BANK OF CANADA ANNUAL REPORT 2005

CELEBRATING 70 YEARS { 1935–2005 }

Bank of Canada
234 Wellington Street,
Ottawa, Ontario K1A 0G9
5317
CN ISSN 0067 3587

CELEBRATING 70 YEARS

Bank of Canada • Banque du Canada

Ottawa K1A 0G9

David A. Dodge
Governor - Gouverneur

28 February 2006

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

Dear Minister,

In accordance with the provisions of the Bank of Canada Act, I am submitting the Bank of Canada's *Annual Report* for the Year 2005 and the Bank's audited financial statements as at 31 December 2005.

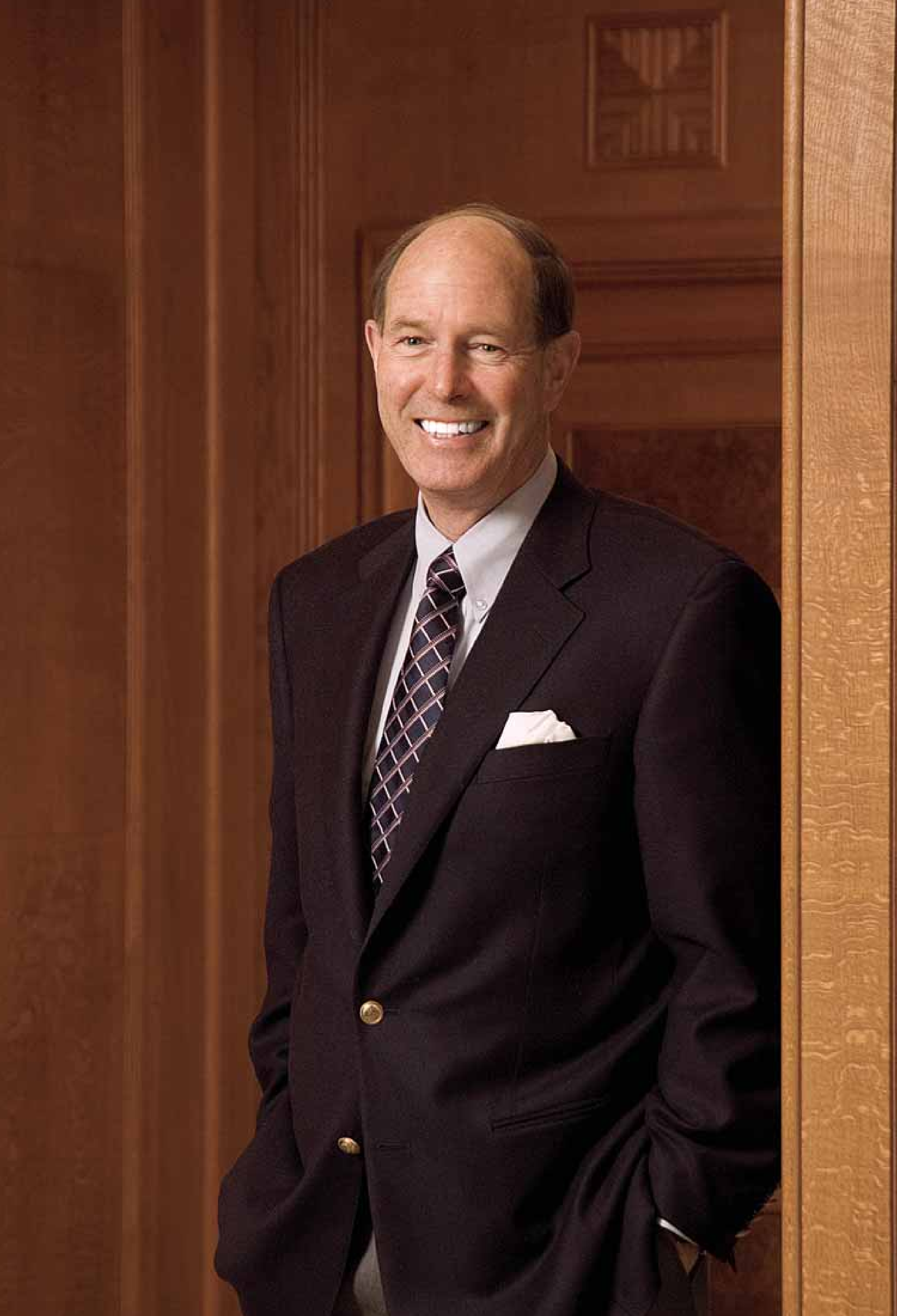
Yours sincerely,

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 features one of the two amphorae, or large urns, that grace the front of the Bank of Canada building on Wellington Street in Ottawa.

In antiquity, amphorae were used to store a variety of precious goods, ranging from wine and oil to coins and jewels. For this reason, they have come to symbolize the storage of wealth.



MESSAGE FROM THE GOVERNOR

In 2005, the Bank of Canada celebrated its 70th anniversary. Since the Bank opened its doors in March 1935, it has evolved into a national institution at the heart of Canada's economy. We had a lot to celebrate in 2005—particularly our progress over the past 70 years and our continuing contribution to the economic and financial well-being of Canadians.

The preamble to the Bank of Canada Act sets out our major objectives. It reads:

> *… it is desirable to establish a central bank in Canada to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada.*

While our country and our economy have grown and evolved considerably since 1935, the Bank of Canada's mandate continues to serve Canada and Canadians very well. How the Bank conducts its business has changed over time, but our objectives remain the same.

The Bank fulfills its mandate through its activities in four business lines: monetary policy, currency, the financial system, and funds management.

Monetary Policy

The Bank's conduct of monetary policy is key to fulfilling its mandate. Our experience, like that of other central banks around the world, has taught us that the best contribution that monetary policy can make to strong and sustained economic growth is to keep inflation low, stable, and predictable.

In 1991, we agreed with the Government of Canada on a formal framework for targeting inflation. Since 1995, the Bank has used this framework to keep inflation at the 2 per cent midpoint of a 1 to 3 per cent range. Achieving and maintaining this target has not only kept inflation under control, it has also helped to reduce fluctuations in production and employment.

Canada's economic performance in 2005 reflects this. Our economy was running very close to its production capacity, and unemployment was at a 30-year low. Although total consumer price inflation fluctuated in response to energy shocks in 2005, underlying (or core) inflation remained close to the 2 per cent target. Inflation expectations also remained solidly anchored at 2 per cent.

Our monetary policy helps the economy to adjust to external events and remain resilient to shocks from abroad. International developments and movements in the external value of the Canadian dollar can significantly affect Canada's foreign trade and overall economic growth. Through our research and analysis, we aim to better understand the forces at work on our economy and to decide on an appropriate monetary policy response. We do this always with the aim of keeping inflation low, stable, and predictable and the economy expanding at a steady, sustainable pace.

Currency

Since 1935, the Bank of Canada has been designing and issuing Canada's bank notes. It is our responsibility to produce secure, high-quality paper currency that Canadians can use with confidence. During recent years, counterfeiting of Canadian notes has been one of our biggest challenges, as high-quality reprographic technology, such as colour photocopiers and scanners, has become widely available. As part of our strategy to protect the integrity of Canada's bank notes, we have been issuing a new series of notes with advanced security features.

We have also worked with our partners in the law-enforcement, retail, and hospitality sectors to develop a comprehensive national strategy for counterfeit deterrence. This strategy has started to pay dividends—counterfeiting levels began to decline in 2005, although they remain a challenge. We will continue to pursue and expand our anti-counterfeiting initiatives, with the help of our partners and with the support of Canadians.

Financial System

In many ways, the central bank is at the centre of Canada's financial system. In the 1950s, we provided the impetus for the development of a Canadian market for government bills, bonds, and other short-term securities. Today, we oversee the clearing and settlement systems that financial institutions use to settle their daily transactions. The Bank of Canada is also the "lender of last resort"—the ultimate provider of liquidity to the financial system.

The Bank plays a key role in improving the financial welfare of Canada, as mandated in the Bank of Canada Act, by promoting the stability and efficiency of the country's financial markets. We do this through research, analysis, and dialogue with other policy-makers and financial system participants.

The Bank promotes increased efficiency in the Canadian financial system because we know that an efficient system facilitates the allocation of scarce resources to their most productive uses in the economy. This, in turn, helps generate higher standards of living for Canadians. An efficient financial system also helps the Bank in its conduct of monetary policy. When we set the target for the overnight interest rate eight times a year, markets and financial institutions transmit the effects of those interest rate decisions to the economy. The financial system also provides us with critical information and feedback about what is happening in the Canadian economy.

Funds Management

In addition to our responsibilities in Canada's financial system, the Bank is also the fiscal agent for the Government of Canada. In this role, we contribute to the efficient management of the federal government's finances. The Bank provides policy advice to the government and manages its cash balances and foreign exchange reserves, as

well as the issuance of Government of Canada debt instruments.

We continue to increase our research and analytic capacity in these areas, and have invested in corporate infrastructure to enhance our decision making and risk management, and to improve service.

Organization and Management

This year, we will reach the end of our 2003–06 medium-term plan, which sets out the strategic priorities needed to fulfill our policy requirements and corporate responsibilities.

Throughout 2005, the Bank continued to work at achieving the outcomes identified in the plan in the most cost-effective way. We have every reason to believe that, by the end of 2006, we will have accomplished almost all of our plan's strategic objectives.

We are now engaged in preparing our next medium-term plan and are focusing on the following challenges:

- Improving our analytic capabilities and the databases necessary for our financial system and monetary policy research;
- Assuring continuity of operations, especially for banking services;
- Investing appropriately in information technology;
- Developing more secure currency, which includes preparing for the next series of bank notes;
- Maintaining best practices in corporate governance;
- Attracting, developing, and retaining the highly skilled staff that we need in order to continue to achieve excellence.

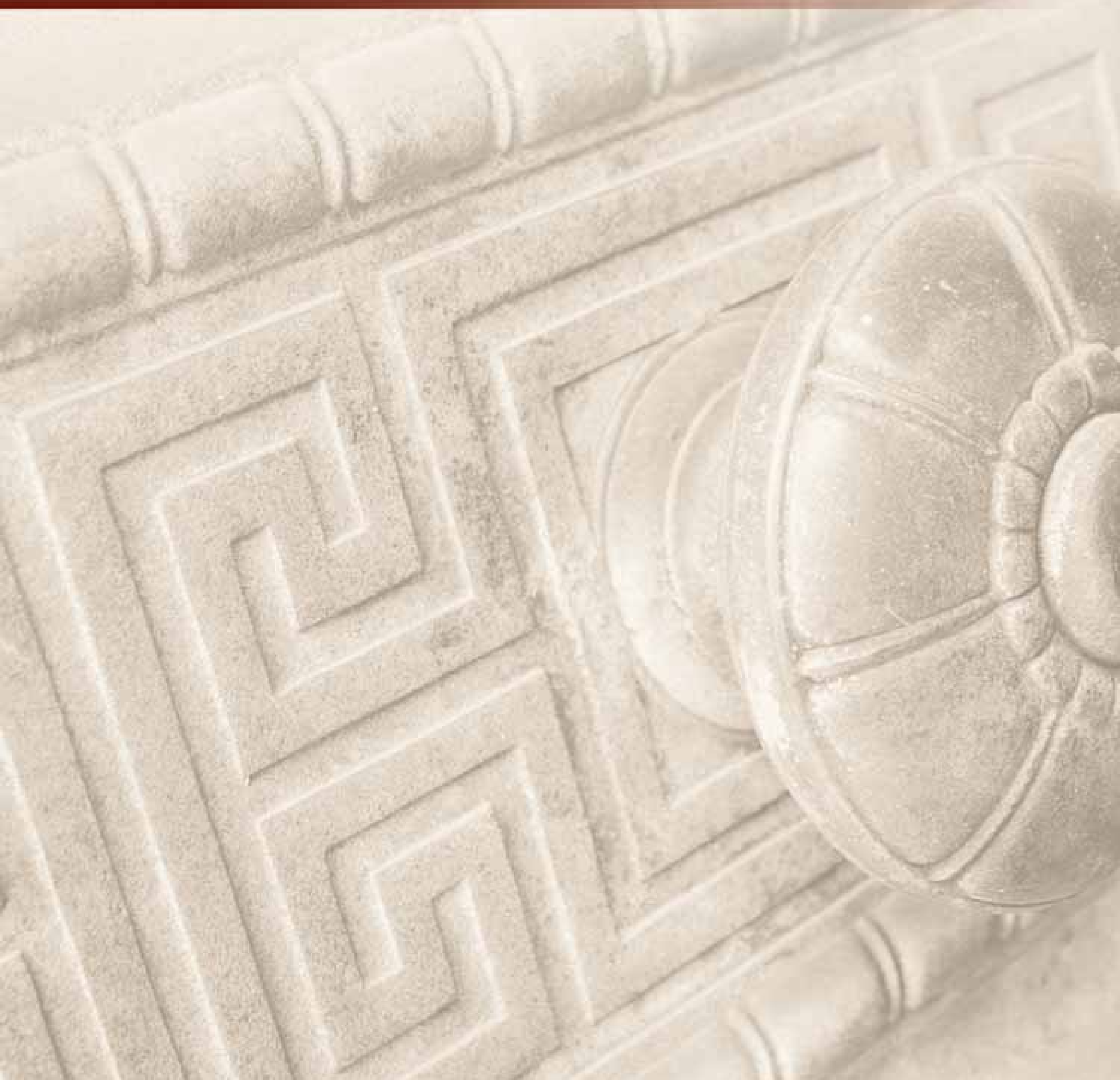
Throughout its history, the Bank of Canada's reputation and success have always relied on the skill, dedication, and professionalism of its staff. As a public institution and as a workplace, we continue to take our bearings from our commitment to Canadians, to excellence, and to one another. I want to personally thank the Bank's employees for their outstanding work in 2005. I also want to thank the members of the Board of Directors for their continuing guidance and support.

