BANK OF CANADA ANNUAL REPORT

2003

Gerald Bouey

Governor of the Bank of Canada from 1973 to 1987,
died in February 2004 at the age of 83.

"I, and many Canadians, will remember Gerry as a consummate Governor, a man of enormous intellect and integrity." — David Dodge, 9 February 2004

Born in Axford, Saskatchewan, Gerald Bouey received his education in the three-room school in Trossachs, where his father was the Wheat Pool agent. He entered the world of banking at 16 as a junior clerk at the Royal Bank in Weyburn. In 1941, he joined the RCAF, achieving the rank of Flight Lieutenant by the end of the war.

Upon graduating from Queen's University in 1948 with the University's Economics Medal, he joined the Bank's Research Department, becoming Department Chief in 1962. He was appointed Adviser to the Governor in 1965, Deputy Governor in 1969, and Senior Deputy Governor in 1972.

Gerald Bouey was recognized as an expert on the Canadian banking system. He played a major role in the Bank's submission to and appearance before the Royal Commission on Banking and Finance that led up to the 1967 revisions to the Bank Act and the Bank of Canada Act.

In 1973, he succeeded Louis Rasminsky as Governor, beginning a 14-year tenure that would see him lead the Bank through the most turbulent and challenging economic period of the post-war era. The skill and wisdom that he brought to his position were widely recognized in international central banking circles. His strong leadership contributed importantly to Canada's economic development and to the Bank's growing international reputation.

In 1981, he was made an Officer of the Order of Canada and also received an Honorary Doctor of Laws from Queen's University. In 1983, he was presented with the Outstanding Public Service Achievement Award. In 1987, he was made a Companion of the Order of Canada.

Those who worked with him over the course of his long and remarkable career will never forget Gerry Bouey and neither will his community to which he contributed to the very end through his many volunteer activities. His warm wit and generous spirit will be sorely missed.

Bank of Canada — 234 Wellington Street, Ottawa, Ontario K1A 0G9 5211 — CN ISSN 0067-3587

Bank of Canada
David A. Dodge
Governor - Gouverneur

Banque du Canada
Ottawa K1A 0G9

27 February 2004

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

Dear Mr. Goodale,

In accordance with the provisions of the Bank of Canada Act, I am submitting the Bank of Canada's *Annual Report* for the year 2003 and the Bank's audited financial statements as at 31 December 2003.

Yours sincerely,

OUR COMMITMENT
TO CANADIANS

- To contribute to the economic well-being of Canadians by
  - conducting monetary policy in a way that fosters confidence in the value of money
  - promoting the safety and soundness of Canada's financial system
  - supplying quality bank notes that are readily accepted without concerns about counterfeiting
- To provide efficient and effective central banking and debt-management services
- To communicate our objectives openly and effectively and to be accountable for our actions

This year's cover shows the back of Canada's new $100 note. The themes of exploration and innovation are illustrated with images of Canada's achievements in cartography and communications. Samuel de Champlain's 1632 map of Canada is juxtaposed with a satellite image of the country. An excerpt from Miriam Waddington's poem, "Jacques Cartier in Toronto," and its French translation by Christine Klein-Lataud, summarizes humanity's eternal quest for discovery.

MESSAGE FROM **THE GOVERNOR**

At the Bank of Canada, we have worked hard over the past several years to define our goals and our methods for achieving them. We have continued to strengthen our monetary policy framework, and we have established priorities in all areas of our operations to help us meet our strategic objectives. In 2002, the Bank set out a medium-term plan for the period 2003–05. The plan's clearly defined policy frameworks and priorities were critical in guiding our analysis and our decisions in 2003, a year in which Canadians across the country were affected by a number of severe and unanticipated events.

In introducing our annual report for 2003, I would like to highlight some of the Bank's activities and decisions during the year. I will begin with monetary policy.

As 2003 opened, consumer price inflation was rising well above our 2 per cent target. We noted that certain one-time factors, including sharply higher automobile insurance premiums, were giving a temporary boost to inflation. But some broadening of price increases at the time indicated that the Canadian economy might have been operating somewhat closer to its level of full capacity than we had thought. There were also signs that expectations of near-term inflation were rising. Given the substantial degree of monetary stimulus in the economy, we decided to withdraw some of that stimulus by raising our key policy interest rate twice, in March and April, by a total of one-half of a percentage point, to 3 1/4 per cent.

With these actions, we expected that inflation would gradually move back towards our target, consistent with the economy operating at full capacity over the medium term. But this outlook changed as a succession of shocks hit the Canadian economy. War in Iraq began towards the end of March, about the same time that SARS became a serious health concern in Canada. In May, one case of mad-cow disease was discovered in Alberta. The bad news continued in the third quarter, with forest fires in the West, a hurricane in the East, and a massive power outage in Ontario. While all of this was unfolding, the Canadian dollar was rising against the U.S. dollar at an unprecedented rate.

Although it was difficult to determine the precise economic impact of each individual event, it was clear that their combined effect would be to slow growth during 2003, so that our economy would be operating further below its full potential by the end of the year than we had expected. In the summer, it also became clear that inflation was falling faster than we had anticipated. Against this rapidly changing backdrop, the Bank lowered its key policy rate in July and September by a total of one-half of a percentage point, returning it to 2 3/4 per cent, where it remained through the end of the year.

Towards the end of 2003, the U.S. dollar weakened further against most major currencies, including the Canadian dollar. The impact of the Canadian dollar's appreciation vis-à-vis the U.S. dollar will continue to be felt in 2004 and beyond.

At the Bank of Canada, we recognize that adjusting to the stronger currency will be one of the most important economic challenges facing Canadians in 2004 and 2005.

Throughout last year's economic challenges, our commitment to keeping inflation low, stable, and predictable continued to guide our actions. At year-end, inflation expectations remained well anchored to our 2 per cent target, indicating that Canadians believe that the Bank will continue to honour this commitment.

In our internal operations last year, we pursued the strategic priorities identified in our medium-term plan. These priorities fell into four broad areas: research and analysis, developing partnerships, security for Canada's bank notes, and organizational effectiveness. Overall, we made significant progress in achieving the plan's first-year goals.

The Ontario power outage, which affected our Ottawa headquarters and Toronto operations, tested our business-continuity plan. We quickly shifted key personnel to our backup facility in Ottawa, which allowed us to support Canada's most important financial clearing and settlement systems without interruption. The Bank provided extra liquidity to the financial system throughout the outage and during its immediate aftermath, to ensure that the system kept functioning smoothly. Essential services also continued uninterrupted in Toronto. The Bank's business-continuity plan proved effective, although the incident did reveal areas for potential improvement that we are addressing.

Last year also saw progress in our objective to strengthen Canada's financial infrastructure. A new clearing and settlement system for securities, CDSX, began operations. Given the critical role of CDSX in the financial system, it was designated as falling under the Bank's oversight responsibility. And we continued to support the international financial system, through our work in groups such as the Financial Stability Forum, the G-20, and the Bank for International Settlements.

A key focus of our work in 2003 was to fulfill our commitment to supply Canadians with secure bank notes.

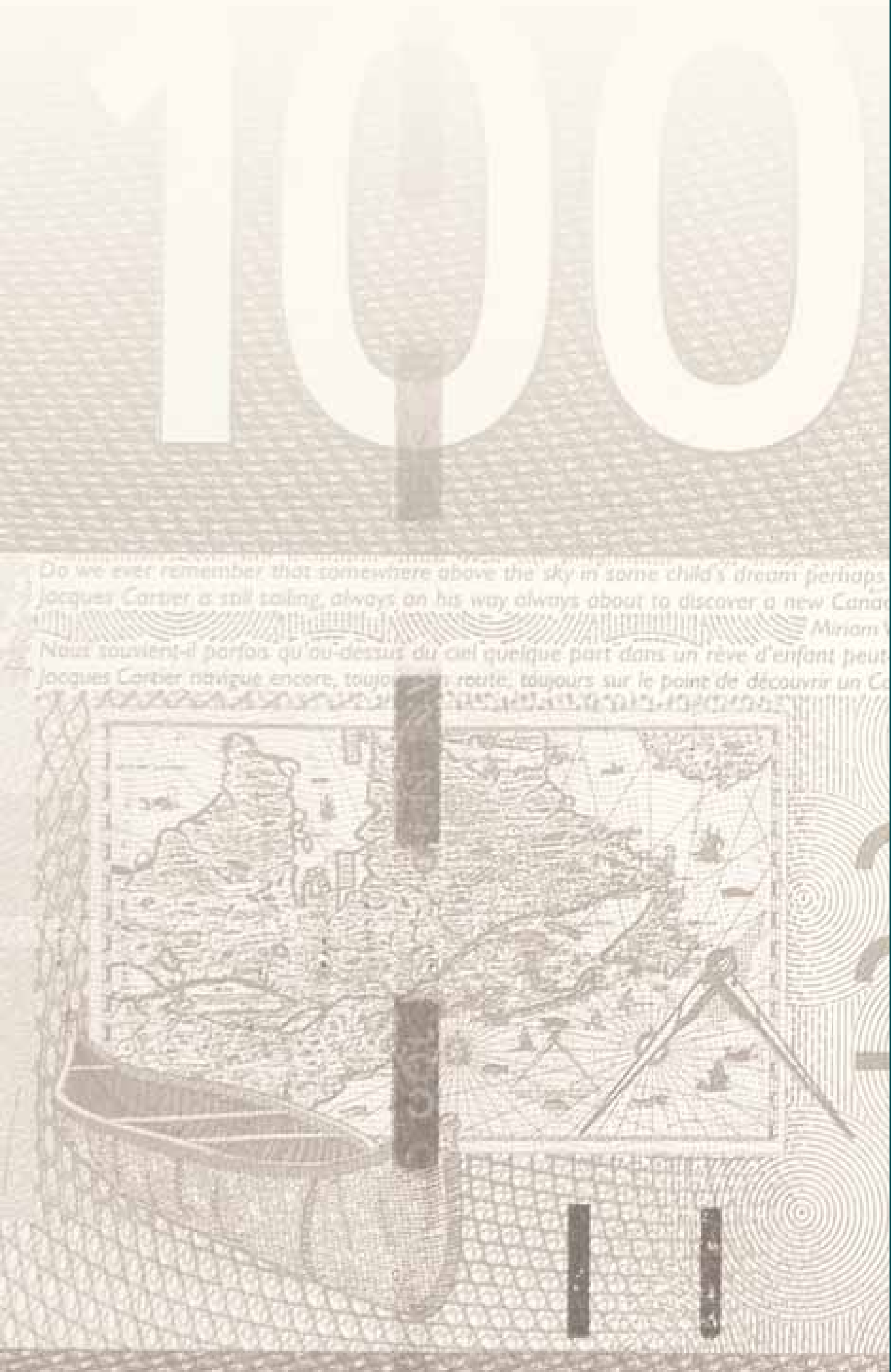
We have increased our efforts to deal with the higher incidence of counterfeiting in recent years that has resulted from advances in photo reproduction technology. In 2003, we finalized the designs for the higher-denomination notes in the *Canadian Journey* series, which include sophisticated new security features. The $20, $50, and $100 notes are scheduled to be issued in 2004. We also stepped up our work with retailers to help them spot counterfeits, strengthened our co-operative efforts with law-enforcement agencies, and continued our collaboration with other central banks on measures to deter counterfeiting.

There were a number of key personnel changes at the Bank during 2003. Our Senior Deputy Governor, Malcolm Knight, left to take up the post of General Manager at the Bank for International Settlements, and Deputy Governor Chuck Freedman retired after nearly 30 years of service at the Bank. Deputy Governor Paul Jenkins was named Senior Deputy Governor, and two new Deputy Governors were appointed: David Longworth, formerly an Adviser at the Bank, and Mark Carney, formerly with Goldman Sachs.

