subject of continuous study at the Bank.

The Bank collects data from financial institutions and uses it to monitor monetary and financial developments for the purpose of conducting monetary policy and to assess the safety and soundness of the financial system. The same data are also used by the Office of the Superintendent of Financial Institutions and by the Canada Deposit Insurance Corporation. Redevelopment of the Bank's system for processing these data was undertaken this year in collaboration with those two agencies under a cost-sharing agreement. Such collaboration helps lower the overall costs for all three agencies.

*Senior Regional Representative Michael Stockfish with commerce students at the University of British Columbia*

At the international level, Bank staff participate in regular meetings of the major economic and financial organizations, sharing views and information on domestic and international issues related to monetary policy. The Bank also provides advice and support to government departments, the Canadian office at the IMF, and the Canadian mission to the Organisation for Economic Co-operation and Development (OECD) on international economic and financial issues. During the second half of 1997, special attention was paid to developments in Asia and their impact globally and on the domestic economy.

**Operating expenses related to monetary policy formulation**




## Operating expenses

The Bank spent just over $37 million, or approximately 20 per cent of its total operating expenses in 1997, on monetary policy formulation. This represents an increase of about $2 million (nearly 7 per cent) over 1996. The establishment of the regional office network accounts for two-thirds of this increase.

## Central Banking Services

Central banking services encompass a wide range of activities. The primary function is the implementation of monetary policy. Central banking services also include the Bank's dealings with the financial industry to promote a safe and sound financial system. A particular challenge for the past several years has been the preparation for the Large-Value Transfer System (LVTS) being developed by the Canadian Payments Association (CPA) to handle large-value payments. The LVTS is currently scheduled to begin operating in mid-1998. Finally, central banking services include services provided to various clients, including the federal government, financial institutions, and the general public. The Bank's goal here is to provide these services as efficiently and effectively as possible.

### Year in review

#### *Market operations to implement monetary policy*

In implementing monetary policy, the Bank focusses on the overnight (one-day) interest rate. The Bank announces a band of 1/2 of a percentage point for movements of this rate and sets the Bank Rate—the Bank's official lending rate—at the upper limit of the band. This band was raised by 1/4 of a percentage point on three occasions during 1997 and once by 1/2 of a percentage point. On each occasion, a press release explained the reason for the change. The Bank also operates in the money market to keep the overnight rate within the band that has been announced. During 1997, there were 8 transactions aimed at keeping the rate from falling below the band and 31 to keep it from rising above.

Since 1996, with the Bank Rate no longer tied to the interest rate set at auctions for 3-month treasury bills, there has been less reason for the Bank to intervene in the treasury bill market and less need to hold a large portfolio of these bills. During the year, the Bank continued to work towards bringing the proportion of treasury bills and bonds in its portfolio into closer alignment with that of the government's outstanding debt.

#### *Promoting the safety and soundness of the Canadian financial system*

The Payment Clearing and Settlement Act (PCSA), enacted in 1996, gave the Bank of Canada formal responsibility for the regulatory oversight of major clearing and settlement systems in Canada (see page 55).

Towards the end of 1997, the Bank issued a guideline on how it will carry out these oversight activities. The guideline notes

*Under the Payment Clearing and Settlement Act, the Bank of Canada has formal responsibility for the regulatory oversight of major clearing and settlement systems in Canada.*

some of the factors that will be considered when deciding if a system should be designated as subject to the act, as well as the minimum standards that the Bank intends to apply to such systems. It also explains how the act will apply to systems located outside Canada that include Canadian participants.

During the year, the Bank continued to work closely with the operators of all the major clearing and settlement systems to identify potential risks in their systems and the appropriate mechanisms to control these risks. In particular, the Bank promoted discussions among participants in the LVTS and other large-value clearing and settlement systems so that the links among them can be identified and strengthened.

To date, private sector institutions have acted as settlement agents for these systems. There is a remote risk, however, that such an institution could fail after it had received payments from participants in the system and before it had made payments to other participants, thus preventing the system from settling. One way to eliminate this risk is for the Bank to act as settlement agent or banker for these systems, a power provided to the Bank in the PCSA. The Bank is actively discussing this possibility with the operators of a number of systems.

A deputy governor of the Bank of Canada served as co-chair of the Payments System Advisory Committee along with a senior official of the Department of Finance. The committee was established by the Minister of Finance in June 1996 to advise him on various issues related to the payments system, including public policy objectives for the system, access to various parts of the payments system, and governance arrangements. Four background papers were prepared for the committee. These papers, along with a summary of the discussions of the committee, are available on the Bank of Canada's web site. The committee completed its work in October 1997, and subsequent steps are currently being considered by the Department of Finance.

## Client services

### ... to the federal government

As the federal government's banker, the Bank manages the government's cash balances. To enhance return, the Bank regularly conducts auctions to place the government's excess cash on deposit in the banking system. Such auctions were conducted almost daily in 1997.

The Bank also measures and monitors the government's exposure to financial risk. Following the release in 1997 of broad guidelines from the Minister of Finance, some detailed operating policies and procedures were put in place. The Bank also introduced new risk-management software.

As agent for the Minister of Finance, the Bank manages the government's foreign exchange reserves. During the year, the Bank increased efforts to minimize the net cost of holding government foreign exchange reserves by more closely matching the maturities of assets and liabilities in the Exchange Fund portfolio. While intervention in foreign exchange markets was stepped up with the weakness of the Canadian dollar towards year-end, the frequency of intervention remained well below the levels experienced before the introduction of new criteria for intervention in 1995. International reserves were U.S.$18 billion at the end of 1997, compared with U.S.$20.6 billion a year earlier.

*During 1997, legislation was passed allowing the Bank to act as the government's agent in international bridge-lending operations for countries seeking financial assistance from the International Monetary Fund or the World Bank.*

Legislation passed in 1997 gave the government the authority to act as principal in international bridge-lending operations for countries seeking financial assistance from the International Monetary Fund or from the World Bank. This legislation also allows the Bank of Canada to act as the government's agent in such transactions. Although no bridge-loan operations were conducted during 1997, the monetary authorities of the G-10 countries (including Canada) and of other Asian and European countries agreed that they stood ready to support the Bank of Thailand by providing short-term liquidity through the Bank for International Settlements. Subsequently, as the Asian crisis widened, the Bank of Canada and the federal government participated in discussions in Manila to devise a framework of financial and technical support for affected countries in the region.