As Canada's central bank, we will continue to be accountable to Canadians and to fulfill our mandate to promote the economic and financial welfare of this country and its citizens.

David A. Dodge

BOARD MEMBERS *admire the National Capital Commission plaque located across from the Bank of Canada's head office on Ottawa's Wellington Street. This area is part of "Confederation Boulevard," a ceremonial route that runs through the heart of the Capital.*

ORGANIZATION AND GOVERNANCE



THE BUSINESS OF THE BANK

The Bank of Canada opened for business in 1935 with a mandate critical to the economic well-being of all Canadians that has remained essentially unchanged over the years. The Bank aims to keep inflation low, stable, and predictable; to supply safe and secure bank notes; to promote a stable and efficient financial system; and to oversee key clearing and settlement systems. Since its creation, the Bank has also been the Government of Canada's fiscal agent, managing its foreign exchange reserves and the public debt.

The work of the Bank is accomplished by a staff of 1,200 employees dedicated to excellence. The majority of the staff is located at the head office in Ottawa, while about 100 others are at operations centres in Toronto and Montréal. As well, about 50 employees work on a range of economic, financial market, and currency issues at regional offices in Vancouver, Calgary, Toronto, Montréal, and Halifax. The Bank also has a financial markets representative in New York.

Managing Risk at the Bank

The Bank has a well-established, integrated risk-management framework for identifying, managing, and monitoring key areas of risk, including business, reputational, financial, operational, and security risks. Through an annual self-assessment process, senior managers identify and assess the key risks that could impede the fulfillment of the Bank's responsibilities and the achievement of its objectives. Cost-effective, risk-mitigation strategies are put in place to manage and monitor these risks. The Board of Directors oversees these processes. The Bank also has an Audit Department, which reports functionally to the Audit Committee of the Board. The Department conducts periodic reviews of Bank operations, including the Bank's risk-management process, to assess the appropriateness and effectiveness of the systems of internal control implemented by management to mitigate risk, and thus to provide reasonable assurance that objectives will be achieved.

In addition, the Bank has a Financial Risk Office, independent of operations, that is responsible for monitoring and reporting to the Department of Finance and to the Bank on risks and investment performance arising from the management of the government's debt and foreign reserves.

The Bank keeps abreast of international best practices in the area of risk management. Staff members have presented the Bank's risk-management practices at conferences in Canada and abroad.

Governing Council

(left to right)

TIFF MACKLEM
Deputy Governor

PAUL JENKINS
Senior Deputy Governor

DAVID LONGWORTH
Deputy Governor

SHERYL KENNEDY
Deputy Governor

DAVID DODGE
Governor

PIERRE DUGUAY
Deputy Governor

THE GOVERNING COUNCIL *takes collective responsibility for monetary policy. The Governing Council, along with the General Counsel/Corporate Secretary (Mark Jewett), the Chief of the Communications Department (Denis Schuthe), and the Adviser responsible for Regulatory Analysis (Clyde Goodlet), make up the Bank's Financial System Committee.*

Corporate Governance

Progress on the medium-term plan

A key element in the Bank's accountability framework is the development, implementation, and monitoring of a medium-term plan. The current plan, which extends from 2003 through 2006, sets out ambitious objectives in the areas of leading-edge research, building partnerships with outside organizations and individuals, creating more secure bank notes, and continuing to improve the Bank's effectiveness as a public institution.

Looking towards the final year of the plan in 2006, the Bank took stock of the progress made and began the process of identifying strategic priorities for the next plan, which will be finalized this year.

The current assessment is that the plan is on track and that the Bank will have achieved almost all of its strategic objectives by the end of the planning period. In the area of monetary policy, the goals of maintaining inflation within the target range and increasing research in areas critical to the Bank's policy needs have been met. Considerable progress has also been made in implementing a strategy to improve the security of bank notes, and counterfeiting levels have started to decline, although they remain unacceptably high. The Bank has successfully implemented improved governance practices and increased operational

EXECUTIVE MANAGEMENT COMMITTEE

SHEILA NIVEN *Chief of the Corporate Services Department*	TIFF MACKLEM *Deputy Governor*	PAUL JENKINS *Senior Deputy Governor*	DAVID LONGWORTH *Deputy Governor*	MARK JEWETT *General Counsel/ Corporate Secretary*	SHERYL KENNEDY *Deputy Governor*	DAVID DODGE *Governor*	PIERRE DUGUAY *Deputy Governor*	SHEILA VOKEY *Chief of the Financial Services Department*	JANET COSIER *Adviser on Strategic Planning and Risk Management*

THE EXECUTIVE MANAGEMENT COMMITTEE *is responsible for matters related to the strategic direction and management of all the functions of the Bank.*

efficiencies in the areas of funds management and retail debt. The Bank has also made significant progress in meeting its objectives for promoting the stability and efficiency of the financial system. In each area, open communication enhanced the effectiveness of the Bank's work.

Management of the Bank

The Board of Directors, as defined in the Bank of Canada Act, contributes to the governance of the Bank mainly in the areas of finance, human resources, and administration. More specifically, the Board is responsible for appointing and evaluating senior management, overseeing the strategic planning and budget processes, and promoting effective corporate governance practices. The Board also monitors internal-control frameworks and provides oversight and advice on how the Bank fulfills its responsibilities under the Act. The Governor, who chairs the Board, is responsible for monetary policy and the other businesses of the Bank. For these functions, and to support the work of the Board, the Governor draws on the Governing Council and the Executive Management Committee, whose members contribute expertise related to the Bank's business lines and corporate administration. The Governing Council meets regularly to be briefed on economic matters and to make decisions, announced on eight scheduled dates each year, on the target overnight interest rate. The Executive Management Committee oversees all the operations of the Bank and ensures that matters related to its strategic direction and management receive close attention at the executive level. The Financial System Committee takes policy decisions in areas specific to the Bank's responsibility in the financial system.

Board of Directors

The Board works towards best governance practices and has taken special note of the report by the federal government on its review of Crown corporation governance. Given the Bank's unique governance framework (reflecting its responsibilities in the conduct of monetary policy), the measures in the report do not apply to the Bank. Nevertheless, the Board intends to adhere to the principles underlying the report in order to ensure that the Bank's corporate governance practices continue to be leading edge.

The Board has six standing committees to deal with matters brought before it for consultation or decision. In 2005, the terms of reference of each Committee were reviewed, as well as the policies related to the Board. On occasion, an Advisory Group of several directors is created to provide a forum for discussion of issues of particular interest. At this time, two Advisory Groups exist to discuss currency and pension matters.

- Executive Committee, Chair – David Dodge (Governor)
- Corporate Governance and Nominating Committee, Chair – Spencer Lanthier (Lead Director)
- Human Resources and Compensation Committee, Chair – Daniel Gallivan
- Audit Committee, Chair – Spencer Lanthier
- Planning and Budget Committee, Chair – Jean-Guy Desjardins
- Pension Committee, Chair – Paul Jenkins (Senior Deputy Governor)

Directors are paid according to a fee structure recommended by the government and approved by Order-in-Council. For 2005, the total remuneration to independent directors was $297,700.

Board Stewardship in 2005

The Board's Corporate Governance and Nominating Committee continued the practice, established last year in response to a government initiative, of contributing to the identification of candidates for nomination as directors to the Board. The Committee engaged an executive recruitment firm to assist in this process, which led to the appointment of several new directors to fill vacancies on the Board and to replace directors whose terms had expired.

The Board of Directors

(left to right)

RONALD J. KEEFE
President and CEO,
Diagnostic Chemicals Limited
Charlottetown, Prince Edward Island
Appointed in October 2003

PAUL JENKINS
Senior Deputy Governor

DANIEL F. GALLIVAN
CEO and Managing Partner,
Cox Hanson O'Reilly Matheson
Halifax, Nova Scotia
Appointed in August 2000

BARBARA HISLOP
Corporate Director
Vancouver, British Columbia
Appointed in March 1998

J. SPENCER LANTHIER
Lead Director
Corporate Director
Toronto, Ontario
Appointed in March 2000

THOMAS J. RICE
Chairman, Jovian Capital Corp.
Winnipeg, Manitoba
Appointed in June 2005

PAUL D. DICKS (SEATED)
Counsel, Benson Myles
St. John's, Newfoundland and Labrador
Appointed in December 2002

GILLES LEPAGE
Corporate Director
Caraquet, New Brunswick
Appointed in May 2005

IAN E. BENNETT
Deputy Minister of Finance
Member Ex Officio

JEAN-GUY DESJARDINS
Chairman and CEO, Centria Inc.
Montréal, Quebec
Appointed in March 2003

KIT CHAN
President, Canada Education Inc.
Calgary, Alberta
Appointed in April 1999

JOCELYNE PELCHAT (SEATED)
President and CEO, Entreprises Pelchat Moïse Inc.
Sutton, Quebec
Appointed in February 2005

DAVID DODGE
Governor

JAMES S. HINDS
Partner, Hinds and Sinclair
Sudbury, Ontario
Appointed in March 1996

DAVID T. BARNARD
President and CEO, iQmedX
Regina, Saskatchewan
Appointed in February 2005

The Board was active in guiding the Bank's evaluation of its progress towards achieving the objectives of the medium-term plan. The Board has also engaged in several stages of consultation towards the development of a new medium-term plan, to be presented for approval in 2006.

Over the year, the Board provided guidance on a number of initiatives relating to the effective management of the Bank's human resources, including a review of direct compensation and of measures to respond to the results of a staff survey on the work environment. The Board also engaged in an annual review of succession planning to ensure effective continuity in the management of the Bank. As part of this responsibility, the Board met regularly with senior staff of the Bank through presentations to the Board, as well as through more informal events.

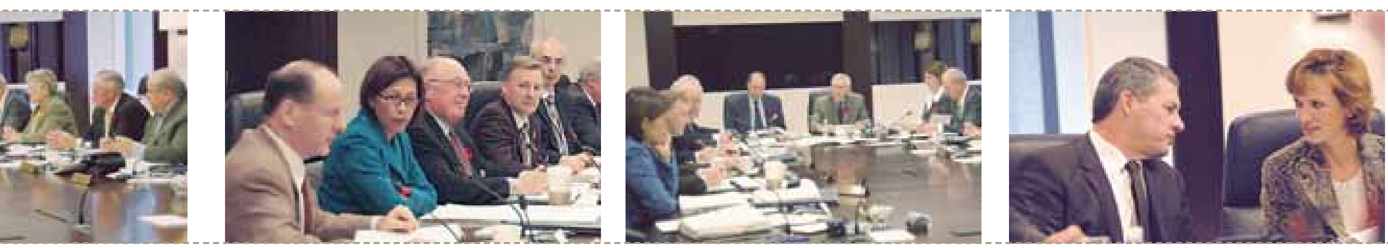
An important part of the Board's oversight is carried out through the Audit Committee, which is chaired by an independent director and consists of independent directors with particular knowledge of financial matters. The Audit Committee is responsible for overseeing the Bank's internal control and risk-management framework and for ensuring that the external and internal audit functions are carried out in an appropriate manner.