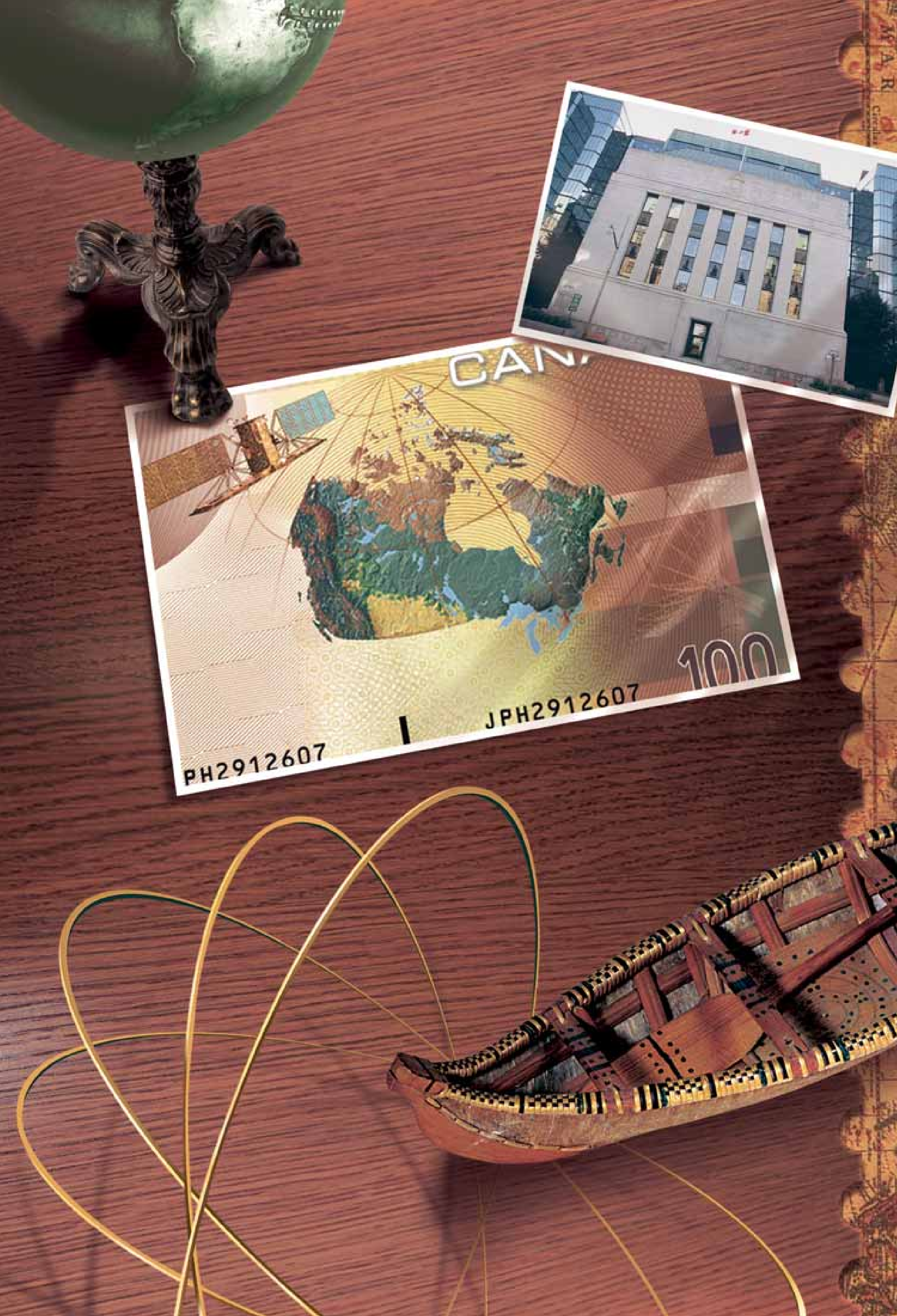
Also in 2003, the Bank said goodbye to three long-serving members of its Board of Directors—Paul Massicotte and Raymond Garneau of Quebec and Barbara Stevenson of Prince Edward Island. I thank them for their outstanding contributions. Jean-Guy Desjardins of Quebec and Ronald Keefe of Prince Edward Island were appointed to the Board during 2003, and J. Spencer Lanthier of Ontario was selected as Lead Director to replace Paul Massicotte. I wish to express my appreciation to the Board for their continuing support and wisdom.

This past year certainly had its challenges, but throughout, the Bank kept its commitment to Canadians. You will find the details in the rest of this report. But let me close by saying that the Bank's achievements during 2003 owe much to the hard work, dedication, and professionalism of its staff. I am proud of their efforts and take this opportunity to publicly thank them all.

David A. Dodge



ORGANIZATION **AND GOVERNANCE**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THE BUSINESS OF THE BANK

As Canada's central bank, the Bank of Canada's responsibilities centre on the goals of low and stable inflation, a safe and secure currency, and stability in the financial system. The Bank is also the Government of Canada's fiscal agent, managing its foreign exchange reserves and the public debt.

A Three-Year Plan: Providing a Medium-Term Focus

The Bank has just completed the first year of an ambitious three-year plan, focused on the goals of advancing leading-edge research, building partnerships with outside organizations and individuals, enhancing the security of Canada's bank notes, and improving the Bank's organizational effectiveness.

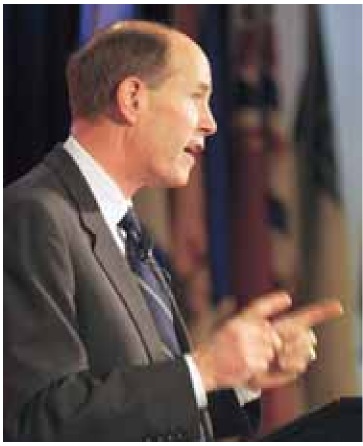
During 2003, work continued to focus on attracting and retaining quality staff; improving the tools that staff need for their work and for collaborating with colleagues inside and outside the Bank; promoting knowledge sharing to enhance quality and productivity; and creating a work environment that encourages a diversity of people and ideas.

Highlights of work planned for 2004 include launching new $20, $50, and $100 bank notes; enhancing business-continuity arrangements; and improving the operations and risk management of the government's foreign exchange reserves.

Executive Interchanges

As an illustration of the Bank's commitment to staff development, working collaboratively, and sharing knowledge, two executive staff, Ron Parker and Tiff Macklem, both Advisers to the Governing Council, are currently engaged in exchanges with the federal government. At the same time, James Haley, an executive from the government, is at the Bank on an exchange. In 2004, as announced, Pierre Godin, formerly of the Quebec Securities Commission, will join the Bank on an 18-month assignment.

In addition to the above arrangements, in January 2004, Deputy Governor Mark Carney accepted a special temporary assignment at the Department of Finance as G-7 Deputy to support Canada's and the Bank's interests in international financial matters through the balance of the 2004 Summit cycle.



Building Partnerships: Governor Dodge greets members of the audience prior to delivering the 2003 OPAS (Office for Partnerships for Advanced Skills) Visionary Seminar at Carleton University.



Members of the Board's Advisory Group on Currency examine new bank notes with Scientific Adviser Sara Church and Deputy Governor Pierre Duguay.

CORPORATE GOVERNANCE: **PROVIDING LEADERSHIP**

Board of Directors

Under the Bank of Canada Act, the Bank's Board is composed of the Governor, the Senior Deputy Governor, and 12 independent Directors, appointed for three-year terms by the Minister of Finance with approval of the Governor-in-Council. The Deputy Minister of Finance sits on the Board as a non-voting member. The Board exercises its responsibilities for the governance of the Bank mainly in the areas of finance, human resources, and administration. The Governor is responsible for monetary policy and for the other business of the Bank. A more detailed description of the Bank's organization and governance can be found in the new booklet *About the Bank* (also available on our Web site at www.bankofcanada.ca/en/pubs.htm).

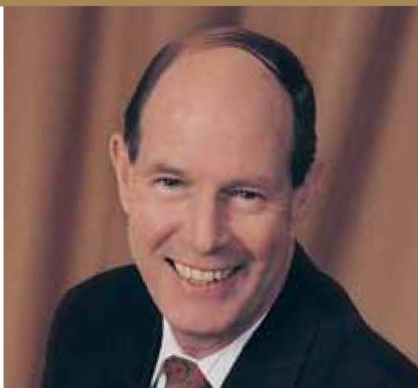
Board Stewardship in 2003

In 2003, the Board's responsibilities for succession planning focused on several changes in senior staff. A Special Committee of the Board was established early in the year to search for a candidate to recommend for approval by Governor-in-Council. This followed the resignation of Malcolm Knight, who had served as Senior Deputy Governor since 1999. Mr. Knight accepted the position of General Manager of the Bank for International Settlements in Basel, Switzerland, and the Board noted his important contribution to the effective management of the Bank.

Pension Committee Established

In September 2003, the Board of Directors approved the establishment of a Pension Committee to oversee the administration of the Bank's pension plan, as well as the investment of pension plan assets. The Committee will also be responsible for communication and member relations. The Committee is chaired by the Senior Deputy Governor and reports to the Board semi-annually. Three Directors, as well as three senior officers of the Bank, are also members.

THE BOARD OF DIRECTORS

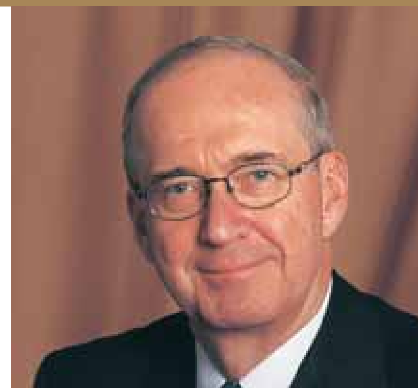


David Dodge

David Dodge
Governor

Paul Jenkins

Paul Jenkins
Senior Deputy Governor



J. Spencer Lanthier

J. Spencer Lanthier
Toronto, Ontario
Appointed in March 2000

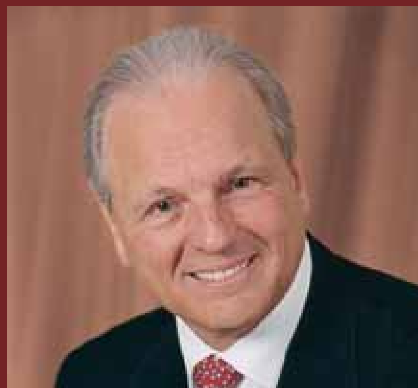
James S. Hinds

James S. Hinds
Sudbury, Ontario
Appointed in March 1996

Barbara Hislop

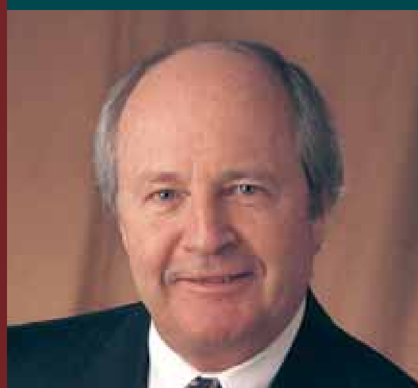
Barbara Hislop
Vancouver, British Columbia
Appointed in March 1998

Kit Chan



Jean-Guy Desjardins

Paul Dicks



Daniel F. Gallivan

Ronald J. Keefe

Aldéa Landry

Armin Martens

Kevin Lynch

Kit Chan
Calgary, Alberta
Appointed in April 1999

Jean-Guy Desjardins
Montréal, Quebec
Appointed in March 2003

Paul Dicks
St. John's, Newfoundland and Labrador
Appointed in December 2002

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

Ronald J. Keefe
Charlottetown, Prince Edward Island
Appointed in October 2003

Aldéa Landry
Moncton, New Brunswick
Appointed in March 1996

Armin Martens
East St. Paul, Manitoba
Appointed in December 2002

Kevin Lynch
Deputy Minister of Finance
Member *Ex officio*

Note: Barbara Stevenson served on the Board in 2003 until the appointment of Mr. Keefe in October.

Two positions were vacant on 31 December 2003.

THE BOARD OF **DIRECTORS**

David Dodge

Governor

Paul Jenkins

Senior Deputy Governor

J. Spencer Lanthier

Lead Director; Chair, Audit Committee, Corporate Governance Committee, and Advisory Group on Currency; and Member, Executive Committee

Chartered Accountant

- Member, Board of Directors, TSX Group Inc.
- Member, Board of Directors, Gerdau AmeriSteel Inc.
- Member, Board of Directors, Ellis-Don Inc.
- Member, Board of Directors, Intertape Polymer Group Inc.
- Member, Board of Directors, TorStar Corporation
- Member, Board of Directors, BCE Emergis Inc.
- Member, Board of Directors, Zarlink Semiconductor Inc.
- Member, Board of Directors, RoyNat Canadian Diversified Fund Inc.

James S. Hinds

Member, Audit Committee, Human Resources and Compensation Committee, and Pension Committee

Lawyer

- Partner, Hinds and Sinclair

Barbara Hislop

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

- Board Member and Officer, Canfor Corporation
- President and CEO, Genus Resource Management Technologies Inc.
- Member, Board of Directors, Forintek Canada Corporation
- Member, Board of Directors, Hudson’s Bay Company

Kit Chan

Member, Human Resources and Compensation Committee and Advisory Group on Currency

- Principal, KBC Enterprises Ltd.
- Member, Board of Directors, CV Technologies Inc.
- President, Canada Education Inc.
- Partner, Good Earth Art
- Member, Cabinet/Board United Way of Calgary and Area

Jean-Guy Desjardins

Member, Pension Committee and Advisory Group on Currency

- President and Chief Executive Officer, Centria Inc.
- Member, Board of Directors, Gaz Métro
- Member, Board of Directors, Mega Bloks
- Member, Board of Directors, Société de services financiers Fonds FMOQ inc.
- Member, Board of Directors, HEC Montréal
- Member, Board of Directors, Institut de recherches cliniques de Montréal Foundation
- Member, Board of Directors, Montreal Museum of Fine Arts
- Member, Board of Directors, Les Grands Ballets Canadiens de Montréal
- Co-President, Major Donors Division, Centraide of Greater Montreal
- Member, Board of Trustees, Canadian Centre for Architecture
- Member, Board of Trustees, Montreal Museum of Fine Arts Foundation

Paul Dicks

Member, Human Resources and Compensation Committee and Pension Committee

Lawyer

- Chairman, Newfoundland and Labrador Hydro
- Chairman, Churchill Falls (Labrador) Corporation Ltd.
- Chairman, Lower Churchill Development Corporation Ltd.
- Chairman, Gull Island Power Company Ltd.
- Member, Provincial Board of Directors and National Governance Committee of Junior Achievement of Canada

Daniel F. Gallivan

Chair, Human Resources and Compensation Committee; and Member, Executive Committee, Corporate Governance Committee, Audit Committee, and Advisory Group on Currency

Lawyer

- Managing Partner, Cox Hanson O'Reilly Matheson
- Director, Ombudsmen for Banking Services and Investments
- Director, ASCO Canada Ltd.
- Secretary, NovaScotian Crystal Limited
- Director, Nova Scotia Sports Hall of Fame
- Member, Accounting Standards Oversight Council

Ronald J. Keefe

Member, Audit Committee

Lawyer/Chartered Accountant

- Partner, Stewart McKelvey Stirling Scales
- President and CEO, Diagnostic Chemicals Ltd.
- President, Communities 13 Inc.
- Director, Spell Read P.A.T. Learning Systems Inc.
- Director, M.F. Schurman Company Limited
- Director, MPM Corporation and subsidiaries

Aldéa Landry

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

Lawyer

- President, Landal Inc.
- Member, Board of Directors, Nexfor Inc.
- Member, Board of Directors, The Shaw Group Limited
- Member of the Advisory Board, Oxford Frozen Foods Limited
- Chair, TVA National Advisory Group (National Television Network)
- Member, Board of Directors, Beauséjour Medical Research Institute
- Chair, Board of Directors, Atlantic ECONOMUSEUM® Corporation

Armin Martens

Member, Audit Committee and Advisory Group on Currency

Professional Engineer

- President and Chief Executive Officer, Marwest Development Corporation
- Director and Officer, Marwest Group of Companies
- Director (Past President), German-Canadian Congress

Kevin Lynch

Deputy Minister of Finance

Ex officio

- Member, Executive Committee

GOVERNING COUNCIL: The Governing Council takes responsibility for monetary policy and for decisions concerning financial systems.