### *... to financial institutions*

In 1997, to prepare for the startup of the LVTS, the Bank implemented an electronic system for receiving pledges of collateral. The pledges are made to secure advances from the Bank that CPA members might need to meet their settlement obligations or to support the use of intra-day credit by private sector participants in the LVTS. The Bank is also developing systems for the processing and management of its own payments and account activity, which will facilitate automatic access to the LVTS.

Under the Bank Act, the Bank must provide a security registry service in all of the provinces. Lenders register with the Bank of Canada their intention to take security in the form of certain assets from borrowers. This register can be searched for prior registrations. During 1997, alternative ways to deliver this service were investigated in light of both the Bank's need to update its computer systems and service requirements and the closure of most of its regional agencies. These service requests, most of which are received by mail, facsimile, and courier, are currently being processed centrally by the Bank of Canada. A new computer system and client service arrangements now in development are expected to be implemented during 1998.

PHOTO: MICHELLE KAMINSKI, CALGARY REGIONAL OFFICE

*L-R: John Todd, Finance Minister, NWT, meeting with Senior Regional Representative Hung-Hay Lau*

New arrangements to consolidate and centralize other banking services were established in 1997. Financial institutions from across Canada are now able to ship redeemed government payment items directly to the government's cheque-processing centre at Matane, Quebec, and to settle these transactions through the Bank of Canada in Ottawa. In late 1997, in connection with the closing of its agencies in six Canadian centres, the Bank made new arrangements with members of the CPA to exchange cheques through the clearings in each of these locations.

The Bank of Canada's U.S.$2 billion reciprocal swap facility with the Federal Reserve Bank of New York and a similar Can.$1 billion facility with the Bank of Mexico were renewed in December 1997. Neither facility was activated during the year.

### *... to the general public*

*Canadians can telephone without charge for information on unclaimed bank balances: 1-888-891-6398 or e-mail ucbalances@bank-banque-canada.ca*

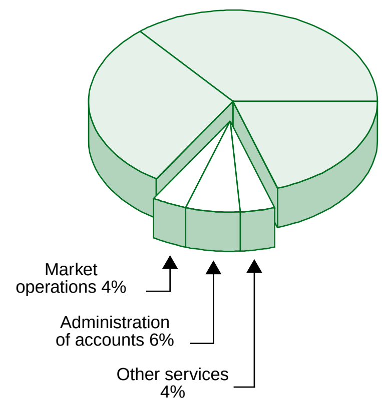
Chartered banks are required to transfer to the Bank of Canada all unclaimed bank balances maintained in Canada in Canadian currency that have been inactive for a period of 10 years. As part of the 1997 amendments to the Bank of Canada Act, the government has increased from $100 to $500 the amount below which unclaimed balances will be transferred to the federal government after being unclaimed for 20 years.

To provide the general public with easier access to information about unclaimed bank balances, the Bank introduced a 1-800 telephone service and an Internet e-mail address. In 1997 the Bank responded to 7,200 general inquiries, completed 28,000 searches, and paid a total of $3.45 million to more than 6,100 claimants. The Bank is continuing to look at ways to improve the public's access to information on these unclaimed balances.

## Operating expenses

Expenses for central banking services were approximately $25 million in 1997, or about 14 per cent of the Bank's total operating expenses. This represents an increase in expenses of about 12 per cent over the previous year. Once completely in place, the streamlining of banking services operations will provide savings of about $1.6 million annually. In 1997, the initial savings were more than offset by investment in a number of computer systems. These investments included the replacement and updating of account-administration systems and the development of the LVTS, as well as support for the Bank's risk-management unit and its regulatory oversight responsibility for major clearing and settlement systems.

**Operating expenses related to central banking services**



# Currency*

Each day Canadians make hundreds of millions of transactions using bank notes. They depend on the Bank of Canada to provide bank notes that can be used with confidence and to make bank notes available in the most economical way possible. The Bank took a number of important steps in 1997 to meet these two objectives, including completing the implementation of a new distribution system, the first phase of a public education program, and increased investment in research and development.

## Year in review

### *Implementing the new bank note distribution system*

In October 1996, the Bank and participating financial institutions began the implementation of a new bank note distribution system that is serving the needs of the institutions and the Bank more efficiently and at less cost than the previous system based on regional Bank of Canada agencies. The new system was first piloted in Calgary (October 1996) and Quebec City (January 1997) and was then implemented at seven other regional distribution points throughout 1997: Ottawa, Regina, Winnipeg, Vancouver, Halifax, Montreal, and St. John's. Toronto—the final location—followed in January 1998. The financial institutions that participated in the system's development, including all Canada's major chartered banks, will manage the flow of notes among themselves in co-operation with the Bank. The Bank will be responsible for handling the notes when they are first issued, maintaining records of note inventories in the system, and for withdrawing notes when they are no longer fit for circulation, as well as for the oversight of quality assurance and authenticity.

*An article on the new bank note distribution system was published in the Summer 1997 issue of the* Bank of Canada Review.

In the first full year after implementation, the new arrangement for bank note distribution will result in annual savings to the Bank of Canada of approximately $8 million. Most of these savings come from the closing of the Bank's cash operations at the agencies in seven cities. Oversight of bank note distribution will be an important function of the staff in the five regional offices in Halifax, Montreal, Toronto, Calgary, and Vancouver.

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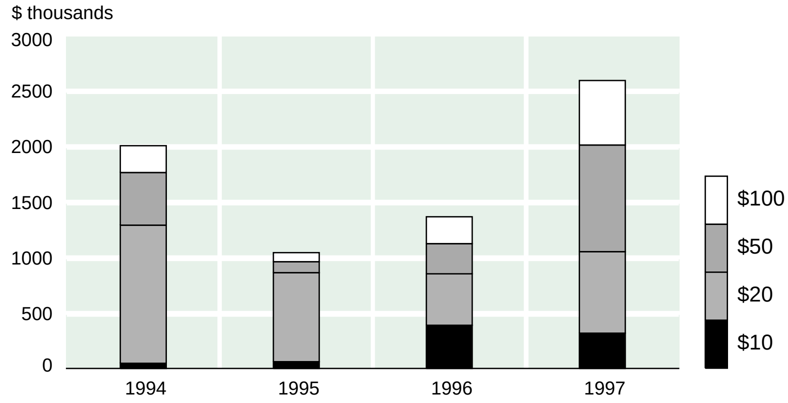
* *This function, previously called "Bank Notes," includes the monitoring and analysis of all forms of retail payments, including electronic cash, in addition to the production and distribution of bank notes. The Bank also maintains a close consultative relationship with the Royal Canadian Mint, which is responsible for issuing coin.*

## Protecting bank notes from counterfeiting

Counterfeiting remains at relatively low levels in Canada but has increased in recent years. The value of counterfeits found in circulation in 1997—a small fraction of one per cent of the total value of notes in circulation—is up substantially from 1996, owing to the increased counterfeiting of the $20 note and of higher denominations. At the same time, counterfeiting of the $10 note has fallen from 1996 levels. While counterfeiting was lower in the second half of 1997, the overall upward trend will be watched closely, particularly because the most-affected denominations are those bearing the Optical Security Device. Statistics on the counterfeiting of Canadian currency are published in the *Bank of Canada Review*.

