

AN ACCOUNT OF  
**OUR STEWARDSHIP**





## MONETARY POLICY



*“Monetary policy has successfully maintained low inflation, and the Bank of Canada’s policy management over the past year has further enhanced the credibility of the monetary policy framework.”*

2002 Article IV Consultation Statement of the IMF Mission (December 2001)

The monetary policy formulated by the Bank of Canada contributes to solid economic performance and rising living standards for Canadians by keeping inflation low, stable, and predictable.

In May 2001, the Bank and the government reaffirmed their commitment to inflation-control targets for the consumer price index (CPI) centred on a 2 per cent target midpoint. The Bank strengthened the implementation of the targeting arrangements through its commitment to report and explain any persistent deviations from the target midpoint, extended the length of the agreement with the government to five years from three years, and adopted a new measure of core (or underlying) inflation. All these changes should help to bolster the confidence of Canadians that future inflation will average close to 2 per cent.

The inflation target provides an anchor for inflation expectations and forms the central part of the Bank’s monetary policy framework, which includes a flexible exchange rate. Canada’s flexible exchange rate acts as a shock absorber and permits us to pursue an independent monetary policy suited to the needs of our own economy.





## THE NEW MEASURE OF CORE INFLATION

The inflation-control target is expressed in terms of the total CPI. As an operating guide for the Bank's forward-looking monetary policy, it is useful to have a measure of the underlying trend in inflation. Measures of core inflation provide this by removing transitory influences on the CPI that stem from its most volatile components. The Bank's new measure of core CPI excludes the eight most volatile components of the CPI: three energy components (gasoline, fuel oil, and natural gas), two food components (fruit and vegetables), and three other components (mortgage interest, tobacco, and intercity transportation). It also excludes the effect of changes in indirect taxes on the remaining components. Overall, the new measure includes 84 per cent of the consumer basket, compared with the 74 per cent included in the previous measure of core inflation, which excluded food, energy, and the effect of changes in indirect taxes.

The Bank implements monetary policy by changing its target for the overnight interest rate. This target rate influences other interest rates and other rates of return, as well as the exchange rate for the Canadian dollar. Over time, these rates all have an impact on spending which, in turn, eventually affects inflation. Thus, the Bank's influence on inflation comes only indirectly and is typically felt over a period of 18 months to 2 years.

## Meeting the Inflation Target

The Bank's core measure of inflation began the year just below the 2 per cent target and then rose to around 2.3 per cent, where it hovered through the spring and summer before moving down to 1.6 per cent in December. Because of volatile energy prices, total CPI inflation was higher and much more variable for most of the year, fluctuating between 2.5 per cent and 3.9 per cent in the first nine months. By the end of the year, however, it had fallen below 1 per cent. Thus, the period in which CPI inflation was above the 1 to 3 per cent target range was short-lived.

In December, average private sector forecasts for the total CPI, at around 1.5 per cent for 2002 and 1.9 per cent for 2003, showed that expectations of future inflation were well anchored to the 2 per cent target midpoint.

Expectations of inflation for longer time horizons, also based on average private sector forecasts, remained near 2 per cent as well. Another indicator of longer-term expectations, the spread between the yields on conventional and inflation-indexed bonds, ended the year slightly under 2 per cent.

Largely because of the rapidly slowing U.S. economy, economic growth in Canada decelerated through 2001, and was close to zero in the second half of the year. To stay on top of a rapidly changing economic environment, the Bank kept a close watch on incoming economic and financial data, as well as gathering information through its regional offices and other contacts with firms, associations, and provincial governments. The regional offices' regular quarterly survey of firms and associations was particularly important in this regard.

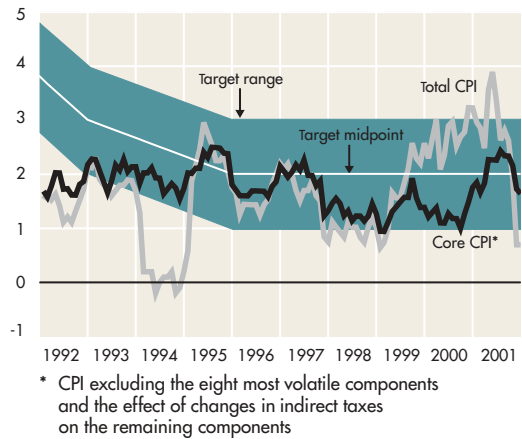
Over the five fixed announcement dates between January and mid-July, the Bank lowered its target for the overnight rate by 150 basis points on the expectation that the economy would begin to recover in the second half of the year. Then, with the global and domestic economies showing more sluggishness than expected—especially following the 11 September terrorist attacks—it became apparent that the recovery would not begin until some time in 2002. As a result, the pace of interest rate reductions picked up, with the next 200 basis points of cuts occurring in the three-month period from late August to late November. This took short-term interest rates down to 40-year lows.