(From left to right)

MARK CARNEY
Deputy Governor

DAVID DODGE
Governor

PAUL JENKINS
Senior Deputy Governor

PIERRE DUGUAY
Deputy Governor

SHERYL KENNEDY
Deputy Governor

DAVID LONGWORTH
Deputy Governor

In early April, Deputy Governor Paul Jenkins was appointed Senior Deputy Governor. This appointment, together with the retirement of another Deputy Governor, Charles Freedman, after almost 30 years of service, led to the Board's appointment of two new Deputy Governors: David Longworth, an Adviser to the Governing Council with 29 years of experience at the Bank, and Mark Carney, recruited from the private sector firm of Goldman Sachs.

The Board's oversight of financial matters and risk management included their support for changes that created a separate department for Financial Services, as well as a Financial Risk Office to monitor the Bank's activities as fiscal agent.

Although the Board is not responsible for the conduct of monetary policy, its broad oversight responsibility includes monitoring the effectiveness of the process for monetary policy formulation. To gain perspective on the Bank's work, the Directors met in private session with the Special Adviser, Andrew Spence, a financial markets expert, who worked with the Bank's management for a one-year period ending in August 2003.

Board Governance Practices

The Board incorporates best governance practices and works to ensure that all its members are provided with information on current issues in corporate governance. The new Directors appointed in 2003 received an in-depth orientation to familiarize them with the Bank and with their governance responsibilities. A new Lead Director, Mr. Spencer Lanthier, was also appointed.

The Board currently has six standing committees and one advisory group to more thoroughly assess issues brought before it for consultation or decision.

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

Freedman Festschrift

A conference was organized as a special tribute to acknowledge the contribution of Deputy Governor Charles Freedman to research in the field of central banking and monetary policy. The Freedman Festschrift attracted wide international participation from the academic world and from other central banks. A collection of the papers presented at the Festschrift will be published later in 2004.

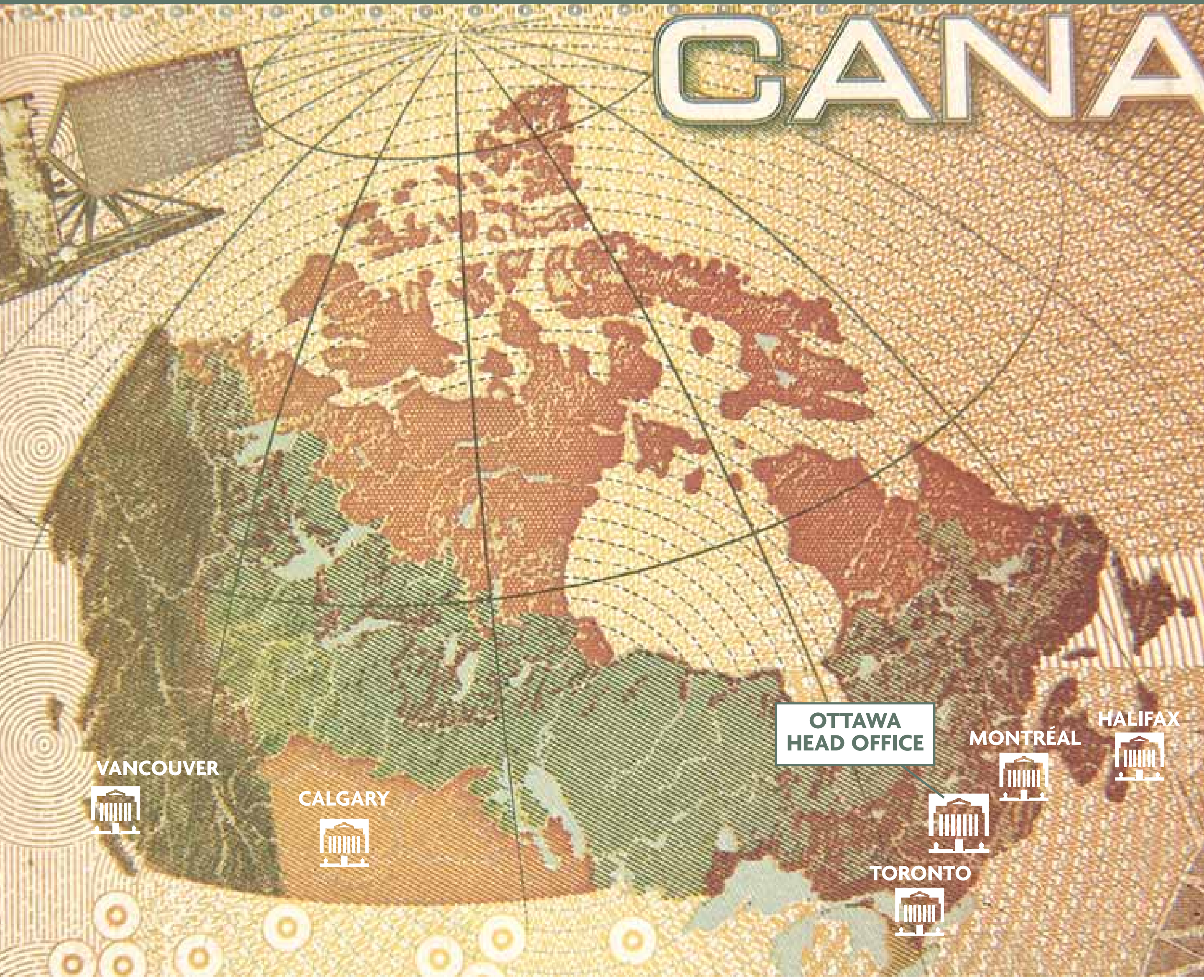
Bill White, Bank for International Settlements (top) and Charles Freedman address the conference.

Executive Management Committee (left to right) Standing: David Dodge, Governor; Mark Jewett, General Counsel/Corporate Secretary; Sheila Vokey, Chief, Financial Services Department; Mark Carney, Deputy Governor; Sheryl Kennedy, Deputy Governor; Paul Jenkins, Senior Deputy Governor. Sitting: Janet Cosier, Adviser on Strategic Planning and Risk Management; Pierre Duguay, Deputy Governor; David Longworth, Deputy Governor; Sheila Niven, Chief, Corporate Services Department. The Executive Management Committee is responsible for matters related to the strategic direction and management of the Bank.

Through these committees, the Board provided guidance on a number of issues in 2003, including the implementation of a new strategy on bank notes, a review of the expenditure-authority framework and related procurement policy, a new governance structure for the pension plan, and input to the plan for a new service-delivery structure for human resources. The Board reviewed the terms of reference of all its committees in 2003 to ensure that they reflected current best practices.

To ensure that independent Directors can candidly exchange their views, the Lead Director chairs private sessions at each Board meeting. In 2003, the Board continued the annual practice of setting aside time to review and discuss its own stewardship to ensure that best practices of corporate governance are achieved.

Directors are paid according to a fee structure recommended by the government and approved by Order-in-Council. For 2003, the total remuneration to independent Directors was $251,700.



Regional Offices

Over the past year, the Bank's regional offices increased their economic research and analysis capabilities and strengthened their role in education on counterfeit awareness. For example, regional staff delivered 650 training sessions to more than 16,000 people in retail businesses and financial institutions on the security features of bank notes. Regional staff interviewed 400 businesses about current and prospective economic conditions and conducted a special survey of pricing decisions among 170 firms. They also delivered 57 speeches and presentations. These offices are located in Halifax, Montréal, Toronto, Calgary, and Vancouver. The Bank also has financial markets representatives in Toronto, Montréal, and New York City.

AN ACCOUNT OF OUR **STEWARDSHIP**


Do we ever remember that

MONETARY **POLICY**

"The Canadian economy proved exceptionally resilient in the face of the global downturn and is well-positioned to cope with the recent challenges. . . . This performance owes much to the skillful implementation of the authorities' monetary and fiscal policy framework, as well as the structural reforms introduced since the early 1990s."

2004 Article IV Consultation with Canada, Statement of the IMF Mission (19 November 2003)

The Bank of Canada's monetary policy contributes to good economic performance and a rising standard of living by keeping inflation low, stable, and predictable. The centrepiece of the monetary policy framework is an inflation-control target range for the consumer price index (CPI). By aiming to keep inflation at the 2 per cent midpoint of this 1 to 3 per cent range, monetary policy minimizes the distortions caused by inflation and contributes to greater stability in economic activity.

Meeting the Inflation Target

The major policy challenge that the Bank faced in the first few months of 2003 was a high and rising inflation rate, coupled with concerns that demand for Canadian products might rise above the production capacity of our economy as the global recovery picked up. The Bank's measure of core CPI inflation, which had risen sharply towards the end of 2002, remained close to the top of the Bank's target range through the first quarter of 2003, averaging 3.1 per cent. Although this largely reflected the one-time influence of higher insurance premiums and other special factors, there were also signs that strong domestic demand in some sectors was pressing against capacity. Meanwhile, total CPI inflation had climbed to 4.5 per cent under the influence of further increases in the world prices of oil and natural gas. In view of this and other evidence of broadening price pressures, the Bank raised its target overnight interest rate by 50 basis points in two steps in March and in April, bringing the overnight rate to 3.25 per cent.

In the second and third quarters of 2003, the Canadian economy was hit by a number of unusual shocks, including the outbreak of severe acute respiratory syndrome (SARS) in Toronto; the discovery of an isolated case of bovine spongiform encephalopathy (BSE) in Alberta; an electrical blackout in Ontario; and, most importantly, for the economy as a whole, a sharp appreciation of the Canadian dollar. The resulting weakness in aggregate demand, combined with some pass-through to prices from the stronger Canadian dollar and downward price pressures associated with the unwinding of excess inventories and the reversal of temporary factors, caused both the core and total CPI to return to the 2 per cent midpoint of the target range much earlier than expected. With increased excess capacity in the economy, a somewhat weaker near-term economic outlook, and an unexpectedly rapid decline in inflation, the Bank decided to cut the target overnight rate by 25 basis points in July and again in September, returning the target rate to 2.75 per cent.

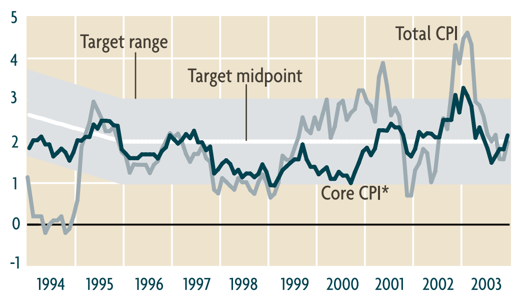
Both core and total CPI inflation continued to ease through the late summer and early autumn, reaching lows of 1.5 per cent and 1.6 per cent, respectively, before moving up towards year-end. By December, total CPI inflation had temporarily returned to 2 per cent, while core CPI inflation had risen to 2.2 per cent, reflecting special factors in December 2002. The Bank expects these rates to fall significantly below 2 per cent in the first quarter of 2004.