**Value of counterfeit bank notes found in circulation**




A well-informed public is the best guarantee of bank note security. Canada's bank notes include a number of security features that allow users to confirm that the notes they are using are genuine. Nearly every bank note transaction involves a member of the public and a retailer or financial institution. The Bank has therefore launched a new program to increase awareness of the security features of Canadian bank notes. The first phase of the currency education program was designed to help cash handlers at retailers and financial institutions recognize the features of genuine bank notes. Posters and leaflets were produced in consultation with financial institutions and the retail sector, which also participated in their distribution. Close to half a million posters and leaflets have been distributed to users to date, and the industry response has been very positive.

The new education material explains the characteristics of the Optical Security Device, the shiny rectangle in the upper left-hand corner of the $20, $50, $100, and $1,000 notes, as well as the distinctive look and feel of the other visible security features.

The Bank also informs the public about the features of genuine bank notes through its regional representatives and its Currency Museum.

### Research and development

*A well-informed public is the best guarantee of bank note security.*

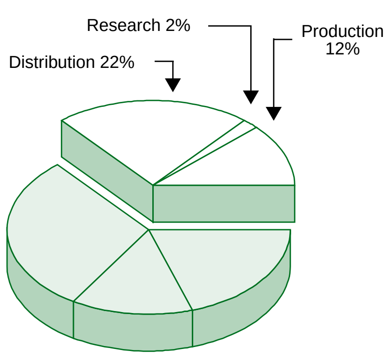
The Bank constantly monitors the level of counterfeiting and the threats posed by new reproduction technologies such as colour copiers. It also follows the development of effective countermeasures, so that bank notes with enhanced security features can be issued as soon as they are required. In 1997, the Bank significantly increased its investment in research on new anti-counterfeiting devices and on new production techniques that increase the durability and economy of bank notes, with a view to producing new note designs over the next several years. The Bank is also consulting note-issuing authorities in other countries and private sector specialists in these fields and continues to work closely with the RCMP and other police forces on training, research, and enforcement.

### Electronic money

The Bank continues to monitor the pilot projects for stored-value cards that are currently under way in Canada. Electronic money has the potential, over time, to reduce the use of bank notes in small transactions. The Mondex and Exact (Proton) card systems are being tested in Guelph and Kingston by several financial institutions, hundreds of merchants, and thousands of cardholders. Other financial institutions are sponsoring tests of the VISA Cash card system in Vancouver, Montreal, Toronto, and Barrie.

## Operating expenses

**Operating expenses related to currency**




Expenses for currency activities were just under $66 million in 1997, about 36 per cent of the Bank's total operating expenses. This represents a decrease in expenses of more than 5 per cent compared with 1996. The cost of the function is declining primarily as a result of changes to distribution, as well as lower production requirements for new notes. The cost savings from the new distribution system will not have full effect until these new arrangements have been fully implemented early in 1998. The savings are partially offset by increased investment in anti-counterfeiting measures such as the currency education program and research and development related to the design and production of the next generation of secure and durable bank notes.

## Due Diligence: The Bank of Canada's Wartime Gold Project

The subject of gold and other assets looted by the Nazi regime from governments and individuals in occupied Europe during World War II has generated worldwide interest over the last several years. There had been no indication of Canadian involvement, however, until a declassified U.S. document surfaced in July 1997, alleging that the Bank of Canada might have facilitated two wartime swaps of "tainted" gold between Portugal and Switzerland.

When the U.S. document was brought to the Bank's attention, an immediate search of its gold records was launched. The initial search showed that Bank of England gold was sent to Canada before and during the war for safekeeping. Ownership of a small portion of that gold was transferred from the Bank of England's account to that of the Swiss central bank and later to the accounts of the Portuguese and Swedish central banks. These were paper transactions on the Bank of Canada's books, and no gold was returned to Europe.

Recognizing the need for more extensive research into its records, the Bank asked Professor Duncan McDowall, an historian at Carleton University, to prepare an independent assessment. He had full access to the Bank's records, and Bank staff reconstructed the accounting ledgers from 1935 to 1956.

In his 100-page report, published at the end of November, Professor McDowall concluded that the Bank of Canada had exercised due diligence in handling these transfer requests from Europe during the war. He found no dormant gold accounts and saw no possibility that tainted gold ever found its way into the Bank's gold holdings. The Bank has made all the documents available to the public, except for information exempt under the Access to Information and Privacy Acts, and has prepared a Finding Aid for researchers.

Professor McDowall's report, entitled *Due Diligence*, and a Finding Aid that describes the records for researchers are available on the Bank's web site or through its Publications Distribution service (see page 58).

## Debt-Management Services

The Bank provides a variety of debt-management services in its role as fiscal agent for the federal government.

Most of these services relate to operations and systems support for what is commonly referred to as the government's retail debt. This is the debt, principally Canada Savings Bonds (CSBs), that is held by individuals. Because of the millions of accounts involved, this debt requires considerably more administrative support than that held by institutional investors. In fact, about 85 per cent of the Bank's debt-management expenditures in 1997 were related to retail debt.

PHOTO: NORMAND HUBERDEAU

*Senior Regional Representative Lorraine Laviolette in Magog, Quebec*

The amendments to the Bank of Canada Act in 1997 included a provision that enables the Bank to charge the federal government for providing retail debt services. This was done to strengthen the accountability framework for the government's retail debt program, which is now under the direction of Canada Investment and Savings, an agency of the Department of Finance. With the change in the act effective on 15 June, the Bank has charged back to the government its retail debt expenses from that date.