### THE TARGET FOR THE OVERNIGHT RATE

The target for the overnight rate is the average interest rate that the Bank wants to see in the marketplace for overnight, or one-day, loans between financial institutions. The target is the middle of the Bank's operating band for these overnight loans, which is one-half of a percentage point wide. The Bank Rate is at the top of the operating band and is thus one-quarter of a percentage point above the target rate.

The target for the overnight rate is the appropriate rate to use when comparing levels of short-term policy interest rates with those of other countries. For example, it corresponds directly to the U.S. Federal Reserve's target for the federal funds rate.

### Consumer Price Index Year-over-year percentage change



## Assessing International Developments

In 2001, most of the shocks affecting the Canadian economy emanated from abroad, particularly from the United States. In such circumstances, understanding and interpreting foreign developments is particularly important, and the exchange of information in the international groups in which Bank officials participate is invaluable. These include the meetings of the G-10 central bank governors, other regular meetings held at the Bank for International Settlements, working parties and committees of the Organisation for Economic Co-operation and Development, and meetings of the G-7, G-10, G-20, and the International Monetary and Financial Committee of the International Monetary Fund. The last two bodies met in Ottawa in November.

In addition to discussions at these formal meetings, Bank officials are in regular contact with their counterparts at other major central

banks to discuss the economic environment and the background of monetary policy decisions. Such contacts were particularly important in the days and weeks following the 11 September terrorist attacks. Because of the increased importance of international issues, the Bank has modestly increased the number of staff involved in this area in the last couple of years.

Through technical assistance provided at the Bank and abroad, as well as through international meetings in which emerging-market countries participate, Bank staff provide insights and advice on the use of inflation targeting in a flexible exchange rate regime. In addition, the Bank hosted a G-20 workshop in June designed to promote discussion of the various practical issues that confront countries operating under various exchange rate regimes.

## Promoting an Understanding of Monetary Policy

On 5 December 2000, the Bank began announcing its official interest rate decisions on eight pre-established dates per year. Over 2001, it was apparent that the fixed dates led to greater public attention on Canada's economic and monetary situation relative to that in the United States. Press releases issued on the fixed dates provided opportunities to underscore the medium-term perspective that underlies monetary policy. Overall, the debate and discussion in Canada surrounding monetary policy issues appear to have benefited significantly.

To complement the communications surrounding the fixed announcement dates, media relations were strengthened during the year to provide additional perspectives and information on the issues.

Communication between Bank officials, industry, and governments on economic and monetary policy issues is a priority at the Bank. Regional staff carry out a regular outreach program, as well as assisting the Governing Council and Directors with their communications activities across the country.

## Carrying Out Research and Analysis

Research and analysis underpin the formulation and implementation of monetary policy. Bank researchers actively participated in over 80 academic and central bank seminars and conferences in 2001. During the year, the Bank increased its partnerships with academics, research institutes, and foreign central banks.

Of particular importance has been the research carried out over the past few years to support the decision regarding the inflation target. Two technical background documents summarized this research, much of which has been published by the Bank in various forms (working papers, technical reports, and a seminar volume).

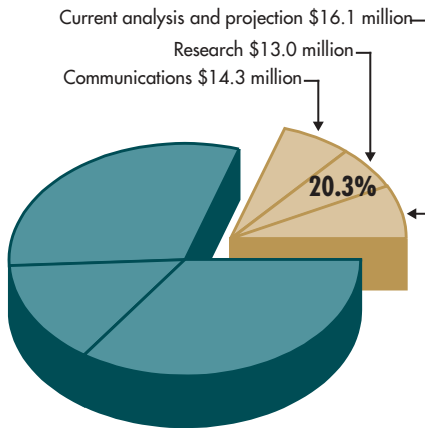
The implication of uncertainty for the conduct of monetary policy continues to be a major focus of research. In October, the Bank hosted a workshop in which the effectiveness of various rules for setting central bank interest rates across 12 models of the Canadian

economy was discussed. The models included five private sector models, two from international organizations, two from the Department of Finance, and three from the Bank of Canada. The conclusion was that no single rule produces low variability of inflation and output in all models.