Working in Partnership with Other Researchers

Research staff in all the Bank's analytic departments have been very active, presenting their findings at academic and policy conferences around the world and working in partnership with researchers at other institutions. In 2003, Bank research staff participated in some 205 academic and policy workshops, conferences, and seminars; worked jointly with 31 external research partners; and hosted 25 lectures. In addition to its annual research conference, the Bank also hosted three workshops involving outside experts and practitioners—one on global economic modelling, a second on stochastic dynamic general-equilibrium models, and a third on financial innovation. A listing of the Bank's economic research appears in the annual *Bank of Canada Publications Catalogue.*

Consumer Price Index

Year-over-year percentage change



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

Assessing Domestic and International Developments

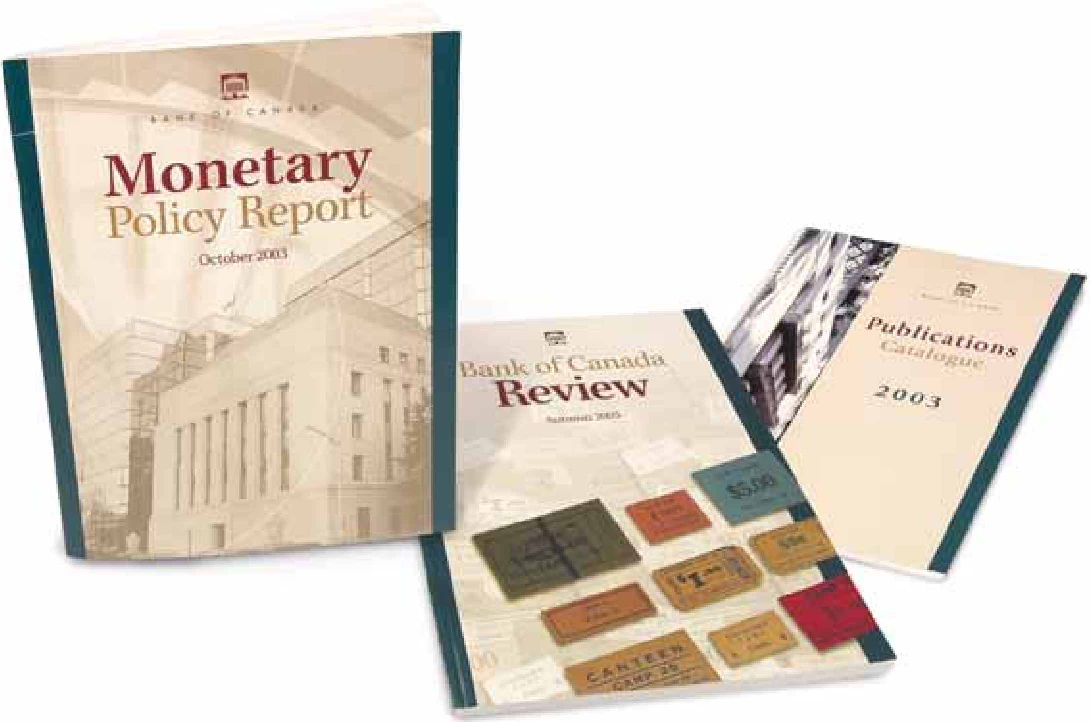
Monetary policy decisions are based on a wide range of information and analysis. As a trading nation, Canada is particularly affected by developments beyond its borders, especially those in the United States. In 2003, the most important of these were the timing and strength of the U.S. economic recovery, the large imbalances that emerged in the global trading system, and the major realignment of currency values that they seemed to have triggered. Assessments of international developments and prospects draw on staff analysis, on forecasts by the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD), and on information exchanged at a host of international meetings in which the Bank of Canada regularly participates.

The implications of international and domestic developments for the Canadian economy are considered from many perspectives. Using a model of the Canadian economy, staff prepare a baseline economic projection, as well as risk analyses around this forecast. This is supplemented with more detailed sectoral and structural analysis and information obtained from monetary and credit aggregates, credit availability, interest rate spreads, and the interest rate expectations of financial market participants. Staff working out of the Bank's five regional offices also conduct quarterly surveys, which provide insights into the outlook and planning of businesses. Plans are underway to release the results of these surveys beginning in 2004.

Bank of Canada's Fellowship Program

In September 2002, the Bank launched a Fellowship Program designed to encourage leading-edge research and to develop expertise in Canada in the fields of macroeconomics, monetary economics, international finance, and the economics of financial markets and institutions (including issues related to financial stability). Successful candidates receive an annual stipend for a renewable five-year period, as well as additional funds for research assistance and related expenses.

The first two fellowships were awarded in February 2003 to Professor Michael Devereux (an international economist teaching at the University of British Columbia) and Professor Shouyong Shi (a monetary theory economist teaching at the University of Toronto). Both recipients are internationally recognized researchers with exceptional track records. A third Fellowship will be awarded early in 2004.



Carrying Out Longer-Range Research

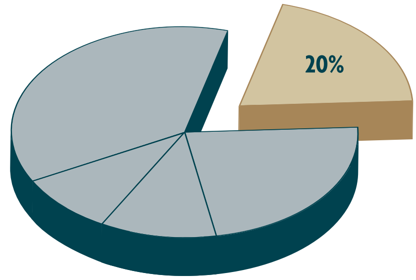
Research that seeks to improve our understanding of the economy and, at the same time, explores the implications of alternative policies is central to the design and effective implementation of the monetary policy framework. Consistent with the Bank's 2002 medium-term plan, greater attention is being given to broadening our research and analytical activities on structural and sectoral issues, as well as to establishing research partnerships with outside institutions and individuals.

In 2003, the Bank's research focused on the following areas: development of new models for policy analysis and for projections of U.S. and Canadian economic activity; examination of the leading-indicator properties of asset prices and credit markets for future output growth and inflation; and investigation of several structural issues, such as the changing nature of the pass-through from exchange rate movements into final goods prices, and how firms set prices for the goods and services they sell. The research program is available on the Bank's Web site at www.bankofcanada.ca.

Operating Expenses

The Bank spent $54.6 million in 2003, or approximately 20 per cent of its total operating expenses, on formulating, implementing, and communicating monetary policy, compared with $51.1 million in 2002. The bulk of this increase is a result of actuarially determined accounting expenses associated with deferred employee benefit plans sponsored by the Bank, which affect all functions of the Bank.

Monetary Policy Activities as a Proportion of Total Bank Expenses



Inspecting the new $100 note

CURRENCY

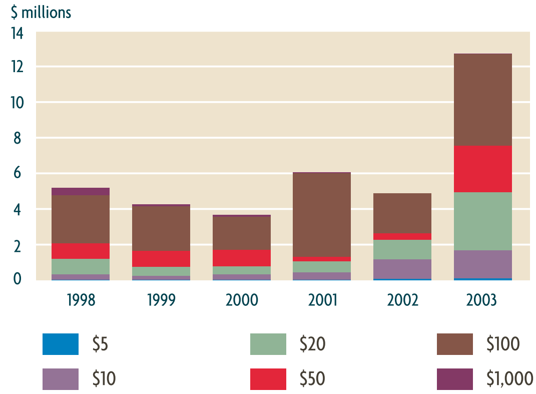
The Bank of Canada is responsible for providing Canadians with secure bank notes that can be used with confidence. In recent years, this confidence has been threatened by the rise in counterfeiting made possible by the proliferation of technologically advanced equipment, available at affordable prices.

The Bank has responded to this threat by developing a three-pronged strategy encompassing security, communication, and compliance (deterrence and enforcement). Significant progress was made in all three areas in 2003—three high-denomination notes in the *Canadian Journey* series, which incorporate state-of-the-art security features, were prepared for issue; counterfeit-detection training activities with retailers and other groups were expanded; and information networks were established with Crown prosecutors. At the same time, however, the incidence of counterfeiting reached new proportions, underlining the importance of the Bank's actions.

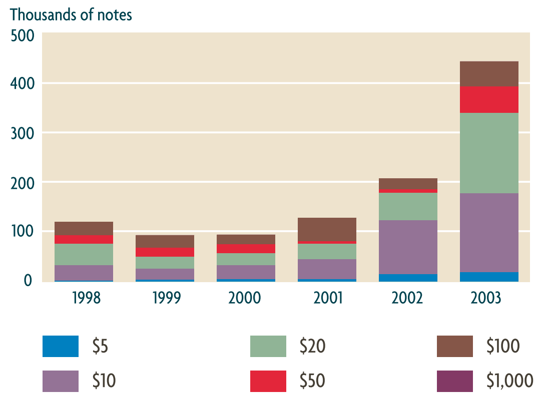
Incidence of Counterfeiting

The value of counterfeit notes detected in circulation rose to $12.7 million (443,000 notes) in 2003, from $4.9 million (208,000 notes) in 2002. The $10 and $20 denominations were the most frequently counterfeited. The number of fraudulent $10 notes was

Value of Counterfeit Bank Notes Found in Circulation



Number of Counterfeit Bank Notes Found in Circulation



particularly high in proportion to the volume of genuine notes in circulation. There was also a marked increase in counterfeit $50 notes.

Legal Tender

The Bank is often asked why bank notes are called "legal tender" if merchants may refuse them.

The term "legal tender" describes the money approved for paying debts or settling commercial transactions. This does not compel anyone to accept that form of payment. The method of payment used in a transaction is a matter of private agreement between the parties involved.

In Canada, legal tender consists of coins issued by the Royal Canadian Mint and bank notes issued by the Bank of Canada. The Bank of Canada Act gives the Bank the sole authority to issue bank notes for circulation in Canada.

Enhancing Bank Note Security

The Bank has significantly increased its efforts to enhance bank note security in the past two years. It fundamentally reassessed the various security elements used on bank notes and selected new and sophisticated features for incorporation into the three high-denomination notes ($20, $50, and $100) of the *Canadian Journey* series. The Bank expects to issue all three notes in 2004.

New Security Features on the $100 Note

1 Holographic stripe

As the angle of the note changes, brightly coloured numerals (100) and maple leaves "move" within this shiny metallic stripe on the front of the note. Colours shift from gold to green to blue and other hues.

2 Watermarked portrait

Watermarks are part of the paper itself and can be seen from both sides of the note. When the note is held up to the light, a small, ghost-like image of the portrait is revealed, along with a small number 100.

3 See-through number

Irregular marks printed on the front and the back of the note, between the watermark and the large numeral, form a complete and perfect number 100 when the note is held up to the light.

4 Windowed colour-shifting thread

A continuous, solid vertical line appears on the right-hand side on the front of the note when it is held up to the light. From the back, this security feature looks like a series of exposed metallic dashes that shift from gold to green when the note is tilted.

Web site: www.bankofcanada.ca/en/banknotes

(Top) Governor Dodge and Deputy Governor Pierre Duguay entertain children with a reading of Roch Carrier's *The Hockey Sweater* on Christmas Eve. (Right) Children enjoy the "Count Your Pennies" exhibit at the Bank's Currency Museum.

The new $100 note, with its theme of Exploration and Innovation, was unveiled in a ceremony in Halifax on 28 January 2004. Same-day media briefings were also held at each of the Bank's regional offices. The new $100 note will be issued on 17 March 2004. Unveiling the note prior to its introduction into circulation gave the Bank an opportunity to familiarize law-enforcement agencies, retailers, and financial institutions with the new, easy-to-recognize security features (see box on page 31).

Research carried out in 2002 confirmed that the public has less difficulty recognizing the security features and verifying the authenticity of bank notes that are in good condition. The Bank therefore developed new standards and, in 2003, began to improve the quality of notes in circulation. Worn notes are now replaced sooner, and a larger quantity of notes is being destroyed. This initiative is particularly important for the $5, $10, and $20 notes, which circulate most heavily.

As an international threat, counterfeiting demands a coordinated international response. The Bank collaborates regularly with other central banks on initiatives related to all aspects of bank note issuance (see box on Pacific Rim Conference, page 34). The Bank is also a member of the Central Bank Counterfeit Deterrence Group, established in 1993 by the governors of the G-10 central banks. The group's main task has been the development of a system that prevents the copying of bank notes by personal computers and digital-imaging tools. The system does not track the use of a personal computer, and consumers should not notice any difference in the performance of products equipped with this technology. Deployment of this system continued in 2003 with its voluntary adoption by several leading manufacturers of personal computer hardware and software.

Informing the Public

A marked increase in counterfeit $100 notes in 2001 led some retailers to refuse high-denomination bank notes. The Bank is concerned about the impact such refusals may have on public confidence in our currency's integrity and intensified its efforts to improve the ability of retailers to identify counterfeit notes.

The Bank has also conducted quarterly surveys of the incidence of bank note verification and outright non-acceptance among retail establishments. These are among the first such surveys ever undertaken by a central bank. The results indicate that, on average in 2003, the $100 note was accepted by 95 per cent of businesses and checked by 59 per cent, although the results vary by region. Both figures are up about 5 percentage points from the first survey in 2002, which represents a notable improvement.

The Bank is using these survey results to be more proactive in its dealings with retail organizations. It has successfully convinced some retailers that both their interests and those of their customers are better served when they check bank notes rather than refusing some denominations, and that notes can be checked quickly and reliably. Consequently, several large national retail and fast-food restaurant chains have rescinded their policy of refusing high-denomination notes.

Much of the Bank's information effort is aimed at community outreach programs delivered by representatives from the Bank's five regional offices. Counterfeit-awareness programs, such as "Don't Pass the Buck" workshops initiated in Calgary in collaboration with the local community, have been held in cities and towns across the country, often with the participation of local police forces, chambers of commerce, business associations, and private industry.

Currency Museum

The Currency Museum, which is housed in the Bank's head office in Ottawa, plays a vital role in educating the public, especially younger audiences, about the role and historical importance of money—bank notes, coins, and other objects. An interactive exhibit, "Count Your Pennies," was developed in 2003 to illustrate the cost of shopping during the first half of the 20th century. A new school program called "Inflation Busters" uses a series of interactive games, simulations, and discussions to teach students about the causes and effects of inflation, and how the Bank of Canada uses monetary policy to keep inflation low and stable. The program received an Award for Outstanding Achievement in the education-programming category from the Canadian Museums Association.

During the year, the Museum welcomed close to 30,000 visitors. Another 3,400 visitors viewed the travelling exhibit "The Colour of Your Money" in other regions of the country.

On average, over the last four months of the year, about 32,000 pages were viewed monthly on the Museum's Web site (www.currencymuseum.ca).

Bonnie Schwab, Chief, Department of Banking Operations, is presented with the gavel at the opening of the XVI Pacific Rim Banknote Printers' Conference hosted by the Bank. Nopporn Pramojaney, Managing Director of the Bank of Thailand's Note Printing Works and chair of the previous conference, looks on.