Market debt-management activities for the Bank relate to the government's treasury bill and marketable bond debt and to borrowings on behalf of the Exchange Fund Account. These activities include providing advice, managing new financings and, for Canadian dollar debt, servicing outstanding issues. Consistent with past practice, expenditures for these operations are not recovered from the government.

### Year in review

#### *Retail debt services*

Work continued on a major computer-based system, initiated in 1994, to upgrade the handling of the government's retail debt. The project is on schedule and is expected to be completed in 1998. The initial phase-in of a new system to handle the CSB payroll savings plan began in 1997. This system will eliminate fees paid by the government to financial institutions for their services and will significantly reduce the workload of companies offering the payroll plan. The Bank also provided systems support for new RRSP and RIF products.

In response to increasing use by the public, the 1-800 call centre for information on CSBs and other retail debt was expanded in 1997. The higher use was due to inquiries regarding new products and maturing CSBs, as well as greater public awareness of this service.

*For CSB information use our call centre (1-800-575-5151) or http://www.cis-pec.gc.ca/ on the World Wide Web.*

### *Market debt services*

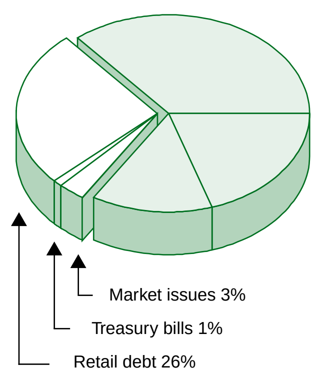
In 1997, the Bank managed over 80 auctions through which new treasury bills and marketable bonds were issued for the government. The Bank was also involved in raising U.S. dollars for the Exchange Fund Account through two global bond issues, several swap transactions from Canadian dollars, regular short-term Canada Bill borrowings, and medium-term note programs both in North America and abroad.

Along with the Department of Finance, the Bank consulted with financial market participants regarding appropriate steps to help markets adjust to reduced government borrowing requirements. One step taken was a shift to fewer maturity dates and to biweekly rather than weekly auctions of treasury bills, resulting in larger and more liquid issues. Another was the sale of government securities from the Bank's portfolio to cope with market shortages of a particular issue. A review of auction bidding rules was undertaken, focussed on limiting the concentration of new government issues among holders.

## Operating expenses

Overall, expenses for debt-management services were approximately $56 million in 1997, about 30 per cent of the Bank's total operating expenses. Retail debt expenses for the full year were close to $48 million, about 26 per cent of total operating expenses. This represents an increase in expenses of 14 per cent from 1996, as a result of the initiatives noted previously, partially offset by savings associated with a consolidation of bond services. About $29 million of these expenses were charged back to the government. Expenses for the market debt services of the Bank declined to $8.5 million from just under $10 million, as continued efficiencies were realized through the elimination of certificates and in the computerized handling of outstanding treasury bills and marketable bonds.

**Operating expenses related to debt-management services**



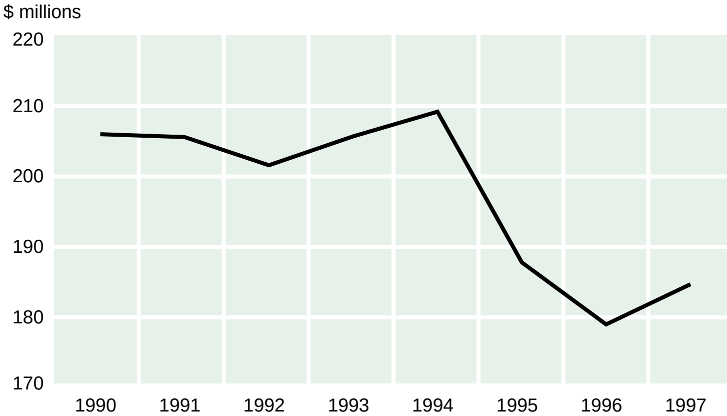
# FINANCIAL SUMMARY

# Financial Summary

The Bank has undertaken significant change over the past few years to sharpen its focus on those activities central to the Bank's public policy role, on the needs of its clients, and on the efficiency and effectiveness of its operations. This has involved new approaches to delivering services, such as the new method for the distribution of bank notes across the country, and has resulted in significant reductions in staff, the sale of a number of the Bank's buildings, and reduced expenses. But the strategy has also necessitated new investments in technology, in staff, and in infrastructure to ensure that the Bank can continue to deliver effective and efficient services into the next century.

**Total operating expenses**

$ millions




The Bank's expense profile (excluding one-time expenses) since 1994 shows the net impact of these new investments, on the one hand, and the gains associated with streamlining, increased efficiency, and a sharper focus on core business, on the other. From 1994 to 1996, savings associated with a fundamental review of operations far exceeded new investment outlays. In 1997, expenses associated with the Bank's investments more than offset further savings accruing from the earlier review of operations.

## Operating expenses

Total operating expenses rose by 3 per cent in 1997. Excluding expenses for retail debt, which the Bank began to recover from the Department of Finance at midyear, operating expenses were flat. Because the recovery of retail debt expenses started in 1997, the year-on-year comparison for net expenses is not meaningful.

Underlying the increase in total expenses were investments in four broad areas: new technology to support the retail debt program, the banking services function, and information systems; currency research, development, and education; the Bank's new regional presence program; and the Year 2000 challenge.

Savings in 1997 were generated by the implementation of the new bank note distribution system and the consolidation of bond and banking services. Also, staff benefits costs were lower, owing to the strong investment returns on pension fund assets.