The external auditors report directly to the Audit Committee. The Chief Internal Auditor reports functionally to the Audit Committee and administratively to the Office of the Governor. The Audit Committee meets privately (without management present) with the Chief Internal Auditor and with the external auditors on a regular basis, and has the authority to engage outside expertise as required. In 2005, the Board supported continuing efforts to proactively disclose such information as contracts and travel costs on the Bank's website.

The Board's oversight of financial matters and risk management included their participation in the Pension Committee, which provides regular updates to the Board and to plan members regarding the pension plan's investment and administrative arrangements. The Board also received updates on the Bank's plans and actions to ensure the continuity of internal operations and briefings on its role in operations supporting payment and settlement systems.

The Board's broad oversight responsibility also includes monitoring the effectiveness of the process for formulating monetary policy. To this end, the Board met in private session with Special Adviser, Christopher Ragan, an academic whose knowledge of macroeconomics contributed to his advice to the Bank's management for a one-year period ending in July 2005.

In 2005, the Board continued its long-standing practice of holding private sessions of independent directors at the conclusion of each Board meeting, chaired by the Lead Director, to promote full discussion without management present. Finally, as an annual practice, the Board conducted a self-evaluation of its own stewardship to ensure that best practices of corporate governance are incorporated in its plans.



BOARD OF DIRECTORS *meeting*

AN ACCOUNT OF **OUR STEWARDSHIP**

MONETARY POLICY

"The existing [inflation-targeting] regime has widespread public support, which the Bank has effectively nurtured with continued improvements in policy transparency, most recently by providing more detail on the outlook and surrounding uncertainties in its Monetary Policy Report.*"*

— 2006 Article IV Consultations with Canada
(Preliminary Conclusions of the IMF Mission, 28 November 2005)

Canada's monetary policy framework has evolved in the 70 years since the Bank of Canada was founded. The inflation-targeting framework that began in the early 1990s has proven to be the most durable and most successful in Canadian monetary policy history, and the basic elements of this approach have since been adopted by a growing number of industrialized and emerging-market economies.

This monetary policy framework, which combines a clear inflation objective and a flexible exchange rate, and its conscientious implementation by the Bank of Canada have played an important role in Canada's strong macroeconomic performance over the past decade. By pursuing a policy of low, stable, and predictable inflation, the Bank has contributed significantly to the economic well-being of Canadians. The inflation-control target range for the consumer price index (CPI), established by the government and the Bank of Canada in 1991, continues to be a key element in achieving this goal and in furthering the Bank's accountability to Canadians. By consistently targeting the 2 per cent midpoint of the 1 to 3 per cent range, the Bank promotes greater economic stability and eliminates the distortions associated with high and unpredictable inflation.

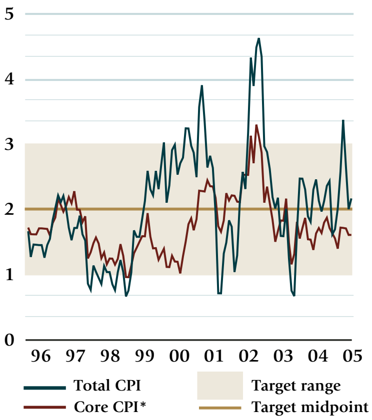
In 2005, despite volatility in the prices for crude oil and natural gas, CPI inflation remained within the target range except for one month. Continued close assessment of international and domestic developments, supported by a base of longer-term research, contributed importantly to this outcome.

Meeting the Inflation Target

Most of the major challenges faced by the Bank of Canada over the past 12 months stemmed from international events. High and volatile prices for crude oil and natural gas, continuing competitive pressures from abroad, and further movements in major currencies, including the Canadian dollar, all served to complicate the task of conducting monetary policy. Despite these challenges, the Canadian economy performed well. Growth of the gross domestic product rebounded from the temporary easing observed in the latter part of 2004 and early 2005, and aggregate output remained near the capacity limits of the economy throughout the year.

Consumer Price Index

Year-over-year percentage change



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

Senior Deputy Governor Paul Jenkins and Governor Dodge *on their way to a press conference following the release of the October* Monetary Policy Report.

Inflation, as measured by the total CPI, displayed considerable volatility and moved temporarily above the 3 per cent upper limit of the inflation-control range in September, in response to a significant jump in gasoline prices. This was quickly reversed in subsequent months, however, as energy prices returned to somewhat lower (albeit still high) levels. Underlying inflation, as measured by the core CPI index, was remarkably steady through the entire period and stayed within a narrow range of 1.4 to 1.8 per cent—averaging just slightly below the 2 per cent midpoint of the target range.

This apparent stability at the aggregate level of the economy masked considerable movement and change at the sectoral and regional levels. The appreciation of the Canadian dollar, continuing downward pressure on the prices of many goods and services subject to import competition, and rising prices for oil, natural gas, and metals, have resulted in a widespread, and often difficult, process of adjustment across the country.

Producers and exporters of many raw materials and resource-based intermediate goods have benefited from strong world demand and high world prices for energy and other commodities, while many manufacturers of finished goods and some service providers (e.g., tourism) have seen their competitive positions eroded by the stronger Canadian dollar and by increased competition from China and other emerging-market economies. The same rising commodity prices that have helped some industries and regions have pushed up production costs and squeezed profit margins elsewhere.

One of the important lessons of monetary policy is that it has to be forward looking and focused on economic outcomes expected at the aggregate level over the next one to two years. Central banks have only one policy instrument at their disposal. For the Bank of Canada, this instrument is the target overnight interest rate that it sets eight times a year on a pre-announced schedule, with a view to influencing the pace of economic activity and, hence, inflation for the country as a whole. Over the period October 2004 to August 2005, the Bank kept its overnight interest rate unchanged at the relatively low level of 2 ½ per cent, in order to move inflation back to 2 per cent and to facilitate the adjustment to international events described above. In September, October, December, and January, the Bank removed some of the monetary stimulus that it had provided to the system, as evidence began to accumulate that the adjustment process was proceeding well and that the economy was operating, and was expected to continue to operate, near its capacity limits.

To make efficient use of the Bank's international resources, it is important to focus them on areas and issues of particular interest. The relevant set will evolve through time, although some issues, such as the performance of the U.S. economy, are always important for Canada. Issues that received special attention in 2005 included the risks related to global financial imbalances; the strength and sustainability of output growth in Asia; the future course of world commodity prices; the likely effects of high and volatile energy prices on global growth and inflation; and the forces underlying recent exchange rate movements. Forecasting and risk analysis associated with the evolution of the U.S. economy were assisted in 2005 by a new econometric model called MUSE (Model of the United States Economy), which was introduced by Bank economists early in the year and presented at numerous international conferences.

Assessing International and Domestic Developments

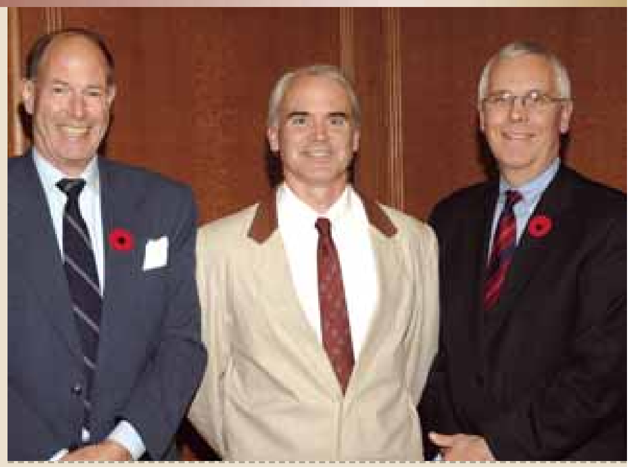
A timely and thorough review of the latest economic and financial data is an essential part of the monetary policy formulation process. Since Canada is a very open economy, both with respect to trade and capital markets, it is not sufficient to concentrate simply on domestic developments. Most of the shocks that hit the Canadian economy, as noted earlier, are external, and their effects must be anticipated to the extent possible in order to achieve an appropriate policy setting. Much of the information relating to the global economy and incorporated into the Bank's current analysis is drawn from external sources, such as the Bank for International Settlements, the International Monetary Fund, and the Organisation for Economic Co-operation and Development, as well as from data published by national authorities in foreign countries. This information is supplemented, in important ways, by intelligence obtained at international meetings and conferences, and through the Bank's active participation in groups such as the G-7, the G-10, and more recently, the G-20.

The value of any information about the global economy rests largely on its contribution to understanding and forecasting developments in our own economy. Insights and information gathered abroad are therefore combined with an extensive examination of the Canadian economy, using data drawn from Statistics Canada, as well as from many other private and public sources. The centrepiece of the Bank's policy-formulation process is the Canadian projection exercise, which is conducted every three months. Until recently, this was done using QPM, the Bank's Quarterly Projection Model. This exercise is supplemented by information from smaller, special-purpose models that focus on specific regions and sectors of the economy, as well as on numerous financial indicators, such as money and credit flows. Projections and policy-simulation exercises have also benefited from the introduction of a new

Bank of Canada Fellowship Program

Launched in 2002, the Bank's Fellowship Program is designed to recognize and encourage leading-edge research in areas critical to the Bank's mandate: macroeconomics, monetary economics, international finance, as well as 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, together with additional funds for research assistance and related expenses.

The 2005 Fellowship was awarded to Professor Paul Beaudry, who is internationally recognized for his work in the field of macroeconomics, particularly labour markets, business cycles, and economic growth.



FELLOWSHIP RECIPIENT FOR 2005, *Professor Paul Beaudry of the University of British Columbia (centre), with Governor Dodge and Senior Deputy Governor Paul Jenkins.*

model of the Canadian economy called TOTEM (Terms of Trade Economic Model), which has recently been developed by Bank staff and which was run in tandem with QPM through the first three quarters of 2005, before being adopted as QPM's replacement in December. The finer sectoral decomposition that TOTEM provides will help current analysis and improve the reliability of the Bank's projections.

Another important way in which the Bank monitors the domestic economy is the quarterly survey conducted by the Bank's regional offices, using a rotating sample of about 100 firms across Canada. Firms are chosen so that the sample is representative of the structure of the Canadian economy. The Bank began publishing the results of these surveys in 2004 in the quarterly *Business Outlook Survey*. Firms are asked a standard set of questions relating to near-term sales expectations, employment and investment intentions, potential capacity constraints, and inflation expectations. Special questions, including (most recently in January 2005) the reaction of Canadian companies to a stronger Canadian dollar, are also asked occasionally on particularly topical issues. Research has shown that the survey provides useful and timely information, supplementing that available elsewhere and serving as a valuable check on our other, more traditional, analyses.

Carrying Out Longer-Term Research

The Bank's monitoring and current analysis activities are combined with an ambitious program of longer-term research, designed to deepen our understanding of how the economy operates and to improve the process of monetary policy formulation and implementation. Although the returns to longer-term research are not immediately apparent, they are significant, and ultimately contribute to better economic performance.

The primary focus of the Bank's research activities in 2005 was inflation targeting—particularly issues surrounding the renewal of the Bank's inflation-targeting agreement with the government. The existing five-year agreement is up for renewal in 2006, and several studies have been undertaken to identify any further refinements that could be introduced to these arrangements. While the present arrangements appear to be working well and are broadly similar to those adopted by other inflation-targeting countries, a number of questions were, nevertheless, examined. These included issues such as what inflation rate should be targeted, how wide the target-control range should be, whether a different price index should be used, the role of asset prices, the potential benefits of price-level targeting, and the advantages of a more flexible target horizon. Many of these issues were reviewed at a conference hosted by the Bank last spring, titled "Issues in Inflation Targeting."

The Bank's longer-term research activities have not been limited to inflation targeting, however. Other important topics related to the Bank's monetary policy function were also examined. These included work on the transmission of exchange rate and commodity price shocks to different sectors of the economy; the economic forces underlying movements in the Canadian dollar and other major currencies; the causes and possible consequences of growing international imbalances; and the linkages between financial sector developments and the output and inflation performance of the economy. A more detailed description of the Bank's research program and its major themes can be found on the Bank's website at <www.bankofcanada.ca/en/fellowship/highlights_res.htm>.