The Bank also had arrangements for partnerships or consulting contracts with about 15 academics during the year, in addition to those who participated in the Bank's conferences and workshop.

## Operating Expenses

### Monetary Policy Activities as a Proportion of Total Bank Expenses





Engraver Jorge Peral works on the image of Sir John A. Macdonald for the new \$10 note.

## CURRENCY



*Although Canadians are making increasing use of credit and debit cards, they rely on bank notes for many of their daily transactions. They depend on the Bank of Canada to supply bank notes that are secure against counterfeiting and to make these notes available reliably and economically.*

The Bank is committed to strengthening the security of Canadian bank notes through research and development on bank note technology and through public education about the security features found on genuine bank notes.



THEMES FOR THE <b>CANADIAN JOURNEY</b> NOTE SERIES	
\$5	Children at Play
\$10	Remembrance and Peacekeeping
\$20	Arts and Culture
\$50	Nation Building
\$100	Exploring and Innovating



## Launching the New Note Series

In January 2001, the Bank launched a new series of bank notes, entitled *Canadian Journey*.

A launch event in Ottawa introduced the public to the themes of the new series and to the first note to be put into circulation—the \$10 denomination. In addition to new security features, the notes have a new tactile feature for use by the blind and vision-impaired as an aid to recognizing different denominations.

Immediately after the launch, the Bank gave technical briefings and presentations across Canada. These events allowed interested members of the public, cash handlers, and retailers to deepen their knowledge of the new security and tactile features of the note.

The remaining denominations in the new series (\$5, \$20, \$50, and \$100) will be introduced over the next three years.

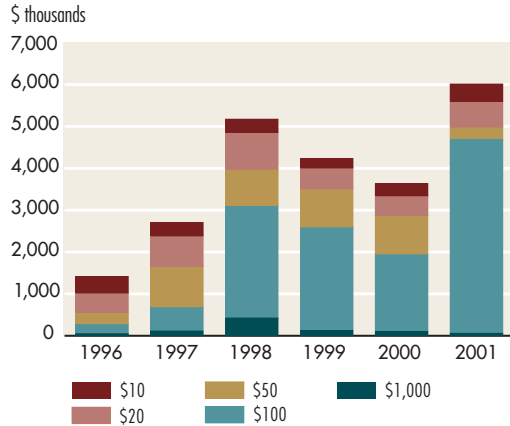
To accompany the launches of the various denominations in the new series, the Bank's Currency Museum has developed a travelling exhibit, *The Colour of Your Money*. The exhibit features the themes of the new series and explores other aspects of bank note history such as design, production, security features, and aids for the blind and vision-impaired. The exhibit was on display at the Currency Museum until early October 2001 and will be travelling to other locations across Canada.

## Counterfeit Prevention and Detection

### The Incidence of Counterfeiting

The value of counterfeit notes found in circulation rose to some \$6.0 million in 2001 from \$3.7 million in 2000. This increase can

### Value of Counterfeit Bank Notes Found in Circulation



be attributed mainly to a sharp jump in the counterfeiting of \$100 notes.

The majority of counterfeit \$100 notes found in circulation during 2001 originated from a single counterfeiting operation. Those



### FOR COLLECTORS

To mark the launch of the new \$10 note, the Bank is offering limited-edition bank note sets entitled *Lasting Impressions*. Each set features two uncirculated bank notes: one \$10 note from the 1986 *Birds of Canada* series paired with a \$10 note from the new *Canadian Journey* series. Both notes have identical serial numbers and are packaged in a presentation folder that contains an informative booklet recounting the history of the \$10 note and highlighting the features that make the notes both secure and unique.

The sets are available at the Currency Museum, at all major Canada Post outlets, and at participating coin dealers.



Inspecting sheets of the new \$10 note

responsible were arrested in mid-July and convicted in October. The number of counterfeit \$100 notes found in circulation peaked in July and declined sharply thereafter.