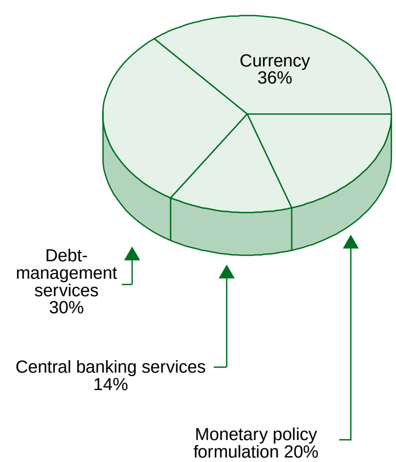
## Operating expenses by function

Millions of dollars

| | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|
| Monetary policy | 33.8 | 33.0 | 35.0 | 37.4 |
| Central banking services | 19.3 | 20.8 | 22.8 | 25.5 |
| Currency | 101.4 | 80.0 | 69.6 | 65.7 |
| Debt-management services | | | | |
| Market debt services | 14.0 | 12.3 | 9.9 | 8.4 |
| Retail debt services | 40.7 | 41.7 | 41.7 | 47.7 |
| **Total operating expenses** | **209.2** | **187.8** | **179.0** | **184.7** |
| Less: Recovery for retail debt services | – | – | – | (28.9) |
| Other expenses (revenue) | – | 33.0 | 34.7 | (11.6) |
| **Net expenses** | **209.2** | **220.8** | **213.7** | **144.2** |

Salary costs were about $72 million in 1997, or $1 million above the 1996 level. Regular staff costs were lower, primarily because of agency closures. At the same time, there was an increase in the cost of temporary and contract staff to support the retail debt program and to meet the Bank's need for specialized computer systems analysts. Although 1997 marked the end of the federal public sector salary freeze, the Board of Directors decided not to implement a general increase in Bank salary ranges for that year. Rather, increases averaging one per cent of total payroll were limited to lower-paid employees, senior officers, and critical-skill areas (information technology and economist groups) where market pressures were strong and compensation significantly lagged the market. Performance-based progression within pay ranges was also restored starting on 1 January 1997.

**Operating expenses by function**



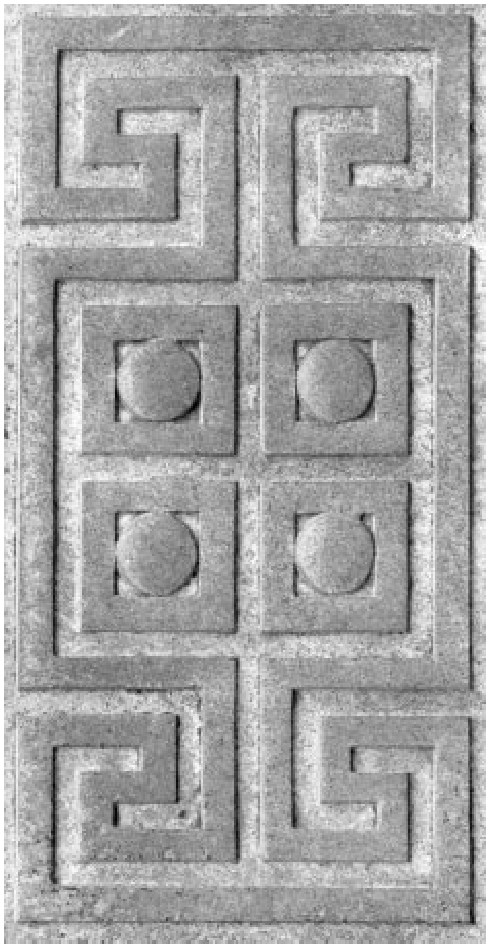

When establishing salary policy, the Bank's objective is to ensure that it has a competitive, equitable salary structure consistent with its responsibilities as a public sector institution. For 1998, the Board of Directors has approved a general increase of 2 per cent in salary ranges, with some further adjustments for certain groups to make compensation more competitive.

*Other expenses*, which this year amounted to a net revenue of $11.6 million, relates mainly to a gain of $10.1 million from the sale during 1997 of Bank buildings in Vancouver, Halifax, Calgary, and Regina. Because of the new bank note distribution arrangements and the consolidation of bond and banking services, these buildings are no longer needed. These sales are also reflected in a reduction in the value of *Bank premises* on the balance sheet. Also included in *Other expenses* is a $4 million recovery of out-of-pocket expenses incurred over the course of the liquidation of the Canadian Commercial Bank as part of the final settlement to the Bank as a secured creditor. Partially offsetting the gains is an expense of $2.5 million associated with the Bank's Workforce Adjustment Program. This amount was provided for in 1997 to cover the estimated cost of termination benefits associated with plans developed in 1997 to eliminate a further 50 positions over two years.

## Revenue

Total revenue was $1.6 billion in 1997, approximately the same as revenue in 1996. The Bank's main source of revenue is interest earned on its holdings of federal government securities that are financed primarily by the bank notes that are issued by the Bank. Net revenue paid to the Government of Canada in 1997 was $1.4 billion, the same as the previous year.

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



# FINANCIAL STATEMENTS

YEAR ENDED 31 DECEMBER 1997

# Bank of Canada
# Financial reporting responsibility

The accompanying financial statements of the Bank of Canada have been prepared by management in accordance with accounting principles generally accepted in Canada and have been consistently applied. 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 maintains financial and management control systems and practices to provide reasonable assurance that the financial information is reliable, that the assets are safeguarded and 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 fulfils its responsibilities for financial reporting and internal control and exercises this responsibility through the Audit Committee of the Board. The Audit Committee reviews the Bank's annual financial statements and recommends their approval by the Board of Directors. The Audit Committee meets with management, the internal auditors, and the Bank's external auditors appointed by order-in-council.

These financial statements have been audited by the Bank's external auditors, Coopers & Lybrand and Caron Bélanger Ernst & Young and their report is presented herein.

G.G. Thiessen, Governor

L.T. Requard, Corporate Secretary

Ottawa, Canada
12 February 1998

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

C. P. 813, SUCCURSALE B
P.O. BOX 813, STATION B
OTTAWA, CANADA
K1P 5P9
CARON BÉLANGER ERNST & YOUNG
COOPERS & LYBRAND

## 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 1997 and the statement of revenue and expense for the year then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Bank as at 31 December 1997 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles.