Pacific Rim: International Collaboration

In partnership with its two printers, Canadian Bank Note Company Limited and BA International Inc., the Bank hosted the XVI Pacific Rim Banknote Printers' Conference (PRBPC) in Banff, Alberta, in September 2003.

This biennial event fosters the exchange of information between member countries on bank note design, production, distribution, and security. At the 2003 conference, multinational technical working groups reported on joint research on intaglio plate-making, automatic bank note inspection, bank note distribution practices, and digital counterfeiting.

The Bank of Canada is one of the founding members of the PRBPC and had last hosted the conference in 1977. The XVI conference attracted 73 participants from 15 member and 4 observer nations who contributed actively to the sharing of ideas and expertise that meetings such as the PRBPC promote.

Promoting Compliance

The Bank works closely with law-enforcement agencies and prosecutors to help them appreciate the seriousness of counterfeiting as a crime. In 2003, the Bank expanded its relationship with key contacts among police forces and developed a Victim Impact Statement detailing the economic and social costs associated with counterfeiting. A national network was established by the RCMP to improve the tracking of counterfeiting incidents and deterrence measures in all regions of the country. An information network for federal, provincial, and territorial Crown prosecutors was also created.

The Bank has established a Law-Enforcement Award of Excellence that will be presented annually to a police officer who demonstrates outstanding commitment and initiative in counterfeit prevention and enforcement. The first award will be presented at the Canadian Association of Chiefs of Police 2004 Annual Conference in Vancouver.

Reproduction of Bank Note Images

The reproduction of bank note images is protected by the Criminal Code of Canada and the Copyright Act. This federal legislation empowers the Bank to authorize reproductions that it deems appropriate.

In consultation with the Canadian advertising industry and law-enforcement agencies, the Bank has developed a policy requiring that anyone wishing to reproduce bank note images first obtain the Bank's written permission. The Bank will ordinarily consent to the reproduction of bank note images if there is no risk that this could lead to counterfeiting activities.

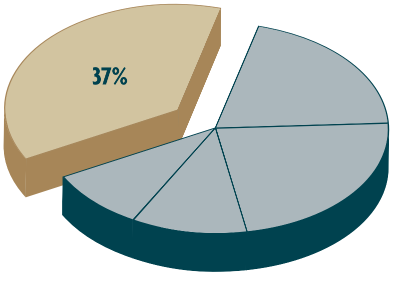
The Bank's policy is posted on its Web site (www.bankofcanada.ca/en/banknotes/legislation/repro.html).

Operating Expenses

Operating expenses for the currency function in 2003 were $101.9 million, about 37 per cent of the Bank's total operating expenses. This represents an increase of $23.1 million from 2002.

Much of this rise relates to the production of bank notes to meet higher quality standards for circulating notes and to build up inventories prior to the launch of the new high-denomination notes. The increase also reflects the expansion of communications initiatives to deter counterfeiting, as well as the development of improved security features.

Currency Activities as a Proportion of Total Bank Expenses



Speakers at the Bank's December 2003 Research Conference: (left) Michel Poitevin, Université de Montréal; (right, top to bottom) Douglas Gale, New York University; Xiaodong Zhu, University of Toronto; Usha Mittoo, University of Manitoba

FINANCIAL **SYSTEM**

The safe and efficient operation of financial institutions, markets, and clearing and settlement systems is crucial to economic activity, both in Canada and abroad. As part of its commitment to Canadians, the Bank undertakes various activities to promote the efficiency, safety, and soundness of the financial system.

Controlling Risk in Clearing and Settlement Systems

The Bank is responsible for the oversight of key clearing and settlement systems. Its objective is to be satisfied that the risk-control mechanisms in these systems virtually eliminate the possibility that a disruption in their operation could have severe repercussions across the financial system and the economy as a whole.

Over the past five years, Canada has made significant progress in developing state-of-the-art clearing and settlement systems. During 2003, this trend continued as a new securities clearing and settlement system called CDSX began full operations. This system, which is owned and operated by The Canadian Depository for Securities Ltd. (CDS), brings together the operations of the Debt Clearing Service and the Securities Settlement Service. Almost all debt and equity trades in Canada now settle through CDSX. CDSX meets or exceeds international standards for the safe and efficient operation of such systems and is one of the most advanced securities clearing and settlement systems in the world. In March 2003, this critical system was designated under the Payment Clearing and Settlement Act, which brought it under the formal oversight of the Bank.

Activity at the CLS (Continuous Linked Settlement) Bank, which began operations in 2002, continues to grow rapidly. Designed to practically eliminate the risk associated with the settlement of foreign exchange trades, in September 2003 the CLS Bank added four new currencies to the seven already eligible for settlement in the system. A number of new banks also joined the system during 2003. The CLS Bank is currently estimated to settle about 40 per cent of the world's foreign exchange trades and is quickly becoming "best practice" in the settlement of such trades. The Bank oversees the management of the risks associated with the settlement of Canadian-dollar transactions in a co-operative oversight arrangement with the New York Federal Reserve Bank and with other central banks whose currencies are involved in transactions settled in the system.

As part of its oversight activities, the Bank of Canada is developing Memorandums of Understanding (MOUs) with the operators of major domestic clearing and settlement systems, the Canadian Payments Association (CPA), and CDS. These MOUs are designed to govern the relationship between the Bank as the oversight agency and the operators that are responsible for the safe and efficient operation of these systems. In addition, the Bank is reviewing its oversight processes, recognizing that its oversight activities are becoming increasingly focused on the safe and efficient operation of these systems, rather than on their design.

Business-Continuity Planning

Business-continuity planning has been a priority for the Bank for a number of years, from the perspective of the Bank's responsibilities for oversight of clearing and settlement systems and its role in financial markets and as agent for the federal government. Events such as the 1998 ice storm in Eastern Ontario and Western Quebec, the Y2K threat, the 2001 terrorist attacks in the United States and, during 2003, the SARS outbreak and the power blackout in Ontario continued to underscore the importance of these plans.

Key clearing and settlement systems (where transactions worth hundreds of billions of dollars are settled every day) are at the centre of Canada's financial system, and their

The Bank's Response to the Ontario Power Blackout in August 2003

The Bank's business-continuity plan successfully met the challenge of the Ontario power blackout. Critical operations were quickly and effectively moved from head office to the backup site, and the Bank was able to supply its key banking services to major clearing and settlement systems and to manage the federal government's funding requirements without any disruption. The Bank also provided extra liquidity to the financial system and maintained contact with various financial market participants during this period to promote the effective functioning of the Canadian financial system.

Arrangements established with the IDA and others for determining when markets are closed and for communicating with market participants during contingency situations proved effective. Given the uncertainty about the reliability of power once it was returned and the provincial government's request to reduce energy consumption, the Bank continued to operate at its backup site for the entire week following the initial blackout. The dedication of its staff was a key factor in the Bank's ability to provide critical services without disruption during this time.

reliable operation is important not only to their participants, but also to other entities in the economy that rely on them. In January 2003, the Bank convened a meeting of the operators and major participants of Canada's critical clearing and settlement systems to encourage them to examine more closely the ability of these systems to withstand and recover promptly from severe shocks and to continue to provide critical services. The focus of the Bank's concern is on the system-wide implications of the business-continuity plans developed by system operators and their major participants and whether coordination of business-continuity planning activities is warranted. Following that meeting, the CPA and CDS agreed to jointly lead a working group to address these issues. This group is making substantial progress.

The Bank of Canada worked with the Capital Markets Committee of the Investment Dealers Association of Canada (IDA), the Canadian Foreign Exchange Committee, and other market participants, to ensure that arrangements are in place to facilitate co-operation when disruptions affect financial markets. In 2003, the Canadian Foreign Exchange Committee established a working group to focus on operational and back-office issues, including business-continuity planning. In September, this group met in New York with similar groups from other financial centres around the world.

In addition, the Bank continuously examines its own business-continuity plans to ensure that the Bank of Canada's operations supporting key clearing and settlement systems and the government's funding requirements are as resilient as possible. To this end, the Bank has taken further measures to provide effective operations at its backup site, to strengthen its internal and external communications procedures, and to investigate the

Participants at the December Conference, "The Evolving Financial System and Public Policy": (left to right) Joseph Atta-Mensah, Bank of Canada; Kina Chenard, Université Laval; Gerald Goldstein, Office of the Superintendent of Financial Institutions

possible use of manual operations out of its Montréal and Toronto locations if needed to support the government's funding requirements.

Promoting the Efficiency of Canadian Capital Markets

The Bank has a particular interest in well-functioning and efficient Canadian capital markets. One way the Bank contributes to their development is through various partnerships, both formal and informal. Through its regional offices in Toronto, Montréal, and New York, as well as through various speeches and presentations, the Bank worked to reinforce connections with the private sector and to enhance long-standing relationships with various regulatory and public sector agencies and associations, such as the Investment Dealers Association of Canada, the Canadian Foreign Exchange Committee, and the Canadian Securities Administrators (CSA). For example, the Bank hosted a series of meetings with the Department of Finance, the Office of the Superintendent of Financial Institutions (OSFI), and members of the CSA to provide a forum for dialogue among the various regulatory authorities in securities markets across jurisdictions. In addition, it worked with the Bond Market Transparency Committee and with the Department of Finance to support enhanced transparency in fixed-income markets. In particular, the Bank and the Department of Finance made contributions with regard to the amendments to the ATS Rules being developed by the CSA.[1]

Research and Communication

The Bank continues to explore ways to promote active debate on issues concerning the financial system. With the publication in December 2002 of its new semi-annual document, the *Financial System Review,* the Bank is now providing information on a variety of topics of interest to policy-makers, market participants, regulators, and academics. It has also increased the frequency of the conferences it hosts to discuss financial system issues. In May 2003, the Bank hosted a workshop that addressed the implications of innovations in financial instruments and in December a conference titled "The Evolving Financial System and Public Policy." The Bank also sponsored sessions at the 2003 meetings of the Northern Finance Association and provided an award for the best research paper on the development of capital markets.

1. Alternative trading systems (ATSs) are electronic financial marketplaces that incorporate quotation and trading services. These systems are a recent development in Canada.

In the past couple of years, the Bank has undertaken an increasing amount of research examining various issues related to financial stability, financial innovation in capital markets, capital market efficiency, the management of operational risk in clearing and settlement systems, and the development of certain specialized markets and infrastructures. The Bank regularly invites academics to make presentations to its staff and actively supports joint working arrangements between its staff and outside researchers.

The Bank and International Financial Stability

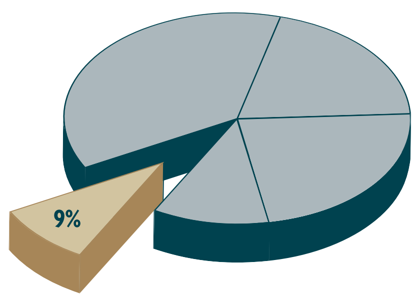
During 2003, the Bank continued to support activities designed to promote international financial stability. Some examples include

- the continued development and promotion of a framework for the prevention and resolution of international financial crises;
- participation in a number of international groups involved in financial stability issues, such as the G-7, the G-20, the Financial Stability Forum, and various BIS committees. On behalf of the G-20, the Bank of Canada and the Deutsche Bundesbank are organizing a workshop on developing sound domestic financial markets to be held in Ottawa in April 2004;
- participation in the development and analysis of the proposed revisions to the Basel Capital Accord, which are designed to promote more effective risk management within banks and to align the banks' capital more closely with the risks that they are incurring;
- the provision of technical assistance to a number of countries participating in Financial System Assessment Programs carried out by the IMF.

Operating Expenses

Operating expenses for the financial system function in 2003 were $24.4 million, or approximately 9 per cent of the Bank's total expenses. In 2002, this function was part of central banking services. Expenditures increased in 2003, primarily reflecting an increase in staff resources (and the associated benefit and support costs) consistent with the Bank's medium-term plan objectives for policy development, research, and operations in this function.

Financial System Activities as a Proportion of Total Bank Expenses



The Bank's Trading Room

FUNDS MANAGEMENT

The Bank's most significant role in the area of funds management is that of fiscal agent to the Government of Canada. In carrying out its responsibilities as fiscal agent (banking services, treasury management, debt and reserves management), the Bank conducts operations, carries out research and analysis, provides policy advice, undertakes complex business decisions, and makes significant investments in its systems and people to support the goals of cost-effectiveness and efficiency.

In 2003, the governance structure surrounding these activities was strengthened and formalized. This structure incorporates a Funds Management Committee composed of members from the Bank of Canada and the Department of Finance to oversee and provide direction for the overall management of the government's foreign and domestic assets and liabilities. The Bank also enhanced the independence of its risk-management oversight, by establishing the Financial Risk Office to monitor the risk positions and performance outcomes of its fiscal-agent activities. Finally, a formal strategic and working relationship was established among the

Department of Finance, Public Works and Government Services Canada, and the Bank that encompasses banking and treasury management.

Key Program Changes

With respect to the domestic debt program, efforts continued to be directed at increasing operational efficiency and promoting a well-functioning market for Government of Canada securities. One related initiative was advancing the timing of treasury bill and associated auctions to mid-morning, when most of the trading in the money market occurs.