This episode led a number of retailers to refuse to accept \$100 bank notes. As a result, the Bank stepped up its efforts with retailers and retailer associations to ensure timely sharing of information about counterfeit detection and prevention, to enlist their co-operation in spotting counterfeits, and to provide training to cash handlers. Specifically, the Bank emphasized that counterfeit notes are readily distinguishable from genuine notes by the absence of a clear gold-to-green colour shift in the Optical Security Device—the shiny rectangle in the upper left-hand corner of genuine \$20, \$50, \$100, and \$1,000 notes.

### Counterfeit Prevention

Since the introduction of the current note series 16 years ago, major technological developments in bank note production have made it possible to incorporate improved security features into paper currency. These advances help to enhance security at a time when affordable high-resolution colour copiers,

ink-jet printers, and computer scanners have increased the potential for counterfeiting. During 2001, the Bank pursued its program of research and development in bank note technology to strengthen the security of the new note series. The security features of this series will be subject to periodic evaluation and possible upgrades as new counterfeiting threats and new solutions emerge.

One security feature of the \$10 denomination in the new *Canadian Journey* series is the group of three iridescent maple leaves on the face of the note. When a genuine note is tilted, these leaves, initially pale and matte in appearance, change to a reflective gold colour. Another security feature is fluorescence. A genuine note does not glow under ultraviolet light, except for the following features, which are not visible in normal light:

- the coat of arms and the words “Dix • Ten” and “BANK OF CANADA BANQUE DU CANADA” glow blue over the portrait;
- white security fibres that glow red.

For more information about the security features found on genuine bank notes, telephone 1-888-513-8212 or visit the Bank’s Web site at [www.bankofcanada.ca/banknotes/counterfeit/education](http://www.bankofcanada.ca/banknotes/counterfeit/education).

The Bank works closely with the Royal Canadian Mounted Police (who are responsible for the enforcement of Canada’s anti-counterfeiting laws) to monitor and analyze counterfeiting in Canada. This monitoring and analysis was instrumental in closing down the operation responsible for the rise in counterfeit \$100 notes. This activity also provides valuable input to the Bank’s program of public education.

## Public Education

The most effective defence against counterfeiting is an informed public that recognizes the security features found on genuine bank notes.

The Bank runs a public education program aimed at increasing awareness of the key security features of genuine bank notes. As part of that program, Bank staff made some 300 presentations to cash handlers in the retail and financial services sectors, to business and civic groups, to educational institutions, and to law-enforcement agencies during 2001, compared with approximately 230 during 2000.

The presentations were complemented by media interviews; by the information provided directly through the 1-888 telephone line and the Bank's Web site; by the distribution of posters, leaflets, training videos, and information kits; and by programs and activities offered through the Currency Museum.

## International Initiatives

Counterfeiting is an international threat, and demands a coordinated international response. Accordingly, the Bank of Canada is actively involved in a number of initiatives with other central banks, note-issuing authorities, and equipment manufacturers and suppliers. These activities range from providing a forum for the exchange of views on all aspects of the design, production, and distribution of bank notes to the co-operative development, assessment, and implementation of bank note technology and security.

One example of such involvement is the Central Bank Counterfeit Deterrence Group (CBCDG), established in 1993 by the governors of the G-10 central banks and chaired by a senior officer of the Bank of Canada. The group's main task has been the development of a system to deter computer-based

Debra Rohac welcomes a visitor to the Currency Museum, while Colleen Bauman checks out a display.





counterfeiting. The CBCDG is now working with manufacturers and software developers to facilitate adoption of this system.

Another example of international involvement is the Currency Developments Advisory Group (CDAG), established in 1997 by the central banks of Canada, the United States, Mexico, and Colombia. This group’s primary focus is the assessment of alternative materials that have the potential for enhancing the security of bank notes and extending their life. CDAG members share their unique skills and expertise as well as the results of their individual work.

### Supplying Bank Notes

Under the Bank Note Distribution System (BNDS), introduced in 1998, participating deposit-taking institutions manage the flow of notes between themselves in co-operation with the Bank. The Bank is responsible for distributing notes when they are first issued,

maintaining records of its own note inventories in the system, withdrawing notes when they are no longer fit for circulation, and overseeing note quality and authenticity.