Caron Bélanger Ernst & Young
Chartered Accountants

Coopers & Lybrand
Chartered Accountants

Ottawa, Canada
23 January 1998

# Bank of Canada
# Statement of revenue and expense

## Year ended 31 December 1997

| | 1997 | 1996 |
|---|---|---|
| | Millions of dollars | |
| **REVENUE** | | |
| **Revenue from investments, net of interest paid on deposits of $3.8 million ($9.8 million in 1996)** | **1,578.6** | 1,648.8 |
| **EXPENSE by function** (notes 1 and 3) | | |
| Monetary policy | **37.4** | 35.0 |
| Central banking services | **25.5** | 22.8 |
| Currency | **65.7** | 69.6 |
| Debt-management services | | |
| Market debt services | **8.4** | 9.9 |
| Retail debt services | **47.7** | 41.7 |
| | **184.7** | 179.0 |
| Less retail debt recoveries | **(28.9)** | - |
| | **155.8** | 179.0 |
| Other expenses (revenue) | **(11.6)** | 34.7 |
| | **144.2** | 213.7 |
| **NET REVENUE PAID TO RECEIVER GENERAL FOR CANADA** | **1,434.4** | 1,435.1 |

**(See accompanying notes to the financial statements.)**

# Bank of Canada
# Balance sheet

## As at 31 December 1997

| ASSETS | 1997 | 1996 |
|---|---|---|
| | Millions of dollars | |
| **Deposits in foreign currencies** | | |
| U.S. dollars | **383.1** | 235.0 |
| Other currencies | **3.2** | 4.0 |
| | **386.3** | 239.0 |
| **Advances to members of the Canadian Payments Association** | **363.3** | 553.8 |
| **Investments** (note 7) | | |
| Treasury bills of Canada | **14,065.0** | 17,416.5 |
| Other securities issued or guaranteed by Canada maturing within three years | **4,165.7** | 2,328.3 |
| Other securities issued or guaranteed by Canada not maturing within three years | **8,799.7** | 5,635.2 |
| Other investments | **3,434.1** | 3,942.4 |
| | **30,464.5** | 29,322.4 |
| **Bank premises** (note 4) | **189.0** | 198.2 |
| **Other assets** | **346.1** | 271.0 |
| | **31,749.2** | 30,584.4 |

**(See accompanying notes to the financial statements.)**

| LIABILITIES | 1997 | 1996 |
|---|---|---|
| | **Millions of dollars** | |
| **Capital paid up** (note 5) | **5.0** | 5.0 |
| **Rest fund** (note 6) | **25.0** | 25.0 |
| **Bank notes in circulation** | **30,542.0** | 29,109.1 |
| **Deposits** | | |
| Government of Canada | **40.6** | 11.0 |
| Chartered banks | **539.0** | 945.5 |
| Other members of the Canadian Payments Association | **24.6** | 14.6 |
| Other deposits | **278.3** | 347.8 |
| | **882.5** | 1,318.9 |
| **Liabilities in foreign currencies** | | |
| Government of Canada | **231.2** | 91.0 |
| **Other liabilities** | **63.5** | 35.4 |
| | **31,749.2** | 30,584.4 |

Governor, **G.G. THIESSEN**

Chief Accountant, **D.D. LUSBY**

On behalf of the Board

Chairman, Audit Committee, **W. Dubowec** FCA

Lead Director, **J. Maxwell**

# Bank of Canada
# Notes to the financial statements

## Year ended 31 December 1997

**1. Bank functions**

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

**Monetary policy**

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

**Central banking services**

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

**Currency**

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

**Debt-management services**

**Market debt services**

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

**Retail debt services**

As fiscal agent, the Bank provides administrative, systems and operational support services to the Canada Investment and Savings Agency in support of the federal government's retail debt program and is responsible for issuing debt, maintaining bondholder records, and making payments on behalf of the federal government for interest and debt redemption. Effective June 1997, as a result of amendments to the Bank of Canada Act, the Bank began charging the Department of Finance with the full cost of retail debt operations.

**2. Significant accounting policies**

The financial statements of the Bank are in accordance with generally accepted accounting principles and conform to the disclosure and accounting requirements of the Bank of Canada Act and the Bank's by-laws. As all material changes in financial position are evident from the financial statements, a separate statement of changes in financial position has not been prepared as it would not provide any additional useful information. The significant accounting policies of the Bank are:

**a) Revenues and expenses**

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

**b) Translation of foreign currencies**

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

**c) Advances**

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

**d) 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. The amortization, as well as gains and losses on disposition, are included in revenue.

**e) 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 |

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

**f) Deposits**

The liabilities within this category are generally Canadian dollar non-interest-bearing demand deposits.

**g) Insurance**

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

## 3. Expense by object of expenditure

| | **1997** | 1996 |
|---|---|---|
| | **Millions of dollars** | |
| Salaries | **72.3** | 71.3 |
| Benefits and other staff expenses | **17.7** | 23.4 |
| Currency costs | **18.4** | 16.8 |
| Premises maintenance, net of rental income | **26.1** | 28.0 |
| Services and supplies | **30.7** | 19.5 |
| Depreciation | **22.3** | 23.4 |
| | **187.5** | 182.4 |
| Recoveries | | |
| Retail debt services | **(28.9)** | - |
| Other | **(2.8)** | (3.4) |
| | **155.8** | 179.0 |
| Other expenses (revenue) | | |
| Settlement cost | **-** | 22.3 |
| Workforce adjustment (note 8) | **2.5** | 5.0 |
| Miscellaneous | **(14.1)** | 7.4 |
| Total | **144.2** | 213.7 |

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

Recoveries represent the fees charged by the Bank for a variety of services. Effective June 1997, the Bank began recovering the cost of retail debt operations from the Canada Investment & Savings Agency on a full cost basis.

Miscellaneous expenses (revenue) for 1997 include a net book gain of $10.1 million related to the sale of four Bank buildings outside of Ottawa, namely Halifax, Regina, Calgary and Vancouver. As well, the Bank received payment for out-of-pocket expenses of $4.0 million incurred in connection with the liquidation of the Canadian Commercial Bank (note 10).

Certain comparative figures have been reclassified to conform with the financial statement presentation adopted in the current year.

**4. Bank premises**

| | **1997** | | | **1996** | | |
|---|---|---|---|---|---|---|
| | **Millions of dollars** | | | | | |
| | Cost | Accumulated depreciation | Net book value | Cost | Accumulated depreciation | Net book value |
| Land and buildings | **201.0** | **88.2** | **112.8** | 224.0 | 97.6 | 126.4 |
| Computer hardware/software | **36.1** | **24.0** | **12.1** | 39.1 | 26.3 | 12.8 |
| Other equipment | **132.5** | **83.0** | **49.5** | 138.7 | 85.7 | 53.0 |
| | **369.6** | **195.2** | **174.4** | 401.8 | 209.6 | 192.2 |
| Projects in progress | **14.6** | **–** | **14.6** | 6.0 | – | 6.0 |
| | **384.2** | **195.2** | **189.0** | 407.8 | 209.6 | 198.2 |

**5. Capital paid up**

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

**6. Rest fund**

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

**7. Investments**

This category includes Government of Canada treasury bills and bonds as well as other investments which are held under short-term foreign currency swap arrangements with the Exchange Fund Account of the Government of Canada as described in note 11(b).