In addition to producing its own research, the Bank is also actively engaged in sharing its work and learning from others. An important part of this effort during the past year involved hosting and/or organizing conferences and workshops, often co-sponsored with another central bank or a Canadian university, on topics such as the behaviour of international financial markets, the determinants of exchange rates, the impact of data revisions on forecast accuracy, and the effects of financial frictions on the real economy. The Bank also organized several special sessions at the annual meetings of the Canadian Economics Association in Hamilton that recognized the important work of the Bank's Fellowship recipients and celebrated the Bank's 70th anniversary. An annual workshop, called the Canadian Macroeconomic Studies Group, is also organized with assistance from the Bank. The 2005 workshop took place in Vancouver and featured the work of several noted economists.

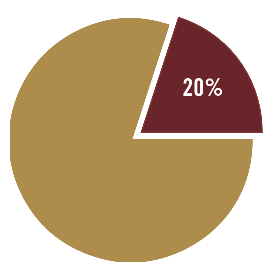
Operating Expenses

The current medium-term plan set out to strengthen the Bank's capacity in research, its analysis of sectoral issues in the Canadian economy, and its regional operations across the country. Since 2002, operating expenses have increased by an average annual rate of 6 per cent, reflecting investments in these priority areas.

For 2005, operating expenses for the monetary policy function were $60.6 million, or approximately 20 per cent of the Bank's total operating expenses. This represents an increase over 2004 of approximately $6 million, and results primarily from recognizing the higher costs associated with employee future benefits, as well as investment in the Bank's information technology systems.

Operating Expenses

Monetary Policy Activities as a Proportion of Total Bank Expenses



APPEARING BEFORE *the Standing Senate Committee on Banking, Trade and Commerce*

Currency Museum Celebrates 25th Anniversary

The Currency Museum opened its doors in Ottawa on 5 December 1980. To celebrate its 25th anniversary, the Museum launched a special exhibit, *Jubilation*!

Located on the ground floor of the Bank's original headquarters building, the Museum's galleries invite visitors to learn about the evolution of money through artifacts from the National Currency Collection. It exhibits various forms of money, including wampum and the playing card money of New France, and explains the concepts of inflation and monetary policy.

Approximately 37,000 people, including an ever-increasing number of school groups and families, visited the Museum in 2005. Travelling exhibitions attracted 30,000 visitors across the country, and the Museum's website drew 250,000 hits.

CURRENCY

The Bank of Canada is responsible for meeting the needs of Canadians for quality bank notes that are readily accepted and secure from counterfeiting. Over the past several years, the widespread availability of reprographic technology has contributed to increased levels of counterfeiting in Canada. In response, the Bank adopted a strategy to secure Canadian bank notes, which is based on enhancing security, building awareness of security features, and promoting compliance.

The Bank has made significant progress in securing Canada's bank notes. In 2005, it upgraded the security features on the *Canadian Journey* series $10 note; increased the training in counterfeit detection offered to retailers and cash handlers; and engaged law-enforcement agencies to increase counterfeit deterrence. The initial impact of the strategy became evident in 2005. Although counterfeiting levels remained high, they declined from those of the previous two years. With the cumulative effect of the strategy and additional initiatives going forward, counterfeiting levels are expected to decrease further.

Enhancing Bank Note Security

In keeping with its strategy to secure bank notes, the Bank continued its efforts to complete the *Canadian Journey* series of bank notes that carry the enhanced security features introduced on the new $20, $50, and $100 notes in 2004. With the issue of the upgraded *Canadian Journey* series $10 note on 18 May 2005, all but one of Canada's five current note denominations have the new security features. The Bank plans to issue an upgraded *Canadian Journey* series $5 note in the autumn of 2006.

Research and Development: International Collaboration

Currency research and development is of particular interest to central banks, security printers, and manufacturers and suppliers of reprographic and note-handling equipment. In 2005, the Bank supported the International Currency Conference in Montréal by hosting visits to its facilities and delivering four presentations to an audience of representatives from central banks, bank note security suppliers, and other key players in the industry.

To enhance its research capacity, the Bank also continued to participate in several international forums.

Central Bank Counterfeiting Deterrence Group

Established in 1993 by the governors of the G-10 central banks, the current mandate of this group is to deploy a system that would prevent personal computers and digital-imaging tools from being used to copy bank notes.

Pacific Rim Banknote Printers' Conference

Established in 1973, members representing printers and note-issuing authorities from 16 countries exchange information and research on bank note design, production, distribution, and security.

Four Nations Advanced Counterfeit Deterrence Group

Established in 1978, this group, with representatives from the Bank of England, the Banco de México, the Reserve Bank of Australia, and the Bank of Canada, shares knowledge and conducts joint research on various currency issues.

Security Features on Bank Notes in the *Canadian Journey* Series

❶ Holographic stripe

As the angle of the note changes, brightly coloured numerals (10, 20, 50, or 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.

❷ Watermark 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 on the note is revealed, along with a number indicating the denomination.

❸ See-through number

Irregular marks printed on the front and back of the note, between the watermark and the large denomination numeral, form a complete and perfect number 10, 20, 50, or 100 when the note is held up to the light.

❹ Windowed colour-shifting thread

A series of exposed metallic dashes on the back of the note shift from gold to green when the note is tilted. This security feature looks like a continuous, solid vertical line visible from both sides, when the note is held up to the light.

❺ Enhanced ultraviolet feature

Under ultraviolet light, the text BANQUE DU CANADA 10 (or 20, 50, or 100) BANK OF CANADA glows over the portrait in interlocking colours of yellow and red on the front of the note, and fibres that appear randomly on both sides of the note glow red or yellow.

The Bank of Canada recommends checking more than one feature. To view these features, visit the Bank's website at <www.bankofcanada.ca/en/banknotes>.

With the assistance of Canadian financial institutions, the Bank conducted an aggressive program to replace bank notes from earlier series with those of the new *Canadian Journey* series. By the end of 2005, just over one-half of all notes in active circulation were from the new series. It is expected that by the end of 2006, nearly three-quarters of all notes in active circulation will be from the *Canadian Journey* series.

Designing and developing secure bank notes that can withstand the ever-advancing development of reprographic technology is technically complex. In 2005, the Bank mapped out its multi-year research and development plan for the next generation of bank notes with a view to staying ahead of counterfeiters. The Bank will also continue to monitor the demand for bank notes relative to other means of payment.

Building Awareness of Security Features

The best security features are effective only to the extent that they are used for verification. With the launch of the upgraded *Canadian Journey* $10 note in 2005, the Bank pursued its targeted communications campaign to increase awareness of the security features and encourage retailers to verify bank notes routinely.

The Bank developed and delivered training programs on counterfeit detection. Primarily through the Bank's regional offices, approximately 12,000 individuals received direct training. The Bank also worked with law-enforcement agencies and retail associations to enhance the knowledge of cash handlers on security features and their use. Equipped with a new Trainer's Resource Kit developed by the Bank, trainers in retail and law-enforcement organizations conducted about 500 training sessions for cash handlers. The Bank's web-based training and information, updated to reflect the upgraded $10 note, continued to be a useful tool for cash handlers.

The Bank's Currency Museum in Ottawa also promoted awareness of the security features on bank notes. Its travelling exhibit on the *Canadian Journey* note series and its school program on bank note design, development, and use continued to be popular. All Museum tours included training in counterfeit detection.

PREVENTION, A SOUND INVESTMENT—*The Bank worked with the Sûreté du Québec in collaboration with the Service de police de la Ville de Montréal and the Canadian Federation of Independent Businesses to create the program "Prevention, A Sound Investment," which provides small businesses in Quebec with tools for preventing theft and fraud.*

Scenes of Canada Series

The *Scenes of Canada* series of bank notes, introduced between 1969 and 1979, preceded the series that featured Canadian birds. The Bank estimates that very few genuine notes from this series remain in active circulation. Since these notes do not include optically variable or holographic security features, they are less secure than notes from either the *Birds of Canada* or the *Canadian Journey* series and are more vulnerable to counterfeiting.

The Bank is encouraging retailers to ask for notes from a more recent series if they cannot confirm the authenticity of a *Scenes of Canada* note that is offered as payment.

The Bank monitors public awareness of bank note security, as well as the behaviour and attitudes of retailers. While Canadians are aware of counterfeiting, they appear relatively confident in their bank notes and express no significant concerns about bank notes as a readily accepted, reliable means of payment. In 2005, survey results suggested that retailers continued to verify high-denomination notes more regularly than low-denomination notes, with retailers checking $100 bank notes in about half the transactions observed.

Promoting Compliance

Compliance is the third critical pillar of the Bank's strategy to secure Canada's bank notes. There is growing evidence that criminal organizations are beginning to gain a foothold in counterfeiting activities. In 2005, the Bank continued to promote counterfeit deterrence by law-enforcement agencies and Crown prosecutors across Canada.

The Bank collaborated with a network of federal, provincial, and territorial Crown prosecutors to improve and deploy tools that facilitate effective enforcement and prosecution. Together with the RCMP, it developed an online learning course for police officers who require basic skills and knowledge about counterfeit bank notes. The Bank also partnered with Grant MacEwan College, the Edmonton Police Service, and the RCMP to create a curriculum on bank note security and verification for college students pursuing a career in law enforcement. This course, now a permanent component of the Police Studies program at Grant MacEwan, is being promoted as a template for other colleges and police academies across the country.

GARY MORIN, *instructor in the Police Studies Program at Grant MacEwan College, demonstrates counterfeit-detection techniques to his students.*

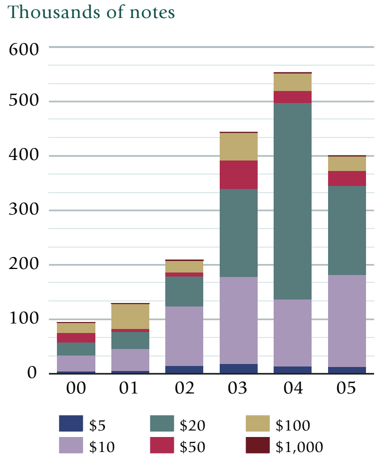
Deputy Governor Pierre Duguay *presented the Law Enforcement Award of Excellence for Counterfeit Deterrence to Corporal Earle Bailey and Sergeant Peter Hadley of the Windsor RCMP Commercial Crime Section for their investigative efforts in 2003, which resulted in the seizure of approximately $1.6 million in counterfeit notes, the dismantling of a large counterfeit production facility in the Greater Toronto Area, and the successful prosecution of a major counterfeiter. From left to right: Gerry Gaetz, Chief, Department of Banking Operations; Deputy Governor Pierre Duguay; Corporal Earle Bailey; Commissioner Giuliano Zaccardelli; Sergeant Peter Hadley; and Inspector Barry Baxter.*

Getting Results: Incidence of Counterfeiting

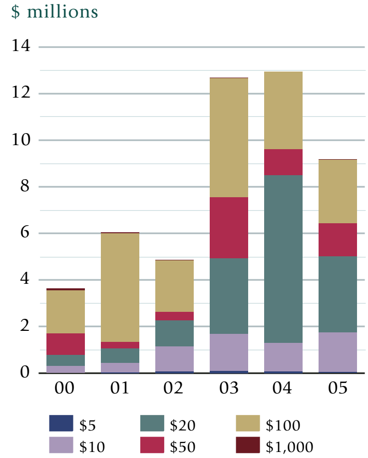
The initial impact of the Bank's efforts over the past several years to enhance bank note security became evident in 2005. Although counterfeiting levels remained high relative to those of other industrial countries, the number of counterfeit notes detected in circulation dropped to 402,300 notes from 552,980 notes in 2004, and the value of counterfeit notes found in circulation decreased to $9.4 million from $12.9 million in 2004.

The original *Canadian Journey* series $10 note (issued in 2001) and the *Birds of Canada* series $20 note (issued in 1991) continued to be the notes most targeted by counterfeiters. While the number of counterfeit $20 notes decreased significantly, the number of counterfeit $10 notes increased. Counterfeits of notes from the *Scenes of Canada* series issued in the 1970s continued to be detected in 2005, although in much lower numbers than in 2004. Also, the first counterfeits of high-denomination notes from the new *Canadian Journey* series were detected in circulation in 2005, primarily in Ontario.

Number of Counterfeit Bank Notes Found in Circulation



Value of Counterfeit Bank Notes Found in Circulation



By the end of 2005, most of the multi-year and complex initiatives associated with the Bank's strategy to secure bank notes had been implemented. *Canadian Journey* series notes with enhanced security features were the primary notes in circulation; law-enforcement agencies across the country were active in deterring counterfeiting activities; and communications and counterfeit-detection training enhanced the verification practices of retailers. The decline in counterfeiting levels indicates that the strategy is beginning to have an impact.