In line with the government's objective of reducing the share of fixed-rate debt from two-thirds to 60 per cent by 2007/08, the amount of treasury bills outstanding increased to $117 billion (up $13 billion) as the floating-rate share of the debt increased to 37.7 per cent from 35.6 per cent. To support the liquidity of the benchmark-bond program in the face of continued reductions in the bond stock, the Bank conducted buyback operations, thus maintaining gross issuance of about $42 billion. In addition, the Bank and the Department of Finance conducted a review of the Real Return Bond program within the broader context of the debt-program structure.

Foreign reserves, held in the Exchange Fund Account (EFA) to provide the government with general foreign-currency liquidity and to provide funds to help promote orderly conditions in the foreign exchange market, decreased by US$0.9 billion to US$36.3 billion. Funding activity by the Bank was limited to US$0.2 billion, since the appreciation of the euro and market revaluation partially offset US$3.6 billion in maturing liabilities. Since 1998, the EFA has been managed in an asset-liability-matching framework to minimize market risk and exchange rate risk. The net liability position, which has gradually been reduced through the orderly purchase of U.S. dollars in the foreign exchange market since the last intervention episode in 1998, was eliminated in mid-2003.

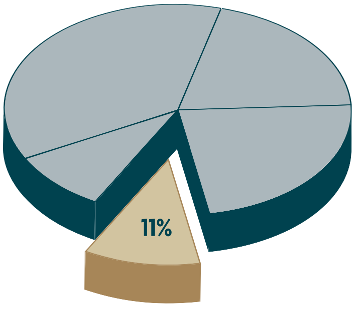
In December 2003, the government's gold bullion sales program was completed. Since 1980, the government had been following a policy of selling its gold at a gradual and controlled pace to enhance the liquidity and rate of return of its portfolio of international reserves.

The operational efficiency and the capacity to measure risk and performance in the Exchange Fund portfolio were significantly enhanced through the successful implementation of a new system to capture, monitor, and process transactions. This will serve as the official system of record for the EFA.

Operating Expenses

Operating expenses for funds management in 2003 were $31.0 million, or approximately 11 per cent of the Bank's total expenses. In 2002, this function was part of central banking services. Expenses related to systems infrastructure have increased to meet the medium-term-plan objectives of providing high-quality, effective, and efficient funds-management services to the Government of Canada.

Funds-Management Activities as a Proportion of Total Bank Expenses



RETAIL DEBT **SERVICES**

Under its retail debt program, the government issues traditional Canada Savings Bonds (CSBs), which are redeemable at any time, and Canada Premium Bonds (CPBs), which are issued at a higher interest rate than CSBs but are redeemable only annually. A new retail debt product, the Canada Investment Bond (CIB), was introduced as a pilot in the autumn of 2003 to be sold only through investment dealers.

This product is a longer-term instrument that is transferable and redeemable upon maturity. Bonds are available through a network of sales agents, as well as through organizations sponsoring the Payroll Savings Program, and through direct sales by telephone or via the Internet.

As fiscal agent for the government, the Bank is responsible for providing operations and systems-support services, accounting, and advice for the retail debt program. The program is directed by the Department of Finance through its agency, Canada Investment and Savings, which is responsible for the strategic direction of the business, including products, sales, marketing, and public relations.

Achieving Cost-Effective Back-Office Operations

In September 2001, the Bank entered into a contract with EDS Canada for the provision of back-office services. Through its Debt Administration Office, the Bank remains accountable for the delivery of these services and for managing the contract with EDS. This outsourcing has been the primary means of achieving cost-effectiveness over the last couple of years. Following a 4 per cent cost reduction in 2002, a further decline of 9 per cent was realized in 2003. The stipulated service levels with EDS continued to be met consistently, and a customer survey completed in the first half of 2003 indicated that customers rank the service as very high.

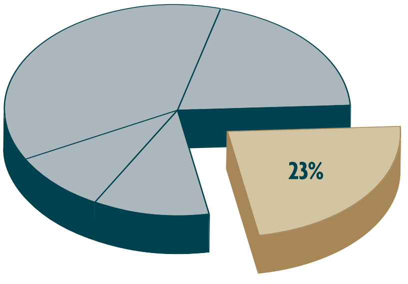
In addition to the continuous improvement in the cost-effectiveness of operations that is expected to come from outsourcing, the retail debt program began focusing in late 2002 and through 2003 on new initiatives to further reduce operating costs.

- The back-office operations contract for bonds held in registered retirement savings plans (RRSPs) or registered retirement income funds (RRIFs) was re-tendered at an annual savings of $1.0 million. Service levels for these operations will remain unchanged.
- A Web-based system was implemented to permit customers who purchase bonds through payroll deductions to make inquiries and redeem their bonds on-line, without the intervention of a customer-service representative. To date, more than 40 per cent of redemptions for these customers are handled through the more cost-effective automated services.
- Some of the retail debt is sold and held on behalf of customers by investment dealers. The register for these holdings was moved to the Canadian Depository for Securities in order to use the existing processes and infrastructure of the investment-dealer community for selling and managing debt instruments. When fully implemented with all investment dealers, this initiative will result in longer-term cost savings for both the program and the dealers.

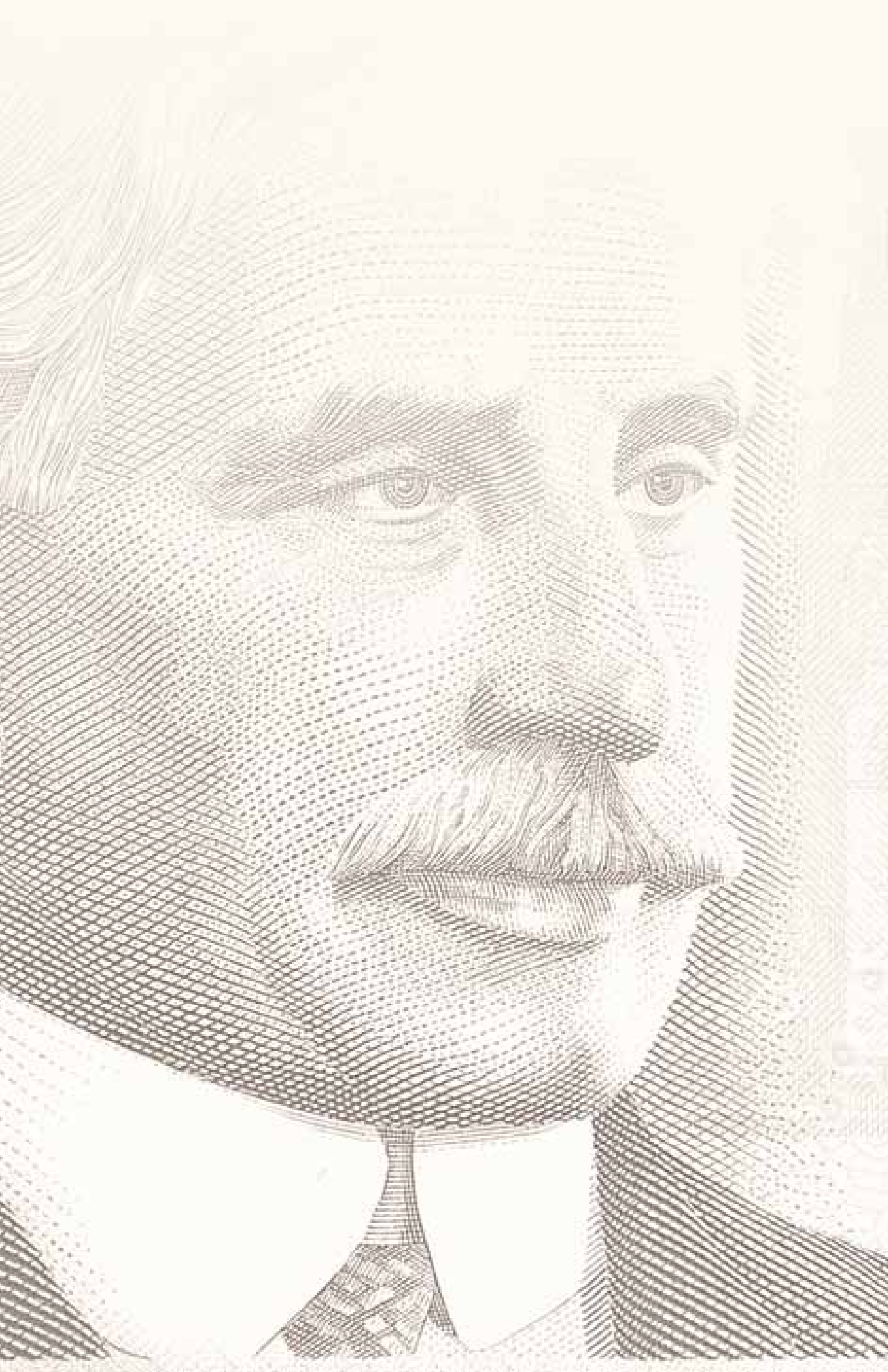
Operating Expenses

Operating expenses for retail debt services were $63.8 million, or 23 per cent of the Bank's total operating expenditures. Expenses in 2003 decreased by $6.5 million from 2002, partially because of the completion of depreciation on the major systems supporting this function.

Retail Debt Activities as a Proportion of Total Bank Expenses



FINANCIAL **SUMMARY**

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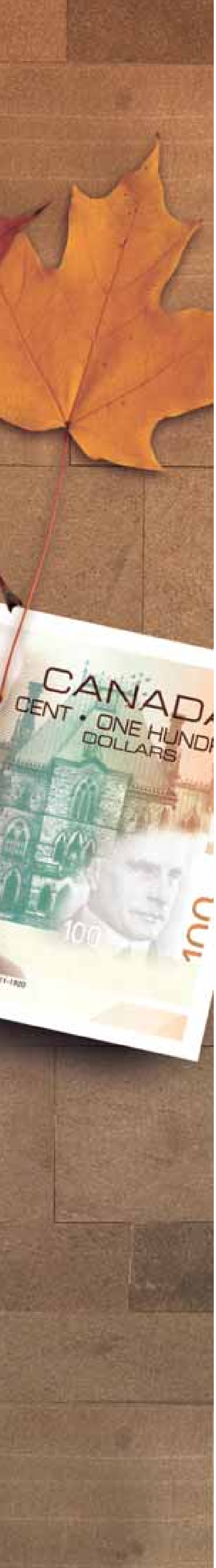
BANQUE DU CANADA



REVENUE AND EXPENSES

Revenue from Investments

Total revenue from investments in 2003 was unchanged from 2002 at $2.0 billion. The main source of revenues is interest earned on holdings of federal government securities. After expenses, the net revenue paid to the Government of Canada in 2003 was $1.8 billion, as in 2002.

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. For this reason, the level of operating expenses is a better indicator of the Bank's stewardship of public resources.

Operating Expenses

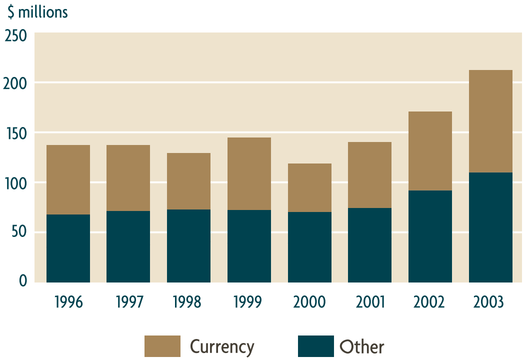
Strategic Initiatives

The Bank's medium-term plan (MTP) for 2003 to 2005 established a number of strategic priorities. These priorities fall into four broad areas—research and analysis, building partnerships, securing Canada's bank notes, and increasing organizational effectiveness.

Operating expenses in 2003 rose to $212 million, an increase of $41 million from 2002. Over half of this increase—$23.1 million—represented an increase in expenditures in the currency function relating to the Bank's three-pillar strategy for securing bank notes. This strategy involves significant investments in bank note security, education, and compliance initiatives over the medium term. Most of the increase in expenses in 2003 related to the preparation for issuance of the new $20, $50, and $100 notes in 2004. The launch of the new $100 note in early 2004 represented significant progress in this priority area.

Progress in the other priority areas of the Bank's MTP—research and analysis, partnerships, and organizational effectiveness—occurred primarily through the work programs of the Bank's three other main functional areas: monetary policy, the financial system, and funds management. Operating expenses for these three functions combined rose by $17.9 million, reflecting both labour inputs and

Operating Expenses
Monetary policy, currency, financial system, and funds management



infrastructure costs. Initiatives in these areas included: broadening and deepening the Bank's research on structural and regional issues, the efficiency of capital markets, and the stability of our financial system; enhancing business-continuity capabilities; supporting funds-management activities for the government; attracting and retaining qualified staff; and improving the delivery of client and corporate services.

Salaries and Benefits

The Bank's compensation strategy offers a market-competitive total compensation program aimed at attracting and retaining staff.

In 2003, the salary-range increase for Bank staff was 2 1/2 per cent. Total salaries also rose as a result of a compositional shift in staff towards more analytic and research professionals and fewer clerical positions, reflecting the combined effect of efficiency measures and staffing to meet strategic initiatives. Current benefit expenses rose along with staff changes and as a result of rising health and dental costs.

Over half of the total increase in salaries and benefits in 2003 was due to accounting provisions. A one-time adjustment of $3 million was made to recognize re-earnable performance pay in the year earned. In addition, approximately $8 million of the increase in benefit expenses resulted from updated estimates and assumptions as specified in Canadian Institute of Chartered Accountants standards. The annual expenses recorded for future benefit obligations can be particularly sensitive to the stipulated annual discount rate. The notes to the financial statements provide a comprehensive review of these expenses.