The Bank typically holds its investments in treasury bills and bonds until maturity. The amortized book values of these investments approximate their par values. At the year-end, the average yield on the Bank's holdings of treasury bills which average three months to maturity was 3.9 per cent (3.6 per cent in 1996), while the average yield for bonds maturing within three years was 6.6 per cent (7.5 per cent in 1996), and for those maturing in over three years was 7.8 per cent (9.1 per cent in 1996).

**8. Workforce adjustment**

Following extensive reviews of its activities, the Bank has been streamlining a number of its operations resulting in an expected total reduction of about 650 of its staff positions. The position reductions are being accomplished through early retirements, voluntary departures and layoffs, and will be completed in 1998. To record termination costs, the Bank made provisions for $33 million in its accounts in 1995, $5 million in 1996 and $2.5 million in 1997. As at 31 December 1997, $31.4 million of the provision of $40.5 million had been paid.

**9. Pension plan**

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

Actuarial valuations of the pension plan are made periodically by an independent actuary using the projected benefit method prorated on service. Market-related values are used to value pension plan assets. Based on the latest actuarial valuation as at 31 December 1995, the estimated present value of the accrued pension benefits as at 31 December 1997 was $423.6 million ($418.8 million in 1996), and the estimated market-related value of the pension plan assets was $508.8 million ($468.9 million in 1996).

Pension expense for 1997 was in a credit position of $1.3 million ($7.0 million expense in 1996). These amounts comprise the actuarially computed cost of pension benefits in respect of current year service and the amortization of past service costs and experience gains and losses. Amortization is calculated on a straight-line basis over the average remaining service life of the plan members, currently 12 years.

**10. Legal matters**

On 3 September 1985 and 20 January 1986 respectively, winding up orders were issued for the Canadian Commercial Bank and the Northland Bank. At those dates, the Bank of Canada had liquidity advances outstanding of $1.3 billion to the Canadian Commercial Bank and $0.5 billion to the Northland Bank.

At 31 December 1997, the residual balance of the advance outstanding was $1 million to the Northland Bank (unchanged from 1996). On the basis of the available information, it is the opinion of the Bank of Canada that it will be fully repaid from the proceeds of the liquidation of Northland Bank.

As a result of a court order issued in December 1997 concerning the Canadian Commercial Bank, the Bank of Canada received payment of the residual balance of the advance outstanding of $45.3 million together with interest of $43.9 million and out-of-pocket expenses of $4.0 million. This brings the total amount received by the Bank of Canada in satisfaction of its claim as a secured creditor of the Canadian Commercial Bank to $1.5 billion.

An amount of $13.8 million remaining to be paid to the Bank of Canada as part of the settlement with unsecured creditors of the Canadian Commercial Bank is reported under Other assets on the Balance sheet. The Bank of Canada expects to receive $10 million of this amount before the end of March 1998.

**11. Commitments**

**a) Bank premises**

As at 31 December 1997, outstanding commitments under contracts for new computer systems and equipment purchases totalled $9.0 million ($9.1 million in 1996). These contracts call for payments over the next year.

**b) Foreign currency contracts**

In the ordinary course of business, the Bank enters into commitments involving the purchase and sale of foreign currencies. In particular, the Bank enters into short-term foreign currency swap arrangements with the Exchange Fund Account (EFA) of the Government of Canada as part of its cash management operations within the Canadian banking system. These transactions, which are made with the concurrence of the Minister of Finance under a standing authority, involve the temporary acquisition by the Bank of foreign currency investments from the EFA. These investments are paid for in Canadian dollars at the prevailing exchange rate with a commitment to reverse the transaction at the same rate of exchange at a future date. The fair values of these investments are not materially different from their book values. At the year-end, the average yield for these investments was 6.1 per cent (6.1 per cent in 1996).

As well, the Bank of Canada is a participant in two foreign currency swap facilities with foreign central banks. The first, amounting to U.S.$2 billion, is with the U.S. Federal Reserve. The second, amounting to Can.$1 billion, is with the Banco de México. There were no drawings under either facility in 1996 or 1997.

A summary of outstanding commitments follows.

| | | **1997** | **1996** |
|---|---|---|---|
| | | **Millions of dollars** | |
| Foreign currency contracts | - purchases | **95.8** | 75.4 |
| | - sales | **3,573.8** | 4,080.5 |

As at 31 December 1997, outstanding foreign currency contracts included sale commitments of $3,476.2 million ($4,005.1 million in 1996) under swap arrangements with the EFA.

**12. Year 2000**

In April 1997, the Bank completed an internal Year 2000 impact assessment. Based on the results of this study, the Bank has developed a business plan to ensure that its critical internal systems will function properly, to co-ordinate testing with business partners of shared systems, and to ensure that appropriate contingency plans are in place in the event of disruption or system failure.

The plan is designed to ensure continued and proper functioning of the payments and settlement systems, monetary policy operations, bank note operations and debt-management services. A dedicated team has been formed to provide overall management, direction and support of the Year 2000 initiatives.

The Bank's plan is to have internal systems completed by the end of 1998. In 1999, the Bank will focus on testing shared systems with its business partners and developing the necessary contingency plans. The Bank estimates that the total cost of external and internal resources for this initiative will be approximately $14.0 million over the period from 1997 to 1999, with $2.0 million of this amount incurred in 1997.

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

*Note: Positions as of 27 February 1998*

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**Vancouver (British Columbia and Yukon)**
Vacant

*Note: Positions as of 27 February 1998*

# APPENDIX

## The Bank of Canada Act: Amendments

In 1997 the Bank of Canada Act was amended in several respects. Among the most important were the following:

- With the consent of the Minister, the Bank is permitted to charge for fiscal agent services provided to the federal government.
- The Bank may pay interest to the federal government on any deposits made to the Bank and may pay interest to member institutions of the Canadian Payments Association (CPA) on deposits accepted for certain specified purposes.
- The Bank is now permitted to buy and sell a wider range of securities in accordance with policies and procedures that will be published in the *Canada Gazette*.
- The Bank may carry on business activities incidental to any of its permitted activities. For example, the sale of collector bank note products will now be allowed.
- The list of persons ineligible to be a director of the Bank is extended to include persons associated with a clearing house or with a participant to which the Payment Clearing and Settlement Act is applicable. This is in addition to the existing list that includes persons associated with a bank, a CPA member that maintains a deposit with the Bank of Canada, or an investment dealer that acts as a primary distributor. Moreover, persons associated with institutions that control, or are controlled by, any of the above entities are also ineligible.
- The Bank is required to turn over to the federal government unclaimed balances of less than $500 that have not been claimed for a period of 20 years. Previously, the amount was $100. Balances of $500 and larger will continue to be kept indefinitely at the Bank.
- The Bank is authorized to gather information from all federally incorporated financial institutions on the same basis as was previously the case for the chartered banks.