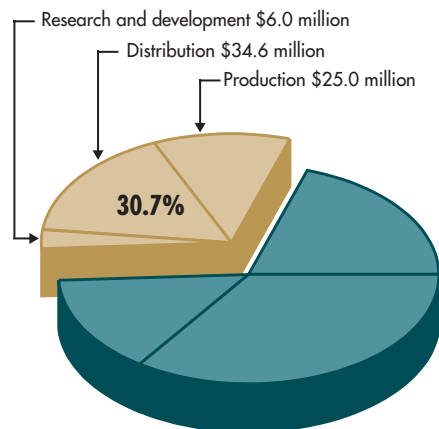
The BNDS successfully met the challenges presented by the disruptions to air traffic following the events of 11 September.

Contingency plans were robust and effectively mitigated the risks involved. Users of bank notes experienced no shortages.

In May 2000, the Bank stopped issuing \$1,000 bank notes and began to withdraw them from circulation as part of the federal government’s fight against money laundering and organized crime. During 2001, some 520,000 \$1,000 notes were returned to the Bank and destroyed, leaving about 2.3 million \$1,000 notes in circulation at year-end. Those notes represented less than 0.2 per cent of the total number of all notes in circulation and about 6 per cent of the value.

### Operating Expenses

#### Currency Activities as a Proportion of Total Bank Expenses



#### The Bank’s currency detectives

Staff in the Mutilated Note Service carefully sift through charred bank notes. Each year, the Bank is asked to identify, for the purpose of reimbursement, the value of notes that have been burned, decomposed, torn, shredded, or contaminated.





**November 2001 Conference on Financial Markets**

Speakers (left to right): Richard Lyons, University of California, Berkeley; Asani Sarkar, Federal Reserve Bank of New York; Eli Remolona, Bank for International Settlements

## CENTRAL BANKING SERVICES

*This function involves two major activities: the promotion of financial stability and the provision of funds-management services to the federal government. We are also concerned with the efficient and effective functioning of financial markets.*

### Promoting Financial Stability

Widespread confidence in financial institutions, markets, and clearing and settlement systems is essential to support economic activity in Canada and abroad. Promoting the safe and efficient operation of these key parts of the financial system is an important activity of central banks and other public sector bodies.

#### Clearing and Settlement Systems

##### Oversight of Major Systems

The Bank oversees Canada's major clearing and settlement systems (under the authority of the Payment Clearing and Settlement Act). Financial institutions use these systems to transfer funds or financial assets (such as debt, equity, or derivatives) and to discharge related payment obligations, either on their own behalf or on behalf of their customers.

While the Bank oversees these systems primarily for their safety, it also takes into account efficiency concerns.

In November 2001, the Committee on Payment and Settlement Systems of the Bank for International Settlements and the Technical Committee of the International Organization of Securities Commissions released their joint report, *Recommendations for Securities Settlement Systems*. The report identifies minimum standards that securities settlement systems should meet. The recommendations on the design, operation, and oversight of such systems are intended to promote the worldwide implementation of measures to reduce risks, increase efficiency, and provide adequate safeguards for investors. These recommendations will be incorporated into the Bank's minimum standards for the securities settlement system that it oversees.

The Bank continues to monitor the work done by the Canadian Depository for Securities Ltd. to enhance the functionality of the Debt Clearing Service (DCS). In the autumn of 2001, corporate debt was added to the list of securities transactions eligible to settle through the DCS, and the ability to net repo transactions was introduced in January 2002. In both cases, the Bank assessed the risk implications of these new activities and the robustness of the proposed risk-control measures, and concluded that any possible systemic risks were well controlled.

The Bank remains closely involved in the international banking industry initiative to reduce

and control the risks associated with the settlement of foreign exchange transactions. The start-up of this arrangement, which is

being developed by CLS ("Continuous Linked Settlement") Services and its subsidiary, the CLS Bank,

has been delayed, and is expected to become operational in the second half of 2002. The Bank is part of a group of central banks examining the risk-control measures proposed by CLS Services, and the Bank has the primary responsibility to satisfy

itself that all risks associated with the settlement of transactions involving the Canadian dollar have been appropriately addressed. During 2001, the Bank worked with the CLS Bank to test the services that the Bank of Canada will provide and to develop contingency arrangements in the event of system failures.



## WHAT SYSTEMS DOES THE BANK OVERSEE?

The Bank of Canada oversees two major clearing and settlement systems: the Large Value Transfer System (LVTS), which processes approximately \$100 billion in payments every day, and the Debt Clearing Service (DCS), which daily handles about \$100 to \$150 billion of securities transactions (primarily involving Government of Canada bonds and treasury bills as well as money market securities).