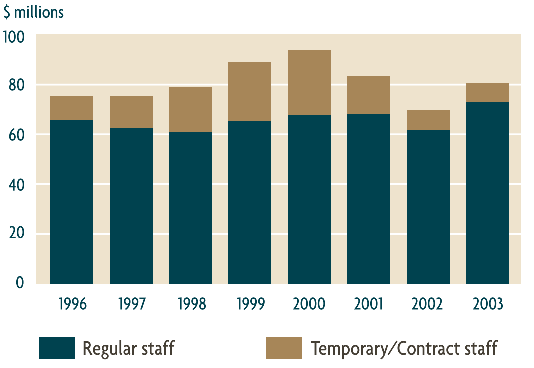
Other Expenses

Retail Debt Services

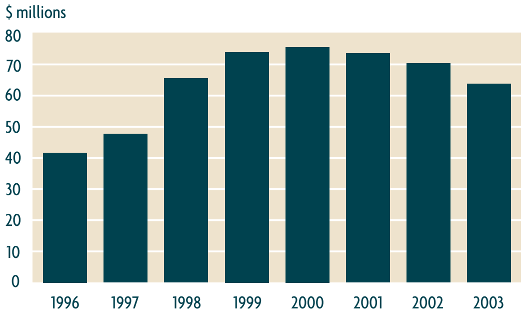
The Bank has provided services on a cost-recovery basis to Canada Investment and Savings—the agency of the Department of Finance responsible for the government's retail debt program—since the agency's inception in 1996.

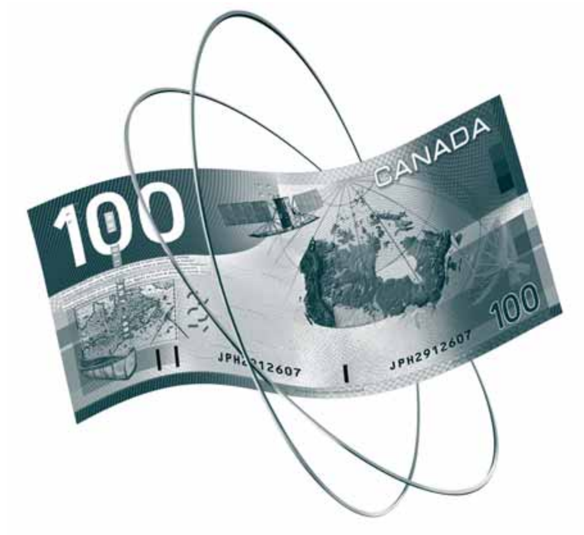
In 2003, expenses for retail debt operations continued to decline as they have done each year since 2001, when the Bank outsourced its retail debt operations to EDS Canada.

Salary Expenses
Monetary policy, currency, financial system, funds management, and retail debt services



Operating Expenses
Retail debt services





FINANCIAL **STATEMENTS**

(Year Ended 31 December 2003)

BANK OF CANADA

FINANCIAL REPORTING RESPONSIBILITY

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

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

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

These financial statements have been audited by the Bank's external auditors, Deloitte & Touche LLP and Raymond Chabot Grant Thornton, General Partnership and their report is presented herein. They obtain an understanding of the Bank's internal controls and procedures for financial reporting to plan and conduct such tests and other audit procedures as they consider necessary in the circumstances to express an opinion in their report presented herein. The external auditors have full and unrestricted access to the Audit Committee to discuss their audit and related findings.

D.A. Dodge, Governor

S. Vokey, CA, Chief Accountant

Ottawa, Canada

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

AUDITORS' REPORT

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

We have audited the balance sheet of the Bank of Canada as at 31 December 2003 and the statement of revenue and expense for the year then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Bank as at 31 December 2003 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

Deloitte & Touche LLP

DELOITTE & TOUCHE LLP
Chartered Accountants

Raymond Chabot Grant Thornton

RAYMOND CHABOT GRANT THORNTON
General Partnership
Chartered Accountants

Ottawa, Canada
20 January 2004

BANK OF CANADA

STATEMENT OF REVENUE AND EXPENSE

Year ended 31 December 2003

	2003	2002
	Millions of dollars	
REVENUE		
Revenue from investments, net of interest paid on deposits of $42.4 million ($8.3 million in 2002)	**1,971.5**	2,016.6
EXPENSE by function (notes 1 and 3)		
Monetary policy	**54.6**	51.1
Currency	**101.9**	78.8
Financial system	**24.4**	15.9
Funds management	**31.0**	25.1
	211.9	170.9
Retail debt services expenses	**63.8**	70.3
Retail debt services recoveries	**(63.8)**	(70.3)
	211.9	170.9
OTHER EXPENSE		
Restructuring costs (note 12)	**–**	23.3
	211.9	194.2
NET REVENUE PAID TO RECEIVER GENERAL FOR CANADA	**1,759.6**	1,822.4

(See accompanying notes to the financial statements.)

BANK OF CANADA

BALANCE SHEET

As at 31 December 2003

ASSETS	2003	2002
	Millions of dollars	
Deposits in foreign currencies		
U.S. dollars	**532.9**	674.2
Other currencies	**8.4**	4.4
	541.3	678.6
Advances to members of the Canadian Payments Association (note 4)	–	534.9
Investments (note 5)		
Treasury bills of Canada	**12,511.2**	13,113.1
Other securities issued or guaranteed by Canada maturing within three years	**8,534.3**	8,571.3
Other securities issued or guaranteed by Canada not maturing within three years	**20,130.5**	18,648.7
Other investments	**2.6**	2.6
	41,178.6	40,335.7
Bank premises (note 6)	**130.9**	135.1
Other assets		
Securities purchased under resale agreements	**1,902.1**	1,904.8
All other assets (note 7)	**365.0**	369.7
	2,267.1	2,274.5
	44,117.9	43,958.8

(See accompanying notes to the financial statements.)

LIABILITIES AND CAPITAL	2003	2002
	Millions of dollars	
Bank notes in circulation	**42,190.6**	41,146.7
Deposits		
Government of Canada	**533.0**	534.6
Banks	**359.5**	1,065.5
Other members of the Canadian Payments Association	**140.8**	125.8
Other deposits	**337.2**	415.0
	1,370.5	2,140.9
Liabilities in foreign currencies		
Government of Canada	**403.0**	516.2
Other liabilities		
All other liabilities	**123.8**	125.0
	44,087.9	43,928.8
Capital		
Share capital (note 8)	**5.0**	5.0
Statutory reserve (note 9)	**25.0**	25.0
	30.0	30.0
	44,117.9	43,958.8

D.A. Dodge, Governor

S. Vokey, CA, Chief Accountant

On behalf of the Board

J.S. Lanthier, CM, FCA,
Chair, Audit Committee and Lead Director

A. Landry, Q.C.
Chair, Planning and Budget Committee

(See accompanying notes to the financial statements.)

BANK OF CANADA

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2003

1. The business of the Bank

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

Monetary policy

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

Currency

Designs, produces, and distributes Canada's bank notes, focusing on counterfeit deterrence through research on security features, public education, and partnership with law enforcement; replaces and destroys worn notes.

Financial system

Promotes safe, sound, and efficient financial systems, both within Canada and internationally.

Funds management

Provides high-quality, effective, and efficient funds-management services for the government, as its fiscal agent; for the Bank; and for other clients.

Retail debt services

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

2. Significant accounting policies

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

The significant accounting policies of the Bank are:

a) Accounting estimates

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

b) Revenues and expenses

Revenues and expenses are accounted for on an accrual basis.

c) Employee benefit plans

The Bank sponsors a number of defined-benefit plans that provide pension and other post-retirement and post-employment benefits to most of its employees. The Bank accrues its obligations under these benefit plans and the related costs, net of plan assets. The costs and the obligations of the plans are actuarially determined using the projected benefit method and using management's best estimate of expected plan investment performance, salary escalation, retirement ages of employees, and expected health care costs. Management considers that the assumptions used to determine the accrued benefit obligation and the net benefit cost of pension and other retirement benefits are of a long-term nature, which is consistent with the long-term nature of employee future benefits.

The benefit expense (income) recognized in the period consists of the current service cost, plus interest on the obligation, less expected return on assets, plus amortization of past incurred costs and actuarial gains and losses. For this purpose, the current service cost of employee benefits and the interest cost on the liability are reported as incurred. The expected return on assets for the year is based on a target rate of return per annum applied to the market-related value of plan assets, which is based on the market value of assets adjusted to amortize over five years the annual excess (shortfall) of investment returns in relation to target returns. Amortization of past incurred costs such as the initial transitional obligation and the cost of plan amendments is carried out over the expected average remaining service lifetime (EARSL) of plan members, which has been determined to be 12 years for the pension plans and for the severance pay and retiring allowance program, 14 years for the post-retirement health care plan, and 7 years for post-employment benefits plans. Cumulative actuarial gains (losses) are amortized over EARSL to the extent they exceed 10 per cent of the greater of the benefit obligation and the market-related value of plan assets.

During 2003, the Bank adopted the proposed accounting recommendations of the Accounting Standards Board, *"Employee Future Benefits – Additional Disclosures"* (see note 10).

d) Translation of foreign currencies

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

e) Advances

Advances to members of the Canadian Payments Association are liquidity loans that are fully collateralized and generally overnight in duration. The Bank charges interest on advances under the Large Value Transfer System (LVTS) at the Bank Rate.

f) Investments

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

g) Securities Lending Program

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

h) 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

i) Securities purchased under resale agreements

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

Term repurchase agreements are also repo-type transactions in which the Bank acquires Government of Canada securities from designated counterparties with an agreement to sell them back at a predetermined price on an agreed resale date, generally over more than one business day. The transactions are carried out at market determined rates of interest, and as with SPRAs, term repurchase agreements are transacted with primary dealers.

The balance sheet category *Securities purchased under resale agreements* represents collateralized lending transactions. As such, this includes amounts at which the securities were originally acquired.

j) Deposits

The liabilities within this category are Canadian-dollar demand deposits.

The Bank pays daily interest on Government of Canada deposits at a market determined rate, specifically, at the weighted average yield on the shortest maturity (typically one business day) of Government of Canada term deposits that are auctioned each morning to a group of eligible financial market participants.

For banks and other members of the Canadian Payments Association, the Bank pays interest on positive balances associated with the LVTS at the lower end of the operating band for the overnight interest rate (50 basis points below the Bank Rate). On special Deposit Accounts, which serve as collateral for LVTS participants, the Bank pays interest at the published overnight rate less a margin, which was 6.25 basis points at 31 December 2003 (6.25 basis points in 2002).

For other financial institution deposits, the Bank pays interest at a rate varying from 0% for non-interest-bearing accounts to a daily rate calculated on the average three-month treasury bill less 0.20%.

k) Securities sold under repurchasing agreements

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

l) Insurance

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

3. Expense by classes of expenditure

	2003	2002
	Millions of dollars	
Salaries	**79.2**	69.9
Benefits and other staff expenses	**25.7**	15.3
Currency costs	**46.6**	31.9
Premises maintenance	**21.5**	17.9
Services and supplies	**93.4**	90.5
Depreciation	**19.3**	24.3
	285.7	249.8
Recoveries		
Retail debt services	**(63.8)**	(70.3)
Other	**(10.0)**	(8.6)
	211.9	170.9
Restructuring and related costs	**–**	23.3
Total	**211.9**	194.2

Recoveries represent the fees charged by the Bank for a variety of services.

4. Advances to members of the Canadian Payments Association

In November 2003, the Canadian Payments Association and the Bank of Canada moved from same-day settlement to next-day settlement environment for payment items cleared through the Automated Clearing Settlement System (ACSS). This eliminated the need to backdate the results of payments settling through the ACSS.

The elimination of retroactive settlement means that the results are recognized on the Bank's books the day the items actually settle in the ACSS. In addition, the operation of the ACSS no longer requires advances to (or deposits from) members of the Canadian Payments Association, which are reflected in the Bank's balance sheet (advances in 2002 were $534.9 million).

5. Investments

Securities	2003 Millions of dollars Amortized cost	Fair market value	Average yield %	2002 Millions of dollars Amortized cost	Fair market value	Average yield %
Treasury bills of Canada	**12,511.2**	**12,521.3**	**2.8**	13,113.1	13,126.3	3.0
Other securities issued or guaranteed by Canada maturing within 3 years	**8,534.3**	**8,842.5**	**5.4**	8,571.3	8,883.8	5.6
Other securities issued or guaranteed by Canada maturing in over 3 years but not over 5 years	**5,760.2**	**6,147.5**	**5.6**	4,599.5	4,968.7	6.0
Other securities issued or guaranteed by Canada maturing in over 5 years but not over 10 years	**9,027.9**	**9,749.5**	**5.8**	9,225.9	10,039.9	6.0
Other securities issued or guaranteed by Canada maturing in over 10 years	**5,342.4**	**6,026.9**	**6.2**	4,823.3	5,398.5	6.3
	41,176.0	**43,287.7**		40,333.1	42,417.2	
Other investments	**2.6**	**2.6**		2.6	2.6	
	41,178.6	**43,290.3**		40,335.7	42,419.8	

The Bank typically holds its investments in treasury bills and bonds until maturity. The amortized book values of these investments approximate their par values. There were no securities loaned under the Securities Lending Program at 31 December 2003.