With the implementation of the final initiatives of the Bank's strategy to secure Canadian bank notes in 2006 and the longer-term impact of the strategy, it is expected that counterfeiting levels will decline further. Given the evolution and accessibility of technology, the Bank will continue to pursue counterfeit-detection training and to assist in the prosecution of counterfeiters as it develops the next series of bank notes.

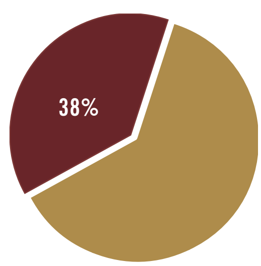
Operating Expenses

The implementation of the currency strategy to protect the integrity of Canada's bank notes increased annual operating expenses from $78.8 million in 2002 to $113.7 million in 2005, representing an average annual increase of 13 per cent. Most of the increase is attributed to the replacement of older bank notes with notes from the *Canadian Journey* series that have enhanced security features. The average unit cost of a *Canadian Journey* bank note is about 9 cents—about 3 cents more than a *Birds of Canada* series note. Additional costs, which supported the other elements of the strategy (research and development; currency education, including communications on *Canadian Journey* series notes; and the promotion of compliance), were also incurred during the period.

In 2005, operating expenses for the currency function were $113.7 million, or approximately 38 per cent of the Bank's total operating expenses. This represents a decrease of $2 million from 2004. With only one new note, the upgraded $10, issued in 2005, costs for this function were approximately $5 million below the levels incurred in 2004 when three new bank notes were issued. This reduction was partially offset by higher expenses associated with employee future benefits.

Operating Expenses

Currency Activities as a Proportion of Total Bank Expenses



FINANCIAL SYSTEM

The financial system is made up of financial institutions, markets, and clearing and settlement systems. The Bank promotes the safety and efficiency of the financial system in Canada and abroad.

Domestically, the Bank's research and analysis in 2005 focused on the efficient regulation of financial institutions and on improving the efficiency of financial markets. An efficient financial system is important for the effective transmission of monetary policy. In addition, a well-functioning financial system makes a key contribution to the overall efficiency of the Canadian economy. The Bank's research and analysis serve as the basis for its policy advice to governments and other regulatory bodies. The Bank makes its analytical work available in the *Financial System Review* and other publications, or in speeches by members of the Governing Council.

Internationally, the Bank participates in various multi-country groups to address such issues as adapting the role of the International Monetary Fund (IMF) to changing global realities and analyzing the potential impact of major global imbalances on the Canadian and other economies. The Bank works closely with public and private sector entities to assess the ability of key parts of the financial system to withstand a variety of unlikely operational disruptions and to bring about improvements where warranted. This is part of its ongoing overall concern for the safe operation of major clearing and settlement systems.

Promoting Safety and Efficiency in the Financial System

An efficient financial system contributes to the economic welfare of Canadians by facilitating commerce, managing liquidity, and by helping to allocate scarce resources to their most productive uses. A number of Bank activities contribute directly to the efficiency of Canada's financial system. The Bank's monetary policy supports the maintenance of a low, stable, and predictable rate of inflation, which allows resources that might otherwise be concerned with inflation to be used more productively. The Bank promotes key clearing and settlement systems that meet or exceed international standards for safety, while at the same time operating efficiently. Through its role as a lender of last resort and through the efficient provision of unique banking services, the Bank permits private financial sector resources to be channelled into more productive uses.

Indirectly, the Bank assists financial system efficiency by conducting and publishing research and by providing advice to various domestic and international policy-making bodies. The Bank also works with other regulatory and public sector agencies, financial sector participants and their associations, and academics to support analysis and research in this area. The Bank's work has been focused on various aspects of the efficient operation of financial markets, on questions related to the efficiency of financial institutions, and on the efficient operation of clearing and settlement systems. During 2005, the Bank concentrated on the transparency of fixed-income markets, issues related to the operation of defined-benefit pension plans, and certain efficiency aspects of the Canadian banking system.

During 2005, the Bank continued to support activities that promote international financial stability. Of particular note is the international debate on the reform of international financial institutions, such as the IMF and the World Bank.

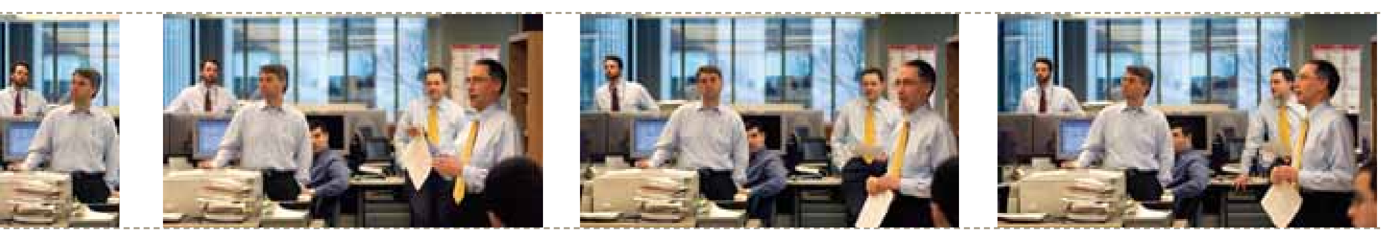
This discussion reflects a desire for the IMF to remain a key player in international financial matters, while responding to concerns about sizable IMF lending to a small number of countries and a need to realign IMF operations with changing global economic realities. The Bank has carried out research on the role and governance of the IMF and, with the Department of Finance and some other central banks, has undertaken joint research and sponsored conference sessions on this topic.

The Bank also participates in international groups, such as the G-7 and the G-20, the Financial Stability Forum, as well as several committees and working groups of the Bank for International Settlements. These groups address a wide range of topics, including the oversight and development of payments systems; arrangements for continuity of operation of payments systems in a cross-border context; issues facing pension funds; housing finance; the impact and resolution of major trade imbalances and associated capital movements; as well as the consequences of China's emergence as a major economic power and its integration into world trade and other cross-border arrangements. The Bank also continues to provide technical assistance to countries by participating in various activities of the IMF.

Reflecting international developments, changing perceptions of best practices, and domestic imperatives, the Bank continues to work with the operators and participants of systemically important Canadian clearing and settlement systems in their efforts to enhance arrangements for continuity of operations. These systems are at the centre of Canada's financial system, and serious economy-wide repercussions could arise if their operations were not extremely reliable. In 2005, the operators of these systems took steps to make their continuity of operations more robust by locating business staff at separate sites and by improving their ability to recover from severe operational disruptions in less than the current target of two hours.

The Bank of Canada is the sole provider of unique services to these systems and continues to move on two fronts to strengthen its ability to provide these services on an extremely reliable basis. The first involves the multi-year redevelopment of essential banking-service information technology systems. The second is an ongoing examination of its own arrangements for continuity of operations. The Bank is making good progress with regard to the former in developing a high-availability system for banking services and expects to complete this project in 2006. With regard to its own arrangements, the Bank completed its three-year effort in 2005 to improve the ability of its backup site to respond effectively to serious operational disruptions. Other possible changes to its business-continuity plans are being examined, including the possibility of geographically splitting its banking-service operations. The Bank has also communicated its views on the crucial role of systemically important clearing and settlement systems to certain provincial emergency-management organizations with a view to having them give priority to the supply of essential inputs such as hydro, diesel fuel, or other municipal services to these systems.

Under the Payment, Clearing and Settlement Act, the Bank is responsible for the oversight of systemically important clearing and settlement systems. These systems enable the daily transfer of funds and other financial assets worth hundreds of billions of dollars, such as foreign exchange or securities, among their participants or among the customers of system participants. The Bank's



Deputy Governor David Longworth *briefs staff in the Financial Markets Department following an interest rate decision.*

objective is to be satisfied that the risk-control mechanisms in these systems virtually eliminate the possibility that a disruption in their operation, caused by a participant failure or otherwise, could have severe repercussions across the financial system and the economy as a whole.

To date, most of the Bank's oversight activities have involved reviewing and analyzing new design proposals for systemically important systems or major innovations to these systems. With the establishment over the past seven years of a number of systemically important clearing and settlement systems that adequately and efficiently control systemic risk, the Bank conducted an extensive review in 2005 of its oversight processes to better align these processes with the ongoing operations of these systems. As a result, the Bank decided to implement more formalized internal processes, including those for handling system changes and conducting annual audits. As well, over the past few years, the Bank has enhanced its oversight resources to provide for greater analytical capability and better backup for important staff functions.

During 2005, the Bank's oversight activities focused on: (i) analyzing the impact of cross-border clearing and settlement services on the risks and risk-containment mechanisms in CDSX; and (ii) working jointly with the supervisor of Canadian banks to bring about greater use by these banks of the CLS Bank for settling foreign exchange transactions. The CLS Bank is now considered best practice for mitigating foreign exchange settlement risk.

Conducting Research and Communication

Promoting an active debate on issues affecting the financial system is a key component of the Bank's work. It publishes the semi-annual *Financial System Review* and hosts conferences and workshops to raise awareness and promote discussion of financial system issues. In 2005, workshops were held on international financial markets; financial system issues for central banks without supervisory responsibilities; and data requirements for analyzing the stability of mature financial systems. This last workshop was organized with the Irving Fisher Committee. All of these workshops attracted international participation. The Bank also continued to host quarterly meetings of various regulatory authorities in securities markets.

Canada's Systemically Important Clearing and Settlement Systems

Large Value Transfer System (LVTS): Handles large-value or time-sensitive Canadian-dollar payments. Average daily number of transactions: approximately 20,000. Average daily value of transactions: $160 billion. Operated by the Canadian Payments Association (CPA).

CDSX: Settles virtually all debt and equity trades in Canada. Average daily number of trades settled: 300,000. Average daily gross value of trades settled: $200 billion. Operated by the Canadian Depository for Securities Ltd.

CLS (Continuous Linked Settlement): Settles foreign exchange transactions in 15 currencies. Average daily number of trades settled: 220,000. Average daily value of trades settled: close to US$2.6 trillion. Operated by the CLS Bank.

The Governor and other members of the Governing Council gave speeches covering a number of these topics.

The Bank's research work addressed topics such as modelling LVTS payment activity to assess trade-offs between liquidity and collateral costs and to assess the impact of a participant default in this system; the development of tools to assess risks in the financial system; market microstructure in fixed-income and foreign exchange markets; and reform of international financial institutions. Much of this work was published as working papers and in economic journals. In addition, the Bank, along with the CPA and the Department of Finance, published a consultation paper examining the arrangements governing the participation of various financial institutions in payments systems operated by the CPA.

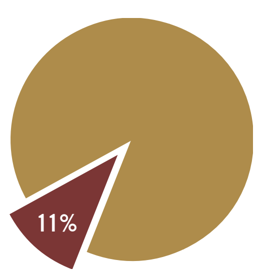
Operating Expenses

Significant resources have been added to the financial system function during the current medium-term plan. Operating expenses have risen from $15.9 million in 2002 to $34.1 million in 2005, which represents an average annual increase of 29 per cent. A considerable proportion of this increase is related to the redevelopment of systems that will permit the Bank to provide essential banking services in a more timely and robust manner. In addition, as noted above, the Bank has improved its oversight processes by adding to its oversight resources to provide greater analytical capability and improved backup of critical staff functions, and has considerably expanded its research capabilities and publication activities in the financial system area. The Bank has also expanded its ability to contribute to international initiatives related to the safety and efficiency of the financial system.

In 2005, the operating expenses for the financial system function amounted to $34.1 million, or 11 per cent of the Bank's total operating expenses. The increase of $8 million over the 2004 operating expenses primarily reflects higher expenses associated with employee future benefits, as well as investments in the Bank's information technology systems.

Operating Expenses

Financial System Activities as a Proportion of Total Bank Expenses



FUNDS MANAGEMENT

Key initiatives were undertaken in 2005 to strengthen the effectiveness and efficiency of the services that the Bank provides to the federal government as its fiscal agent. The Bank worked closely with the Department of Finance to improve the framework for issuing government debt, as well as the methodology used to monitor risk exposures and to measure performance. Operational and systems-support changes were introduced to reduce costs and improve efficiency. The Bank also took steps to strengthen the effectiveness of the funds-management activities that it undertakes on its own account.