Parliament passed the Canadian Payments Act in the autumn of 2001, which gives the federal government the capacity to oversee payments systems, including those currently overseen by the Bank of Canada. To minimize any duplication or overlap of oversight activities and to coordinate work related to payments systems, the Bank and the Department of Finance have established a payment advisory committee.

Given the critical nature of major clearing and settlement systems, the Bank's oversight activities have increasingly focused on operational risks in these systems. Operational risks relate to potential disruptions because of internal systems failures or human error. The year-2000 concerns and the 11 September terrorist attacks in the United States have highlighted the need for sound operational arrangements and well-developed contingency plans. The Bank annually audits the implementation of risk-control arrangements in these systems, the nature and testing of backup arrangements, and system-capacity planning.

#### Operational Support for Clearing and Settlement Systems

The provision of accounts at the Bank of Canada to settle obligations among participants in major clearing and settlement systems, the provision of liquidity to system participants, and other central bank services are also critical elements of the Bank's contribution to the safe and reliable operation of these systems.

On 1 November, the Bank expanded the range of securities that it is prepared to accept as collateral when providing liquidity in normal circumstances through its Standing Liquidity

Facility. This initiative will reduce costs for direct participants in payments systems and lessen concerns regarding the adequacy of the future supply of government securities for collateral purposes (see [www.bankofcanada.ca/en/notices\\_fmd/not221001.htm](http://www.bankofcanada.ca/en/notices_fmd/not221001.htm)).

In June, the Bank outsourced the platform on which the computer applications used to support clearing and settlement systems are run. This has resulted in improved recovery times in the event of system problems and has enhanced the Bank's contingency plans in this area.

#### International Financial Stability Activities

In collaboration with the Bank of England, the Bank published a paper in November that lays out a clear framework for resolving international financial crises. The paper, *The Resolution of International Financial Crises: Private Finance and Public Funds*, is available on the Bank's Web site.



#### FINANCIAL STABILITY AND THE BANK

The Bank's contribution to financial stability reflects its system-wide perspective and draws on its expertise as a monetary authority, its ability to create liquidity in the form of risk-free claims on the Bank, and its knowledge of clearing and settlement systems and financial markets. The Bank works closely with other federal and provincial agencies that contribute to financial stability.



**Action in the Bank's Trading Room**

Left to right: Alan Andree, Ivan Semerdjiev, and Sébastien Guilbault

The Bank participates in the Financial Stability Forum, which in 2001 focused on the implications of the global slowdown for domestic and international financial systems and reviewed such issues as the supervisory

and information-exchange practices of off-shore centres, as well as the implementation of international standards. In this last area, the Bank provided experienced personnel to participate in joint missions of the International Monetary Fund and the World Bank. These missions assess the progress of countries in adopting international standards and codes of conduct.

The Bank also continued to support and participate in the work of the many committees and working groups of the Bank for International Settlements, which address a wide range of financial stability issues.

The issues discussed in the G-20 by finance ministers and central bank governors are of significant importance from the Bank's perspective. These include exchange rate regimes, prudent debt management, and the use of standards and codes.

At the November G-20 meetings held in Ottawa and chaired by Finance Minister Paul Martin, the Bank participated in discussions on detecting and preventing the misuse of the global financial system by terrorists and ways of making the world less vulnerable to financial crises.

## THE BANK AND FINANCIAL STABILITY RESEARCH

The Bank is intensifying its research into financial stability issues, including the examination of various arrangements in the financial system and their policy implications. Examples include assessing models of financial contracting, studying the impact on market liquidity of the consolidation of financial intermediaries, and analyzing the evolution of financial market structure. Some of this work is being conducted jointly with other research organizations.

### Financial Markets

Financial markets have been experiencing important and rapid changes, owing to such factors as consolidation among market participants, the adoption of new technologies, and evolving regulations governing market structure and practices. The Bank has increased its research in this area and has expanded its contacts with other public sector agencies interested in the operation and evolution of markets.



The Bank took part in discussions with market participants and securities commissions regarding issues associated with the development of alternative electronic trading systems in the domestic fixed-income market. The Bank drew on its research and practical experience in financial markets as well as on the specialized experience of a Bank of England employee seconded to the Bank to assist in this work.