6. Bank premises

	2003 Millions of dollars Cost	Accumulated depreciation	Net book value	2002 Millions of dollars Cost	Accumulated depreciation	Net book value
Land and buildings	**167.5**	**81.6**	**85.9**	167.5	78.3	89.2
Computer hardware/ software	**57.7**	**43.0**	**14.7**	53.5	42.7	10.8
Other equipment	**136.8**	**107.7**	**29.1**	135.5	105.9	29.6
	362.0	**232.3**	**129.7**	356.5	226.9	129.6
Project in progress	**1.2**	**–**	**1.2**	5.5	–	5.5
	363.2	**232.3**	**130.9**	362.0	226.9	135.1

The project in progress consists of the replacement of the HR service delivery system. Depreciation, on a straight-line basis over 5 years, will commence in 2004 upon completion of the project.

The Bank's new automated system that forms the core of foreign reserves management was placed into production in the current year and is included in the category *Computer hardware/software*.

7. All other assets

This category includes accrued interest on Canadian investments of $257.9 million ($267.9 million in 2002). It also includes the pension accrued benefit asset of $78.6 million ($70.7 million in 2002).

8. Share capital

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

9. Statutory reserve

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

10. Employee benefit plans

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

Description of plans

a) Pension benefit plans

The Bank of Canada Pension Plan was established in accordance with the provisions of the Bank of Canada Act. The Plan is a contributory defined-benefit plan that covers the majority of the Bank's employees. The Plan provides for retirement pension, survivors' pensions and refunds occasioned by termination of employment or death. Pension calculation is based mainly on years of service and average pensionable income and is generally applicable from the first day of employment. In 1992, a Retirement Compensation Arrangement was introduced to supplement the pensions of those employees who contribute above the maximum for the registered pension plans prescribed by Canada Customs and Revenue Agency. The Pension is indexed to reflect changes in the Consumer Price Index on the date payments begin and each January 1st thereafter. On 1 December 2003, as a result of the Bank's new pension governance structure, the Bank appointed an independent trust company (CIBC Mellon Trust Company) as Trustee of the Bank's Pension Trust Fund. Prior to December 2003, the trustees were appointed individually by the Bank's Board of Directors.

b) Other benefit plans

The Bank sponsors post-retirement health, dental, and life insurance benefits, as well as post-employment self-insured Long-Term Disability (LTD) and continuation of benefits to disabled employees. The Bank also sponsors a severance pay and retiring allowance program for the majority of its employees. There are no requirements regarding the funding of those programs.

Funding policy

Contributions to the Pension Plan are determined by actuarial valuations which are made at least on a triennial basis. The most recent actuarial valuation for funding purposes of the Plan was done as of 1 January 2002. These valuations are done in accordance with legislative requirements and with the recommendations of the Canadian Institute of Actuaries for the valuation of pension plans. Employees are required to contribute to the Plan a percentage of their pensionable salary, which is 5.7% up to the Year's Maximum Pensionable Earnings (YMPE) and 7.5% of salary in excess of the YMPE until a maximum of 35 years of credited service. As a result of the current excess funded status of the Pension Trust Fund, the Bank has been required to take a legally mandated contribution holiday as of 1 January 2000. The next actuarial valuation for funding purposes will be done as of 1 January 2005. For the Supplementary Trust Fund, the Bank, as a plan sponsor, is responsible for any funding requirements.

Plan assets, benefit obligation, and plan status

	Pension benefit plans		Other benefit plans	
	2003	**2002**	**2003**	**2002**
	Millions of dollars		**Millions of dollars**	
Change in fair value of plan assets[1]				
Fair value of plan assets at beginning of year	**639.2**	690.6	–	–
Bank's contributions	**3.1**	2.7	–	–
Employees' contributions	**5.2**	5.1	–	–
Benefit payments and transfers	**(26.2)**	(22.0)	–	–
Actual return on plan assets	**105.5**	(37.2)	–	–
Fair value of plan assets at end of year	**726.8**	639.2	–	–

1. Plan assets are held in the Bank of Canada Pension Trust Fund and the Supplementary Trust Fund. Based on the fair value of the plan assets held at 31 December 2003, the Pension Trust Fund's assets were composed of 59.6% in equities, 27% in bonds, 10% in real return assets, 2% in real estate assets, and 1.4% in short-term securities and cash. The Supplementary Trust Fund's assets were composed of 53% in equities and 47% short-term securities.

Plan assets, benefit obligation, and plan status (cont'd)

	Pension benefit plans		Other benefit plans[1]	
	2003	**2002**	**2003**	**2002**
	Millions of dollars		**Millions of dollars**	
Change in benefit obligation				
Benefit obligation at beginning of year	**612.1**	486.4	**106.4**	87.4
Service cost	**17.7**	13.3	**4.4**	3.5
Interest cost	**33.9**	29.2	**5.8**	5.2
Benefit payments and transfers	**(26.2)**	(22.0)	**(6.6)**	(5.4)
Plan amendments	**–**	27.6	**–**	–
Actuarial loss	**25.8**	77.6	**2.7**	16.4
Release of obligation due to curtailment	**–**	–	**–**	(0.7)
Benefit obligation at end of year	**663.3**	612.1	**112.7**	106.4
Plan status				
Excess (deficiency) of fair value of plan assets over benefit obligation at end of year	**63.5**	27.1	**(112.7)**	(106.4)
Unamortized net transitional (asset) obligation	**(100.6)**	(113.2)	**29.2**	33.0
Unamortized cost of amendments	**24.2**	26.5	**5.0**	6.0
Unamortized net actuarial loss	**91.5**	130.3	**18.2**	15.9
Accrued benefit asset (liability)	**78.6**	70.7	**(60.3)**	(51.5)

1. Annual rate of increase assumptions in the per capita cost of health care benefits used in performing the actuarial valuation of employee future benefits, were 10% for drugs and 9% for hospital costs grading down to 4.5% over 10 years and level thereafter (9% in 2002 grading down to 4.5% over 10 years), and 4% for dental (3% in 2002). The assumed health care cost trend rate for next year is 9.63% grading down to 4.5% by 2013 (9% in 2002 grading down to 4.5% by 2012). A one percentage point increase in assumed health care cost trend rates would have increased the service and interest costs and obligation by $1.0 million and $13.4 million respectively for post-retirement benefits and $0.03 million and $0.18 million respectively for post-employment benefits. A one percentage point decrease in assumed health care cost trends would have lowered the service and interest costs and the obligation by $0.77 million and $10.4 million, respectively for post-retirement benefits and $0.02 million and $0.15 million respectively for post-employment benefits.

The accrued benefit asset for the defined-benefit pension plans is included in the balance sheet category *All other assets*. The total accrued benefit liability for the other benefit plans is included in the balance sheet category *All other liabilities*.

Weighted-average assumptions used to determine benefit obligation

	Pension benefit plans		Other benefit plans	
	2003	**2002**	**2003**	**2002**
Discount rate	**5.25%**	5.50%	**5.30%**	5.30%
Rate of compensation increase	**4.00% +merit**	4.00% +merit	**4.00% +merit**	4.00% +merit

Net benefit expense (income) incurred in the period

	Pension benefit plans		Other benefit plans	
	2003	2002	2003	2002
	Millions of dollars		Millions of dollars	
Current service cost	**12.3**	8.1	**4.3**	3.5
Interest cost	**33.9**	29.2	**5.8**	5.2
Actual return on plan assets	**(105.5)**	37.2	**–**	–
Plan amendments	**–**	27.6	**–**	–
Actuarial loss	**25.8**	77.6	**2.7**	16.4
Release of obligation due to curtailment	**–**	–	**–**	(0.7)
Curtailment loss	**–**	–	**0.1**	2.7
Net benefit expense (income) incurred in the period	**(33.5)**	179.7	**12.9**	27.1

Net benefit expense (income) recognized in the period[1]

	Pension benefit plans		Other benefit plans	
	2003	2002	2003	2002
Current service cost	**12.3**	8.1	**4.3**	3.5
Interest cost	**33.9**	29.2	**5.8**	5.2
Expected return on plan assets	**(41.1)**	(38.8)	**–**	–
Curtailment loss	**–**	–	**0.1**	2.7
Amortization of transitional obligation (asset)	**(12.6)**	(12.6)	**3.5**	3.6
Amortization of plan amendments	**2.3**	1.2	**1.0**	1.0
Amortization of net actuarial loss	**0.4**	0.5	**0.4**	–
Net benefit expense (income) recognized in the period	**(4.8)**	(12.4)	**15.1**	16.0

1. A discount rate assumption of 5.50% (5.75% in 2002) and an expected rate of return on plan assets assumption of 6% (5.70% in 2002) were used to determine the benefit expense of the pension plans. A discount rate of 5.30% (5.99% in 2002) was used to determine the benefit expense of the other benefit plans. A compensation increase assumption of 4% (3% in 2002) was used for all plans to determine the pension benefit expense.

2003 sensitivity of key assumptions – Impact of 0.25% increase/decrease in assumptions

	Change in obligation	Change in expense
	Millions of dollars	Millions of dollars
Pension benefit plans		
Change in discount rate	(28.4) / 28.4	(0.9) / 1.9
Change in the long-term rate of return on plan assets		(1.7) / 1.7
Other benefit plans		
Change in discount rate	(4.3) / 4.5	(0.4) / 0.4

11. Commitments, contingencies, and guarantees

a) Operations

The Bank has a long-term contract with an outsourced service provider for retail debt services, expiring in 2011. As at 31 December 2003, fixed payments totalling $110.6 million remained, plus a variable component based on the volume of transactions. The Bank recovers the cost of retail debt services from the Canada Investment and Savings Agency.

Commitments related to other support services are $1.8 million over the next year. The current contract is renewable in June 2004 for two 1-year extensions.

b) Foreign currency contracts

The Bank is a participant in foreign currency swap facilities with the U.S. Federal Reserve for US$2 billion, the Banco de México for Can$1 billion and with the Exchange Fund Account of the Government of Canada. There were no drawings under any of those facilities in 2003 or 2002 and, therefore, there were no commitments outstanding at 31 December 2003.

c) Investment contracts

Outstanding sale investment contracts of $1,899.7 million, at an interest rate of 2.75 per cent under special purchase and resale agreements, were settled by 9 January 2004 ($1,906.1 at the end of 2002 at an interest rate of 2.74 per cent).

d) Contingency

The Bank holds 8,000 shares in the Bank for International Settlements (BIS). The nominal value of each BIS share is 5,000 special drawing rights (SDR) of which 25%, i.e.: SDR 1,250, is paid up. The balance of SDR 3,750 is callable at three months' notice by decision of the BIS Board.

e) Guarantees

In 2003, the Bank adopted the requirements of the CICA Accounting Guideline (AcG 14) "Disclosure of Guarantees" which requires additional disclosure about a guarantor's obligation under certain guarantees. A guarantee is defined in AcG 14 as including: (i) a contract that contingently requires the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an obligating agreement (a performance guarantee); and (ii) an indemnification agreement.

Large Value Transfer System (LVTS) Guarantee

The Bank provides a variety of settlement services to the LVTS, which is owned and operated by the Canadian Payments Association. The LVTS is a well risk-proofed large-value payment system. The risk controls in this system include caps on net debit positions and collateral to secure the use of overdraft credit, both intraday and overnight. These risk control arrangements are sufficient to protect the system from the effects of the failure of a single participant and to allow the system to settle without any unwinding of payments. The Bank has agreed to guarantee the settlement of this system in the extremely remote event that more than one participant were to fail on the same day during LVTS operating hours. The amount at risk under this guarantee is not determinable since the guarantee would only be called upon if a series of extremely low probability events were to occur. No amount has been provided for in the liabilities of the Bank and no amount has ever been paid under this guarantee.

Other Indemnification Agreements

In the normal course of operations, the Bank provides indemnification agreements with various counterparties in transactions such as service agreements, software licenses, leases, and purchases of goods. Under these agreements, the Bank agrees to indemnify the counterparty against loss or liability arising from the acts or omissions of the Bank in relation to the agreement. The nature of the indemnification agreements prevents the Bank from making a reasonable estimate of the maximum potential amount that the Bank would be required to pay such counterparties.

12. Restructuring costs

As at 31 December 2003, a liability of $3.2 million remained to meet future obligations related to staff redundancies. The total unutilized balance of restructuring costs shown below is included in *All Other Liabilities*.

	Millions of dollars
Balance at beginning of period	**4.4**
Amount utilized during the period	**1.2**
Balance at end of period	**3.2**

Costs of $5.2 million were incurred during 2003. Of this amount, $1.2 million related to severance, which was recorded as a reduction in the restructuring provision, and the remaining $4.0 million was recorded in the expenses by function component of the *Statement of revenue and expense*.

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Dale Fleck	Chief

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David Sullivan	Internal Auditor

Note: Positions as of 31 January 2004
* Member of Executive Management Committee
1. On Executive Interchange to Government of Canada
2. Also Chair of the Board of Directors of the Canadian Payments Association
3. Visiting economist
4. On leave
5. Also Deputy Chair of the Board of Directors of the Canadian Payments Association
6. On Executive Interchange from Government of Canada

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PUBLICATIONS

Monetary Policy Report* and *Update

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

Financial System Review

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

Bank of Canada Review

A quarterly publication that contains economic commentary and feature articles. By subscription.

Bank of Canada Banking and Financial Statistics

A comprehensive package of Canadian data. Published monthly. By subscription.

Weekly Financial Statistics

A 20-page package of banking and money market statistics. By subscription.

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Note: Positions as of 31 January 2004