Acting as Fiscal Agent

The federal government's wholesale domestic debt program is directed at achieving low and stable borrowing costs, an objective facilitated by promoting well-functioning Canadian financial markets. In 2005, work focused on identifying and developing key initiatives to maintain the liquidity and efficiency of markets for Government of Canada bonds in the face of a declining debt stock. The liquidity of benchmark issues continued to be enhanced through the buying back of less-liquid, off-the-run issues to provide a larger gross issuance of benchmark bonds. These bond-buyback operations also provided an estimated saving in interest costs to the government of approximately $30.3 million. In the coming year, efforts will be directed at reviewing and implementing other ways to ensure that the Government of Canada bond market remains liquid and well-functioning as the stock of bonds available for buyback operations declines.

Crown Borrowing Review

As part of the government's Treasury Evaluation Program, the Department of Finance, supported by the Bank, initiated an external review to assess the current governance of the borrowing programs of the major government-backed borrowers, as well as the costs and benefits of alternative methods for issuing debt. Evaluations conducted under this program are posted on the Department of Finance website as part of the government's commitment to openness and transparency <http://www.fin.gc.ca/access/fininste.html#Treasury>. The Department of Finance is conducting follow-up analysis on the report in consultation with the borrowers.

THE BANK'S *trading room*

In line with the government objective of reducing the share of fixed-rate debt to 60 per cent by 2007/08, the stock of bonds declined in 2005 by $5.0 billion to $254.7 billion, while the stock of treasury bills increased by $10.0 billion to $127.1 billion. The gross issuance of bonds, supported by buyback operations, was $36.4 billion.

Several changes to the framework through which the government issues its debt were introduced in 2005, aimed at promoting continued competition and participation in the auction process. In addition, the average turnaround time for government securities auctions was reduced to 2 minutes in 2005 from 3 minutes in 2004, and the time for buyback operations was reduced to 4 minutes in 2005 from 7 minutes in 2004. The reduction in the turnaround time of bond buybacks was supported by an upgrade to the valuation approach used for pricing.

At year-end, the government held official international reserves totalling US$33 billion. The Exchange Fund Account (EFA), which represents the largest component of the official international reserves, is maintained to provide foreign currency liquidity for the Government of Canada and to provide the funds needed to help promote orderly conditions for the Canadian dollar in foreign exchange markets. The official international reserves are funded by foreign currency liabilities of the government. In 2005, the issuance of US$5.6 billion in cross-currency swaps was partially offset by US$4.4 billion in maturing debt. The net return for the EFA for the calendar year was calculated on a total return, market value basis at 6 basis points.

In 2005, the Bank upgraded the monitoring of risks arising from the government's foreign currency reserves, as well as the monitoring of their performance. A new performance-attribution system was introduced that distinguishes between portfolio returns derived from movements in interest rates and those related to movements in exchange rates. In addition, the monitoring of credit risk associated with the reserve assets was enhanced. The new credit-risk model was validated by an external expert, who noted that the modelling approach used by the Bank is in line with current best practice. In June, the Bank hosted and chaired a meeting of risk managers from 25 central banks and the Bank for International Settlements that focused on the management of credit risk in central bank activities.

Retail debt

As the government's fiscal agent, the Bank provides back-office operations and systems-support services, accounting, and advice for the government's retail debt program. In the context of a declining stock of retail debt, efforts continued to focus on activities that promote cost-effective operations. Outsourcing arrangements and other efficiency improvements over the past several years have realized substantial cost reductions. To achieve further significant cost efficiencies in coming years, efforts were directed towards developing a new business model under which the operations could be transformed to better align them with industry best practices through standardization of product rules, services, and processes.

The Retail Debt Program

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. 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.

The launch of the 2005–06 Canada Savings Bond campaign was held in October 2005 at the Canadian War Museum in Ottawa. To mark the opening of the campaign, the Museum was presented with a commemorative 1945 Victory Bond certificate. The event provided an ideal opportunity to honour Canada's veterans and to acknowledge the role played by Victory Bonds (the origin of Canada Savings Bonds) in the war effort.

Other Funds-Management Activities

Several initiatives were undertaken in 2005 to strengthen the performance of the Bank's pension fund and to adjust investments in order to better match pension plan assets to liabilities. Performance measurement and risk management were also strengthened.

Chartered banks and federally chartered trust and loan companies are required to transfer to the Bank of Canada all unclaimed balances maintained in Canada in Canadian currency that have been inactive for a period of 10 years. The owners of these accounts can have their money returned once they provide the Bank with proof of ownership. During 2005, financial institutions transferred $39 million in unclaimed balances to the Bank. There were about 34,500 general inquiries, and the Bank paid a total of $9.9 million to satisfy 5,700 claims.

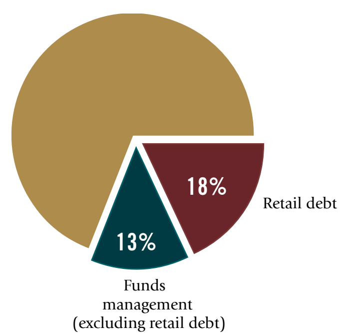
Operating Expenses

The 2003–06 medium-term plan set out to increase research and analytic capacity to support the provision of policy advice and the taking of complex business decisions, to invest in infrastructure to promote the management of operational and financial risk, and to strengthen the governance framework within which the Bank undertakes its funds-management activities. After remaining largely unchanged in 2003 and 2004, operating expenses for the funds-management function, excluding retail debt, rose by $6 million in 2005 to $37.5 million, approximately 13 per cent of the Bank's total operating expenses. This change was due mainly to increased costs for information technology associated with the redevelopment of automated systems, as well as higher expenses associated with employee future benefits.

After having decreased over the past few years, operating expenses for retail debt rose by $1.4 million in 2005 to $55.2 million (18 per cent of the Bank's total operating expenditures). This increase reflects additional investment to keep the infrastructure current and to develop a new business model for continuing to improve cost effectiveness. Against the background of this increased investment, however, operations costs continued to decline as a result of efficiency gains from outsourcing. Expenses for the retail debt program are recovered from the Government of Canada.

Operating Expenses

Funds-Management Activities as a Proportion of Total Bank Expenses



FINANCIAL SUMMARY


CLOSED
THE MOSLER SAFE CO
HAMILTON OHIO

REVENUE AND EXPENSES

Revenue from Investments

Total revenue from investments in 2005 was $2 billion, an increase of 3 per cent over 2004. The main source of revenues is interest earned on holdings of federal government securities. After expenses, the net revenue paid to the Receiver General for Canada in 2005 was $1.7 billion, similar to the amount paid in 2004.

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

The Bank's operating expenses are allocated across four main functions: monetary policy, currency, financial system, and funds management. Expenses for retail debt operations are fully recovered from the Government of Canada.

The Bank's medium-term plan, which covers the four years from 2003 to 2006, established a number of strategic priorities. These priorities involved investments in the Bank's research and analytic capabilities, bank note security, and clear communication within the Bank and with Canadians. Expenditures in 2005 were again directed towards achieving these medium-term goals and delivering on the Bank's functional responsibilities.

For the Bank's main functions, total operating expenses in 2005 were $245.9 million, an increase of $18 million from 2004. The main factor accounting for this change was higher employee future benefit costs.

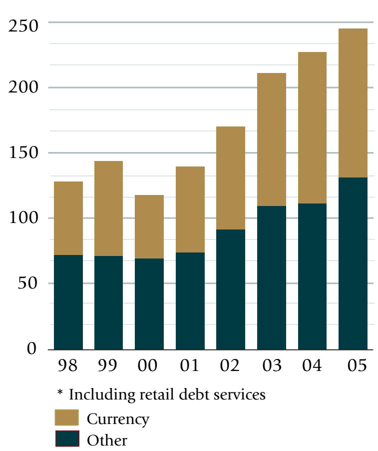
Compensation

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

Operating Expenses

Monetary policy, currency, financial system, and funds management*

$ millions

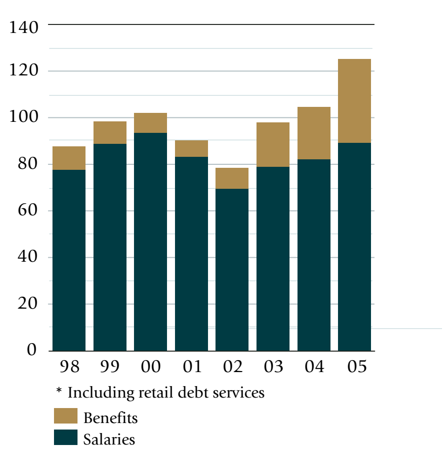


* Including retail debt services

Salaries and Benefits

Monetary policy, currency, financial system, and funds management*

$ millions



* Including retail debt services

Salaries

For 2005, the Bank's salary expense rose by $7 million as a result of an annual salary increase of 2.25 per cent, additional requirements for technological staff to support the redevelopment of the Bank's critical operating systems, and a shift towards skilled resources in support of the Bank's medium-term plan for research and analysis in the areas of monetary policy and financial stability.

Employee future benefits

Employee future benefit costs increased by $12 million in 2005, representing two-thirds of the increase in total operating expenses. Updates to demographic and economic actuarial assumptions, as well as a lower discount rate used to calculate the present value of the future obligations, account for the increase in the provision for employee future benefit costs. These expenses are expected to increase by an additional $9 million in 2006 as a result of a further decline in the discount rate.

Bank notes

In response to concerns about bank note security, the Bank's medium-term plan included significant investments for the design, upgrade, and launch of new bank notes. In 2004, the Bank successfully launched the three high-denomination notes ($100, $50, and $20). During 2005, an upgraded $10 note was launched. The launch of only one note in 2005 resulted in a decrease of approximately $3 million in the cost of bank notes. An upgraded $5 note will be introduced in the autumn of 2006.

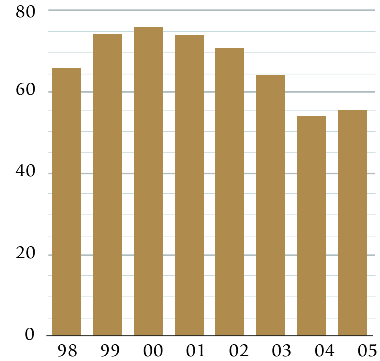
Retail debt services

The Bank has provided "back-office" services 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.

Operating Expenses

Retail debt services

$ millions



In 2005, expenses for retail debt operations were slightly higher than in 2004, because of increased spending related to information technology upgrades required to maintain status quo operations. Expenses for the retail debt program, including amounts invoiced by EDS Canada, are recovered from the Government of Canada.

Capital Expenditures

In late 2004, the Bank initiated a major infrastructure project to replace the exterior windows and frames of the Bank's head office building in Ottawa. The majority of the work associated with this $16 million capital project was completed in 2005, resulting in an ongoing annual depreciation expense of approximately $1 million. The project is expected to be completed in the first half of 2006.

FINANCIAL **STATEMENTS**

(Year Ended 31 December 2005)

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 are management's responsibility. Management is responsible for ensuring that all information in the *Annual Report* is consistent with the financial statements.

In support of its responsibility for the integrity and reliability of these financial statements and for the accounting system from which they are derived, management has developed and maintains a system of internal controls 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 controls 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. 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 Chief 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 a material effect on the financial statements, and to review and assess key management judgments and estimates material to the reported financial information.

These financial statements have been audited by the Bank's external auditors, Ernst & Young LLP and Deloitte & Touche LLP, and their report is 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' 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 2005 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 2005 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

Ernst & Young LLP

ERNST & YOUNG LLP

Chartered Accountants

Deloitte & Touche LLP

DELOITTE & TOUCHE LLP

Chartered Accountants

Ottawa, Canada
20 January 2006

BANK OF CANADA

STATEMENT OF REVENUE AND EXPENSE

Year ended 31 December 2005
(Millions of dollars)

	2005	2004
REVENUE		
Revenue from investments, net of interest paid on deposits of $43.9 million ($38.2 million in 2004)	**1,978.3**	1,928.9
EXPENSE by function (notes 1 and 3)		
Monetary policy	**60.6**	54.3
Currency	**113.7**	115.7
Financial system	**34.1**	26.6
Funds management	**37.5**	31.3
	245.9	227.9
Retail debt services – expenses	**55.2**	53.8
Retail debt services – recoveries	**(55.2)**	(53.8)
	245.9	227.9
NET REVENUE FOR ACCOUNT OF THE RECEIVER GENERAL FOR CANADA	**1,732.4**	1,701.0

(See accompanying notes to the financial statements.)