In November 2001, the Bank held a conference entitled "Financial Market Structure and Dynamics," to help improve the understanding of financial market structures and their implications for market liquidity and price dynamics.

## Funds Management

In the past year, the Bank's regular strategic review process reaffirmed the importance of providing funds-management services to the government. With the rapid pace of change in financial markets, it was concluded that further investment will be needed in financial markets expertise and technological infrastructure.

### Advising the Government on Its Borrowing Program

As fiscal agent for the government, the Bank advises the government on the management of the federal public debt and provides treasury-management services. The objective of debt management continues to be to provide stable, low-cost funding to the government.<sup>1</sup>

Debt-management initiatives are developed in conjunction with the Department of Finance after consultations with market participants.

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1. Link to Debt Management Objectives  
([http://www.fin.gc.ca/dms/dms01\\_1e.html#DebtManagementObjectives](http://www.fin.gc.ca/dms/dms01_1e.html#DebtManagementObjectives))

## The Bank's Response to 11 September

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Following the terrorist attacks on the United States, central banks around the world moved quickly to support the financial system. The Bank of Canada rapidly assured financial market participants and the general public of its willingness to take actions to promote a stable financial system. Specifically, the Bank:

- provided LVTS participants with ready access to additional liquidity;
- agreed to extraordinary arrangements under which direct participants in the Automated Clearing Settlement System could trade and reduce imbalances in their payments positions;
- arranged for a temporary increase (to US\$10 billion) to an existing swap facility with the U.S. Federal Reserve to enhance the Bank's capacity to provide short-term U.S.-dollar liquidity to Canadian banks. In the event, it was not necessary to draw on this facility.
- communicated its activities quickly and openly to the market and the general public.

The events of 11 September were a significant test for Canadian financial markets and market participants, and for clearing and settlement arrangements. The financial system performed very well, reflecting previous efforts to develop robust, timely, and effective contingency plans, as well as a high degree of dedication and professionalism on the part of all participants.



## UNCLAIMED BALANCES

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 ten years.

To increase public access to information on unclaimed balances, the Bank provides a toll-free telephone service (**1-888-891-6398**) and an e-mail address at **ucbalances@bankofcanada.ca**.

There is also a search facility on the Bank's Web site at **www.bankofcanada.ca** where members of the public can find out if there is an unclaimed balance to which they may be entitled. They will also be told how to claim a balance. The public can also access information on unclaimed balances at any of the Bank's five regional offices. (See page 68 for addresses.)

During 2001, financial institutions transferred \$26 million in unclaimed balances to the Bank. In addition, the Bank handled more than 19,000 general inquiries, completed nearly 45,300 searches, and paid a total of \$8.1 million to satisfy 7,600 claims.

These have continued to focus on enhancing the market for Government of Canada securities and improving the government's treasury operations in an environment of budget surpluses and declining debt.

In 2001, two initiatives were taken to promote additional liquidity in the secondary

market for Government of Canada securities. First, the target size for issues of benchmark bonds was increased by about 30 per cent for 10- and 30-year bonds. Second, the bond-buyback program, under which the government repurchases existing, less-liquid debt issues in exchange for a cash payment to the seller of the debt, was used more extensively. This allowed the government to maintain the level of issuance of benchmark bonds in spite of its declining financial requirements. A new feature of the program, to be implemented in 2002, will give investors the opportunity to exchange outstanding debt for new issues of current benchmark securities. Another debt-management initiative launched in 2001 was a pilot cash-management buyback program. This program aims at smoothing the government's cash needs over the year and reducing fluctuations in the size of the treasury bill program by repurchasing selected bonds with a remaining term to maturity of less than one year.

Significant improvements continued to be made in the auction services provided to the government. New technology and improved business processes reduced the time between the deadline for the submission of bids and the release of the auction results from 30 to 15 minutes.