## Payment Clearing and Settlement Act (PCSA): An Update on Activities

During 1997, the Bank, with the approval of the Minister of Finance, obtained information from those clearing and settlement arrangements currently operating in Canada that might be subject to the PCSA. One system, the Debt Clearing Service (DCS), operated by The Canadian Depository for Securities Ltd. (CDS), was judged to have the potential to pose systemic risk if not properly risk-proofed, and this system was designated under Part I of the PCSA early in 1998. Since the Bank has engaged in an informal oversight of this system for a number of years, the designation will not result in any significant changes to the risk-containment arrangements of the DCS system. But designation does provide system participants with greater legal certainty that, in the event of a failure of one of the participants, all participant obligations will settle as anticipated in the system's settlement rules and procedures.

As part of its oversight of the DCS, the Bank agreed in principle in 1997 to risk-containment mechanisms that would permit the inclusion of provincial government securities as well as private sector debt and equity in the system. (Previously, only Government of Canada securities transactions had been settled on the DCS.) The introduction of some of these securities is expected in the late summer of 1998. In addition, in anticipation of the introduction of the LVTS in mid-1998, the Bank, the CDS, and DCS participants have agreed to a mechanism that will minimize the amount of collateral needed to settle DCS transactions on the LVTS, while ensuring the integrity of the risk-containment arrangements in the DCS. The Bank also agreed to play a key role in facilitating the transfer of surplus balances from the DCS to the LVTS and vice versa. Both of these latter measures are intended to promote the efficiency of these systems while maintaining robust systemic risk controls.

The Bank has also held discussions concerning appropriate systemic risk controls with participants and operators of systems designed to clear and settle large-value foreign exchange transactions. The Bank and other central banks in the G-10 countries are co-operating to oversee these cross-border multi-currency clearing and settlement systems. Under international arrangements and the PCSA, the Bank of Canada has a responsibility to satisfy itself that the procedures to be used to settle Canadian dollar transactions are appropriate.

PRESS RELEASE
24 February 1998

## Inflation-Control Targets Extended

*The Bank of Canada today released a joint statement of the Government of Canada and the Bank of Canada on the extension of the inflation-control targets, as well as additional information on the Bank's approach to implementing the targets.*

### Joint statement

The objective of Canadian monetary policy is to contribute to sustainable economic expansion, high levels of employment, and rising standards of living. The best contribution monetary policy can make to these goals is through preserving confidence in the value of money by providing an environment of stable average prices. Accordingly, the Government of Canada and the Bank of Canada today reaffirmed that monetary policy in Canada will continue to be oriented towards achieving and maintaining price stability and announced that the current inflation-control targets will be extended until the end of 2001.

Targets for reducing inflation were adopted in February 1991. In December 1993, the government and the Bank of Canada agreed to extend the targets from the end of 1995 to the end of 1998 with the objective of holding inflation inside the range of 1 to 3 per cent. It was also agreed that the targets would be re-examined by the end of 1998 and that a new long-term target range consistent with price stability would be set at that time.

Since the initial adoption of these targets, considerable progress has been made in reducing inflation and maintaining it at a low level. Economic decisions are increasingly being made on expectations of a continuation of low inflation, and Canadians are beginning to experience the benefits from such an environment. For example, low inflation, together with the progress made by all levels of government in Canada to restore fiscal balance, has resulted in a substantial decline in interest rates, with medium- and long-term interest rates near their lowest level in decades. However, over the past several years the Canadian economy has been through a difficult period of private and public sector restructuring, and the full benefits for economic performance from low inflation have yet to be realized.

It would be helpful to have a longer period of time in which the economy demonstrated more fully its ability to perform well under conditions of low inflation before determining the appropriate long-run target consistent with price stability. Consequently, the

Government of Canada and the Bank of Canada have agreed to extend the existing inflation-control targets, which are to hold inflation inside the range of 1 to 3 per cent, to the end of 2001. The government and the Bank plan to determine the long-run target for monetary policy before the end of 2001. Providing Canadians with such a long-term commitment will help to secure the benefits that a stable price environment can bring to the growth of incomes and employment in Canada.

## Implementation of policy under the targets

The Bank will continue the current approach to implementing the targets, as set out in 1991 and developed over the years. This will include the following elements.

- The target will continue to be defined in terms of the 12-month rate of increase in the total CPI, and the operational guide for policy will continue to be the CPI excluding food and energy prices and adjusted for the effects of indirect tax changes, as before.
- Monetary policy actions will continue to focus on countering persistent upward or downward pressures on the trend rate of inflation, not temporary pressures that are expected to reverse, or one-off price level changes.
- In the case of large unforeseen shifts in supply or demand, inflation may temporarily move outside the target range. Monetary policy actions would then be directed to bringing the trend rate of inflation back towards the centre of the range over a period of about two years.
- More generally, since monetary actions have their effects on economic activity and inflation with long lags, policy actions must always be directed to responding to expected developments in inflation six to eight quarters in the future.
- The Bank of Canada will continue to report in its semi-annual *Monetary Policy Report* on inflation developments, actions to achieve the targets, and its assessment of the outlook for inflation in light of economic trends.

## Further information about the Bank of Canada

*The Bank's Currency Museum welcomes 30,000 visitors each year. Our student programs are especially popular.*

### Internet

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

Provides timely access to press releases, speeches by the Governor, many of our major publications, and current financial data.

### Publications

*Monetary Policy Report*
A detailed summary of the Bank of Canada's policies and strategies as well as a look at the current economic climate and its implications for inflation. Semi-annual. Without charge.

*Bank of Canada Review*
A quarterly publication that combines economic commentary and feature articles with a set of statistical tables. By subscription.

*Weekly Financial Statistics*
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### Public information

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PHOTO: JAMES ZAGON

*School activities wrap up in the garden court with an examination of the special design of Canadian bank notes.*