BANK OF CANADA

BALANCE SHEET

As at 31 December 2005
(Millions of dollars)

	2005	2004
ASSETS		
Deposits in foreign currencies		
U.S. dollars	**84.6**	507.2
Other currencies	**3.5**	5.5
	88.1	512.7
Advances to members of the Canadian Payments Association	–	0.5
Investments (note 4)		
Treasury bills of Canada	**16,384.6**	13,628.8
Other securities issued or guaranteed by Canada maturing within three years	**10,337.1**	9,153.9
Other securities issued or guaranteed by Canada maturing after three years	**19,689.3**	20,408.1
Other investments	**38.0**	2.6
	46,449.0	43,193.4
Bank premises (note 5)	**136.6**	129.3
Other assets		
Securities purchased under resale agreements	**1,297.1**	2,519.1
All other assets (note 6)	**349.5**	375.8
	1,646.6	2,894.9
	48,320.3	46,730.8

(See accompanying notes to the financial statements.)

LIABILITIES AND CAPITAL	2005	2004
Bank notes in circulation (note 7)	**46,077.9**	44,240.6
Deposits		
Government of Canada	**911.1**	1,062.7
Banks	**32.8**	382.1
Other members of the Canadian Payments Association	**17.1**	118.8
Other deposits	**422.4**	382.8
	1,383.4	1,946.4
Liabilities to the Government of Canada		
U.S. dollars	**–**	383.5
Other liabilities		
Securities sold under repurchase agreements	**684.3**	–
All other liabilities	**144.7**	130.3
	829.0	130.3
	48,290.3	46,700.8
Capital		
Share capital (note 8)	**5.0**	5.0
Statutory reserve (note 9)	**25.0**	25.0
	30.0	30.0
	48,320.3	46,730.8

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

J.-G. Desjardins, LScCom, CFA,
Chair, Planning and Budget Committee

(See accompanying notes to the financial statements.)

BANK OF CANADA

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2005
(Amounts in the notes to the financial statements are in millions of dollars, unless otherwise stated.)

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 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 a safe, sound, and efficient financial system, 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 from the Canada Investment and Savings Agency.

In accordance with the Bank of Canada Act, the net revenue of the Bank is remitted to the Receiver General for Canada.

2. Significant accounting policies

The financial statements of the Bank are in accordance with Canadian generally accepted accounting principles (GAAP) and conform to the disclosure and accounting requirements of the Bank of Canada Act and the Bank's bylaws. A cash-flow statement has not been prepared, since the liquidity and cash position of the Bank and other cash-flow 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 requires management to make estimates and assumptions that affect the amounts reported in the financial statements and the notes to the financial statements. These estimates, mostly in the area of pension and other employee future benefits, are based on management's best knowledge of current events. 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 its eligible 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 the expected investment performance of the plans, salary escalation, retirement ages of employees, and expected health care costs.

The benefit plan expense (income) for the year consists of the current service cost, the interest cost, the expected return on plan assets, and the amortization of unrecognized past service costs, actuarial losses (gains) as well as the transitional obligation (asset). Calculation of the expected return on assets for the year is based on the market value of plan assets using a market-related value approach. The market-related value of plan assets is determined using a methodology where the difference between the actual and expected return on the market value of plan assets is amortized over five years.

The excess of the net accumulated actuarial loss (gain) over 10 per cent of the greater of the benefit obligation and the market-related value of plan assets is amortized over the expected average remaining service lifetime (EARSL) of plan members. Past service costs arising from plan amendments are deferred and amortized on a straight-line basis over the EARSL at the date of amendments.

On 1 January 2000, the Bank adopted the new accounting standard on employee future benefits using the prospective application method. The initial transitional balances are amortized on a straight-line basis over the EARSL, as at the date of adoption. The EARSL has been determined to be 11 years (12 years for the period 2002–04) for the pension plans and for the long-service benefit program, 14 years for the post-retirement health care plan, and 7 years for post-employment benefits plans.

d) Translation of foreign currencies

Assets and liabilities denominated in foreign currencies are translated to Canadian dollars at the rates of exchange prevailing at the balance sheet dates. 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

Securities, consisting mainly of Government of Canada treasury bills and bonds, are held for investment purposes. These investments 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, is included in the *Statement of revenue and expense* as revenue.

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. 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

Projects in progress are not depreciated until the asset is put into use.

i) Securities purchased under resale agreements

Securities purchased under resale agreements are reverse 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 an agreed transaction date. These agreements are treated as collateralized lending transactions and are recorded on the balance sheet at the amounts at which the securities were originally acquired plus accrued interest.

j) Deposits

The liabilities within this category are Canadian-dollar demand deposits. The Bank pays interest on the deposits for the Government of Canada, banks, and other financial institutions at market-related rates. Interest paid on deposits are included in the *Statement of revenue and expense*.

k) Securities sold under repurchase agreements

Securities sold under repurchase agreements are 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 on an agreed transaction date. These agreements are treated as collateralized borrowing transactions and are recorded on the balance sheet 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 class of expenditure

	2005	2004
Salaries	**89.5**	82.1
Benefits and other staff expenses	**43.2**	29.7
Currency costs	**55.4**	58.6
Premises maintenance	**21.1**	20.5
Services and supplies	**84.0**	83.9
Depreciation	**17.2**	17.0
	310.4	291.8
Recoveries		
Retail debt services	**(55.2)**	(53.8)
Other	**(9.3)**	(10.1)
	245.9	227.9

Retail debt services are recovered from the Canada Investment and Savings Agency. Other recoveries represent the fees charged by the Bank for a variety of services.

4. Investments

The Bank invests in treasury bills and bonds issued by the Government of Canada. These holdings are distributed to broadly resemble the structure of the Government of Canada domestic debt outstanding and are typically held to maturity. The amortized book values of these investments approximate their par values.

There were no securities loaned under the Securities Lending Program as at 31 December 2005.

The Bank also holds shares in the Bank for International Settlements (BIS) in order to participate in the BIS and in international initiatives generally. On 31 May 2005, the Bank acquired 1,441 BIS shares at a price of CHF34,551,663 (Can$35,405,090), increasing its holdings to 9,441 BIS shares.

Credit risk

The portfolio is essentially free of credit risk because the securities held are direct obligations of the Government of Canada, the Bank's shareholder. Advances to Members of the Canadian Payments Association and securities purchased under resale agreements do not pose material credit risk for the Bank because they are collateralized transactions fully backed by high-quality Canadian-dollar-denominated securities. The credit quality of collateral is managed through a set of exposure limits tied to credit ratings of the collateral and term to maturity.

Interest rate risk

The Bank is exposed to interest rate risk arising from fluctuations in interest rates on treasury bills and bonds issued by the Government of Canada. Since the Bank's revenues greatly exceed expenses, changes in interest rates would not affect the ability of the Bank to fulfill its obligations. Fluctuations in fair value of the instrument resulting from changes in interest rates are not reflected in the Bank's revenue since the investments are typically held to maturity. The Bank does not use derivative instruments to reduce its exposure to interest rate risk.

Fair values

The fair values of the securities presented below are based on quoted market prices. The amortized cost of all other financial instruments held by the Bank (assets or liabilities including accounts payable, securities purchased under resale agreement, and securities sold under repurchase agreements) approximates the fair value, given their short-term nature.

The BIS shares are not traded; however, based on recent share issues, their fair value is estimated as being 70 per cent of the Bank's interest in the BIS shareholder's equity, which is denominated in special drawing rights (SDRs).

	2005			2004		
Securities	Amortized cost	Fair value	Average yield per cent	Amortized cost	Fair value	Average yield per cent
Treasury bills of Canada	**16,384.6**	**16,365.2**	**3.2**	13,628.8	13,634.1	2.6
Other securities issued or guaranteed by Canada maturing within 3 years	**10,337.1**	**10,534.9**	**5.1**	9,153.9	9,480.1	5.3
Other securities issued or guaranteed by Canada maturing after 3 years but not over 5 years	**5,768.0**	**6,024.4**	**5.1**	5,910.4	6,271.1	5.2
Other securities issued or guaranteed by Canada maturing after 5 years but not over 10 years	**8,127.9**	**8,802.2**	**5.4**	8,954.2	9,786.5	5.7
Other securities issued or guaranteed by Canada maturing after 10 years	**5,793.4**	**7,379.3**	**5.9**	5,543.5	6,469.4	6.0
	46,411.0	**49,106.0**		43,190.8	45,641.2	
Shares in the Bank for International Settlements	**38.0**	**226.0**		2.6	200.4	
	46,449.0	**49,332.0**		43,193.4	45,841.6	

5. Bank premises

	2005			2004		
	Cost	Accumulated depreciation	Net book value	Cost	Accumulated depreciation	Net book value
Land and buildings	**181.6**	**89.5**	**92.1**	167.5	85.0	82.5
Computer hardware/ software	**63.8**	**45.9**	**17.9**	65.6	49.3	16.3
Other equipment	**137.6**	**111.6**	**26.0**	140.5	114.0	26.5
	383.0	**247.0**	**136.0**	373.6	248.3	125.3
Projects in progress	**0.6**	**–**	**0.6**	4.0	–	4.0
	383.6	**247.0**	**136.6**	377.6	248.3	129.3

Projects in progress in 2005 consist of upgrades to the Bank's computer infrastructure.

The improvement project to the head office building and the upgrade to the note-processing system were completed in 2005 and are reported, respectively, in *Land and buildings* and in *Other equipment.*

6. All other assets

This category includes accrued interest on Canadian investments of $227.5 million ($245.9 million in 2004). It also includes the pension accrued benefit asset of $81.0 million ($84.7 million in 2004).

7. Bank notes in circulation

In accordance with the Bank of Canada Act, the Bank has the sole authority to issue bank notes for circulation in Canada.

A breakdown by denomination is presented below.

	2005	2004
$5	**920.8**	**891.0**
$10	**1,039.0**	**1,018.3**
$20	**14,312.4**	**13,729.7**
$50	**6,524.2**	**6,681.9**
$100	**21,421.3**	**19,919.6**
Other bank notes	**1,860.2**	2,000.1
	46,077.9	44,240.6

Other bank notes include denominations that are no longer issued but remain as legal tender.

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 statutory reserve was established in accordance with the Bank of Canada Act. It 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 its eligible employees.

The pension plans provide benefits under a Registered Pension Plan and a Supplementary Pension Arrangement. Pension calculation is based mainly on years of service and average pensionable income and is generally applicable from the first day of employment. The pension is indexed to reflect changes in the consumer price index on the date payments begin and each 1 January thereafter.

The Bank sponsors post-retirement health, dental, and life insurance benefits, as well as post-employment self-insured Long-Term Disability and continuation of benefits to disabled employees. The Bank also sponsors a long-service benefit program for employees hired before 1 January 2003.

The Bank measures its accrued benefits obligations and fair value of plan assets for accounting purposes as at 31 December of each year. The most recent actuarial valuation for funding purposes of the Registered Pension Plan was done as of 1 January 2005 and the next required valuation will be as of 1 January 2008.

The total cash payment for employee future benefits for 2005 was $8.8 million ($8.6 million in 2004), consisting of $4.2 million ($3.5 million in 2004) in cash contributed by the Bank to its funded pension plans and $4.6 million ($5.1 million in 2004) in cash payments directly to beneficiaries for its unfunded other benefits plans.

Information about the employee benefit plans is presented in the tables below.

Plan assets, benefit obligation, and plan status

	Pension benefit plans[1]		Other benefit plans	
	2005	**2004**	**2005**	**2004**
Plan assets				
Fair value of plan assets at beginning of year	**799.4**	726.8	**–**	–
Bank's contributions	**4.2**	3.5	**–**	–
Employees' contributions	**6.1**	7.9	**–**	–
Benefit payments and transfers	**(28.8)**	(30.4)	**–**	–
Actual return on plan assets	**112.6**	91.6	**–**	–
Fair value of plan assets at year-end[2]	**893.5**	799.4	**–**	–
Benefit obligation				
Benefit obligation at beginning of year	**715.2**	663.3	**126.2**	112.7
Current service cost	**22.1**	22.2	**4.7**	4.5
Interest cost	**37.7**	35.2	**6.5**	6.1
Benefit payments and transfers	**(28.8)**	(30.4)	**(4.6)**	(5.1)
Actuarial loss	**141.0**	24.9	**18.3**	8.1
Benefit obligation at year-end	**887.2**	715.2	**151.1**	126.3
Plan status				
Excess (deficiency) of fair value of plan assets over benefit obligation at year-end	**6.3**	84.2	**(151.1)**	(126.3)
Unamortized net transitional obligation (asset)	**(75.5)**	(88.1)	**22.2**	25.8
Unamortized cost of amendments	**19.5**	21.9	**3.0**	4.0
Unamortized net actuarial loss	**130.7**	66.7	**41.6**	25.6
Accrued benefit asset (liability)	**81.0**	84.7	**(84.3)**	(70.9)

1. For the Supplementary Pension Arrangement, in which the accrued benefit obligation exceeds plan assets, the accrued benefit obligation and fair value of plan assets totalled $48.0 million ($36.9 million in 2004) and $26.7 million ($21.3 million in 2004), respectively.
2. The assets of the pension benefit plans were composed as follows: 58 per cent equities, 27 per cent bonds; 10 per cent real return investments; 3 per cent real estate assets; and 2 per cent short-term securities and cash (58 per cent, 27 per cent, 10 per cent, 2 per cent, and 3 per cent respectively in 2004).