### Investing Government Funds

The Bank manages the investment of the government's Canadian-dollar cash balances and its foreign exchange reserves. Domestic cash balances range between \$1 billion and \$23 billion, typically rising to the upper end of this range prior to quarterly principal and interest payments. Foreign exchange reserves stood at US\$34.2 billion, up from

US\$32.4 billion in 2000 (year-end data). Foreign exchange reserves increased principally as a result of cross-currency swaps of domestic obligations. Foreign exchange reserves are held to provide general liquidity for the government and to fund exchange market intervention. Overall, the net difference between the liabilities of the Exchange Fund Account and its assets fell to US\$4.9 billion (on a par value basis) from US\$6.5 billion last year as a result of U.S.-dollar purchases.<sup>2</sup>

Several key initiatives, involving both Bank and Department of Finance staff, are underway to improve the investment of the government's funds. New draft terms and conditions for Receiver General Auctions of Canadian-dollar-denominated funds were published for comment in August 2001 and included revisions based on the comments on an earlier discussion paper. These rules will broaden participation in auctions and lower credit risk for the government, because a significant proportion of the investments will be collateralized. The new framework is expected to be ready in 2002. Research also began on refining the measurement of the cost of foreign exchange reserves in order to better assess the financial performance of the Exchange Fund Account. The results of this work will be implemented in 2002 when the Bank installs a new trading, portfolio-management, risk-management, and accounting system for the Account. Finally, 2001 saw the start of a program to improve the management of the operational risk related to funds management.

2. Link to Exchange Fund Report  
[http://www.fin.gc.ca/efa/efa2000\\_1e.html#Gap](http://www.fin.gc.ca/efa/efa2000_1e.html#Gap)

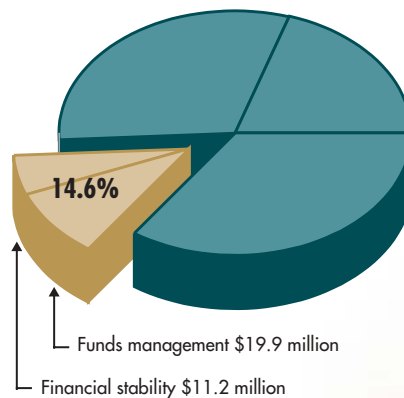
## Banking Agent for the Government

Government of Canada receipts and payments transferred through Canadian financial institutions are forwarded to the Bank of Canada for settlement. While large in value, the number of items processed by the Bank is very low, because financial institutions consolidate the individual payment items and forward them to the Bank for bulk settlement. These settlement payments are channelled through the Canadian Payments Association's (CPA) LVTS, which is also used by the federal government to make most of its large payments.

Working with the federal government and the CPA, the Bank is involved in several initiatives to further improve the efficiency of processing government payments and deposits. For example, a more secure Web-based system for submitting payments from financial institutions to the Bank was introduced in 2001 as a pilot project. It will be made available to all financial institutions in 2002.

## Operating Expenses

### Central Banking Services Activities as a Proportion of Total Bank Expenses





## RETAIL DEBT SERVICES

*As the government's fiscal agent, the Bank is responsible for providing advice and operations- and systems-support services for the retail debt program.*

*The program is directed by the Department of Finance through its agency, Canada Investment*

*and Savings, which determines the products to be offered, the interest rates to be paid, and strategies for sales and marketing.*

Under the retail debt program, the government issues traditional Canada Savings Bonds (CSBs), which are redeemable at any time, and Canada Premium Bonds (CPBs), which offer a higher interest rate at the time of issue than CSBs but are redeemable only annually. Bonds are available through a network of



sales agents, as well as organizations sponsoring the Payroll Savings Program, and through direct sales by telephone or via the Internet.

In 2001, a milestone in retail debt services was achieved as the Bank outsourced the operations and systems support to a private sector firm, EDS Canada Inc. An integral part of this outsourcing was the transfer of about 430 of the Bank's staff, including consultants and contract employees, to EDS effective 1 September 2001.

The contract with EDS was the result of a rigorous, year-long competitive process to select a private sector partner from among several leading outsourcing companies. This arrangement will ensure more flexible and cost-effective "back-office" services for the retail debt program. The contract stipulates detailed service levels that EDS must meet to ensure that bondholders continue to receive the same high level of service. In line with this initiative, the Bank has established a new department, the Debt Administration Office, to oversee the contract. The Bank remains fully accountable for bondholder records and debt accounting, as well as customer service.

This major change involves a one-time charge to the retail debt program of \$23.2 million, for which the government will reimburse the Bank. This amount will be more than recaptured from the annual operational savings that will be achieved over the life of the contract.

## Operating Expenses

### Retail Debt Activities as a Proportion of Total Bank Expenses