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 benefits plans is included in the balance sheet category *All other liabilities*.

Benefit plan expense (income)

	Pension benefit plans		Other benefit plans	
	2005	2004	2005	2004
Current service cost, net of employees' contributions	**16.1**	14.3	**4.7**	4.5
Interest cost	**37.7**	35.2	**6.5**	6.1
Actual return on plan assets	**(112.6)**	(91.6)	**–**	–
Actuarial loss	**141.0**	24.9	**18.3**	8.1
Benefit plan expense (income), before adjustments to recognize the long-term nature of employee future benefit costs	**82.2**	(17.2)	**29.5**	18.7
Adjustments				
Difference between expected return and actual return on plan assets for the year	**71.8**	48.8	**–**	–
Difference between amortization of past service costs for the year and actual plan amendments for the year	**2.3**	2.3	**1.0**	1.0
Difference between amortization of actuarial loss for the year and actual loss on accrued benefit obligation for the year	**(135.8)**	(23.9)	**(16.8)**	(7.4)
Amortization of transitional obligation (asset)	**(12.6)**	(12.6)	**3.5**	3.5
Benefit plan expense (income) recognized in the year	**7.9**	(2.6)	**17.2**	15.8

Significant assumptions

The significant assumptions used are as follows (on a weighted-average basis).

	Pension benefit plans		Other benefit plans	
	2005	2004	2005	2004
Accrued benefit obligation as at 31 December				
Discount rate	**4.25%**	5.00%	**4.15%**	4.80%
Rate of compensation increase	**3.50% +merit**	4.00% +merit	**3.50% +merit**	4.00% +merit
Benefit plan expense for year ended 31 December				
Discount rate	**5.00%**	5.25%	**4.80%**	5.30%
Expected rate of return on assets	**5.50%**	6.00%	**–**	–
Rate of compensation increase	**3.50% +merit**	4.00% +merit	**3.50% +merit**	4.00% +merit
Assumed health care cost trend				
Initial health care cost trend rate			**8.25%**	9.63%
Health care cost trend rate declines to			**4.80%**	4.50%
Year that the rate reaches the ultimate trend rate			**2015**	2014

2005 sensitivity of key assumptions

	Change in obligation	Change in expense
Impact of 0.25 per cent increase/decrease in assumptions		
Pension benefit plans		
Change in discount rate	(38.5) / 41.1	(3.9) / 4.1
Change in the long-term rate of return on plan assets	0.0 / 0.0	(1.9) / 1.9
Other benefit plans		
Change in discount rate	(6.2) / 6.6	(0.2) / 0.2
Impact of 1.00 per cent increase/decrease in assumptions		
Other benefit plans		
Change in the assumed health care cost trend rates	(14.8) / 19.4	(1.1) / 1.5

11. Commitments, contingencies, and guarantees

a) Operations

The Bank has a long-term contract with an outside service provider for retail debt services, expiring in 2011. As at 31 December 2005, fixed payments totalling $86.8 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 relating to other outsourced processing services are $1.9 million, expiring in June 2006.

The Bank occupies leased premises in Halifax, Montréal, Toronto, Calgary, and Vancouver. As at 31 December 2005, the future minimum payments are $4.6 million for rent, real estate taxes and building operations. The expiry dates vary for each lease, from September 2008 to August 2014.

Minimum annual payments for long-term commitments

	Outsourced services	Leased space	Total
2006	20.8	1.3	22.1
2007	17.5	1.2	18.7
2008	16.4	0.3	16.7
2009	15.5	0.3	15.8
2010	14.8	0.4	15.2
Thereafter	3.7	1.1	4.8
	88.7	4.6	93.3

Commitments related to capital improvements to the head office building totalling $1.6 million are outstanding as at 31 December 2005; the work is expected to be completed in the first half of 2006.

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 2005 or 2004 and, therefore, there were no commitments outstanding as at 31 December 2005.

c) Investment contracts

Sale investment contracts outstanding as at 31 December 2005, of $1,300.0 million, at an interest rate of 3.21 per cent under special purchase and resale agreements, were settled by 13 January 2006 ($2,516.8 at the end of 2004 at an interest rate of 2.50 per cent).

Purchase investment contracts outstanding as at 31 December 2005, of $685.0 million, at an interest rate of 3.25 per cent under sale and repurchase agreements, were settled on 3 January 2006 (none outstanding at the end of 2004).

d) Contingency

The 9,441 shares in the BIS have a nominal value of 5,000 special drawing rights (SDRs) of which 25 per cent, i.e., SDR1,250, is paid up. The balance of SDR3,750 is callable at three months' notice by decision of the BIS Board of Directors. The Canadian equivalent of this contingent liability was $58.5 million at 31 December 2005, based on prevailing exchange rates.

e) Legal proceedings

In 2004, legal proceedings were initiated against the Bank relating to the Bank of Canada Registered Pension Plan. Since the Bank's legal counsel is of the view that the plaintiff's claims for compensation do not have a sound legal basis, management does not expect the outcome of the proceedings to have a material effect on the financial position or operations of the Bank.

f) Guarantees

In the normal course of operations, the Bank enters into certain guarantees, which are described below.

Large Value Transfer System (LVTS) Guarantee

The LVTS is a large-value payment system, owned and operated by the Canadian Payments Association. The system's risk-control features, which include caps on net debit positions and collateral to secure the use of overdraft credit, are sufficient to permit the system to obtain the necessary liquidity to settle in the event of the failure of the single LVTS participant having the largest possible net amount owing. The Bank guarantees to provide this liquidity, and in the event of the single participant failure, the liquidity loan will be fully collateralized. In the extremely unlikely event that there were defaults by more than one participant during the LVTS operating day, in an aggregate amount in excess of the largest possible net amount owing by a single participant, there would not likely be enough collateral to secure the amount of liquidity that the Bank would need to provide to settle the system. This might result in the Bank having unsecured claims on the defaulting participants in excess of the amount of collateral pledged to the Bank to cover the liquidity loans. The Bank would have the right, as an unsecured creditor, to recover any amount of its liquidity loan that was unpaid. The amount potentially at risk under this guarantee is not determinable, since the guarantee would be called upon only if a series of extremely low probability events were to occur. No amount has ever 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 licences, 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.

SENIOR OFFICERS

Governing Council

David A. Dodge, *Governor**
W. Paul Jenkins, *Senior Deputy Governor**

Deputy Governors

Pierre Duguay* · Sheryl Kennedy* · David J. Longworth* · Tiff Macklem*

Marcus L. Jewett, QC, General Counsel and Corporate Secretary*

Advisers

Janet Cosier,*[1] Clyde A. Goodlet, Bruce Little,[2] John D. Murray, Ronald M. Parker,[3]
George Pickering, Bonnie J. Schwab, John G. Selody

Financial Markets
Donna Howard, *Chief*
Carolyn Wilkins, *Deputy Chief*
Ross MacKinnon, *Director, Toronto Division*
Miville Tremblay, *Director, Montréal Division*
Scott Hendry, *Research Director*
Ron Morrow, *Director*
Jeremy Rudin, *Research Director*[4]

Financial Risk Office
Mark Zelmer, *Director*[5]

Research
Agathe Côté, *Chief*
Paul Fenton, *Deputy Chief*
Robert Amano, *Research Director*
Sharon Kozicki, *Research Director*

Monetary and Financial Analysis
Allan Crawford, *Chief*
Dinah Maclean, *Deputy Chief*
Walter N. Engert, *Research Director*
Pierre St-Amant, *Research Director*

International
Lawrence L. Schembri, *Chief*
Graydon Paulin, *Deputy Chief*
James A. Haley, *Research Director*[4]
Donald Coletti, *Research Director*
Robert Lafrance, *Research Director*

Banking Operations
Gerry T. Gaetz, *Chief*
Nicole Poirier, *Director, Currency Communication and Compliance*
Louise Hyland, *Director, Financial System and Funds Management*
Charles Spencer, *Director, Currency Research and Development*
Richard Wall, *Director, Currency Operations*

Executive and Legal Services
Marcus L. Jewett, *General Counsel and Corporate Secretary**
Colleen Leighton, *Director of Executive Services*
Lorna Thomas, *Special Assistant to the Governor*
Robert Turnbull, *Assistant General Counsel*

Communications
Denis Schuthe, *Chief*
Jean-Michel Catta, *Deputy Chief*

Corporate Services
Sheila Niven, *Chief**
Janice Gabie, *Deputy Chief*
Frances Boire-Carrière, *Director, Human Resources Services*
John Otterspoor, *Director, Information Technology Services*
Steve Little, *Deputy Director, Information Technology Services*

Financial Services
Sheila Vokey, *Chief and Chief Accountant**
Rudy Wytenburg, *Deputy Chief*

Debt Administration Office
Dale M. Fleck, *Chief*

Audit
David Sullivan, *Chief Internal Auditor*

Note: Positions as of 31 January 2006

** Member of Executive Management Committee*
1. Also Chair of the Board of Directors of the Canadian Payments Association
2. Visiting Special Adviser
3. On Executive Interchange to Government of Canada
4. On Executive Interchange from Government of Canada
5. Also Deputy Chair of the Board of Directors of the Canadian Payments Association

Bank of Canada Regional Offices

Atlantic Provinces
1583 Hollis Street, 5th Floor,
Halifax, Nova Scotia B3J 1V4
David Amirault, *Senior Regional Representative (Economics)*
Monique Guérin, *Senior Regional Representative (Currency)*

Quebec
1501 McGill College Avenue, Suite 2030
Montréal, Quebec H3A 3M8
Thérèse Laflèche, *Senior Regional Representative (Economics)*
Pierre Laprise, *Senior Regional Representative (Currency)*

Ontario
150 King Street West, 20th Floor, Suite 2000
Toronto, Ontario M5H 1J9
Hung-Hay Lau, *Senior Regional Representative (Economics)*
Paul de Swart, *Senior Regional Representative (Currency)*

Prairie Provinces, Nunavut, and Northwest Territories
404–6th Avenue SW, Suite 200
Calgary, Alberta T2P 0R9
Mark Illing, *Senior Regional Representative (Economics)*
Ted Mieszkalski, *Senior Regional Representative (Currency)*

British Columbia and Yukon
200 Granville Street, Suite 2710
Vancouver, British Columbia V6C 1S4
Farid Novin, *Senior Regional Representative (Economics)*
Lisa Elliott, *Senior Regional Representative (Currency)*

New York Office
Canadian Consulate General
1251 Avenue of the Americas
New York, NY 10020-1151 U.S.A.
Zahir Lalani, *Consul and Senior Representative for the Bank of Canada*

Note: Positions as of 31 January 2006

FOR FURTHER INFORMATION ABOUT **THE BANK OF CANADA**

PUBLICATIONS

Monetary Policy Report* and *Updates—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.

Business Outlook Survey—Published quarterly. 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.

For information about these and other publications, contact:

Publications Distribution, 234 Wellington Street, Ottawa, K1A 0G9

Telephone: (613) 782-8248 Fax: (613) 782-8874
Email: publications@bankofcanada.ca

INTERNET

http://www.bankofcanada.ca

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

PUBLIC INFORMATION

For general information on the role and functions of the Bank, contact our Public Information Office.

Telephone: 1-800-303-1282 Fax: (613) 782-7713
Email: info@bankofcanada.ca

For information on unclaimed balances:

Telephone: 1-888-891-6398 Fax: (613) 782-7802
Email: ucbalances@bankofcanada.ca