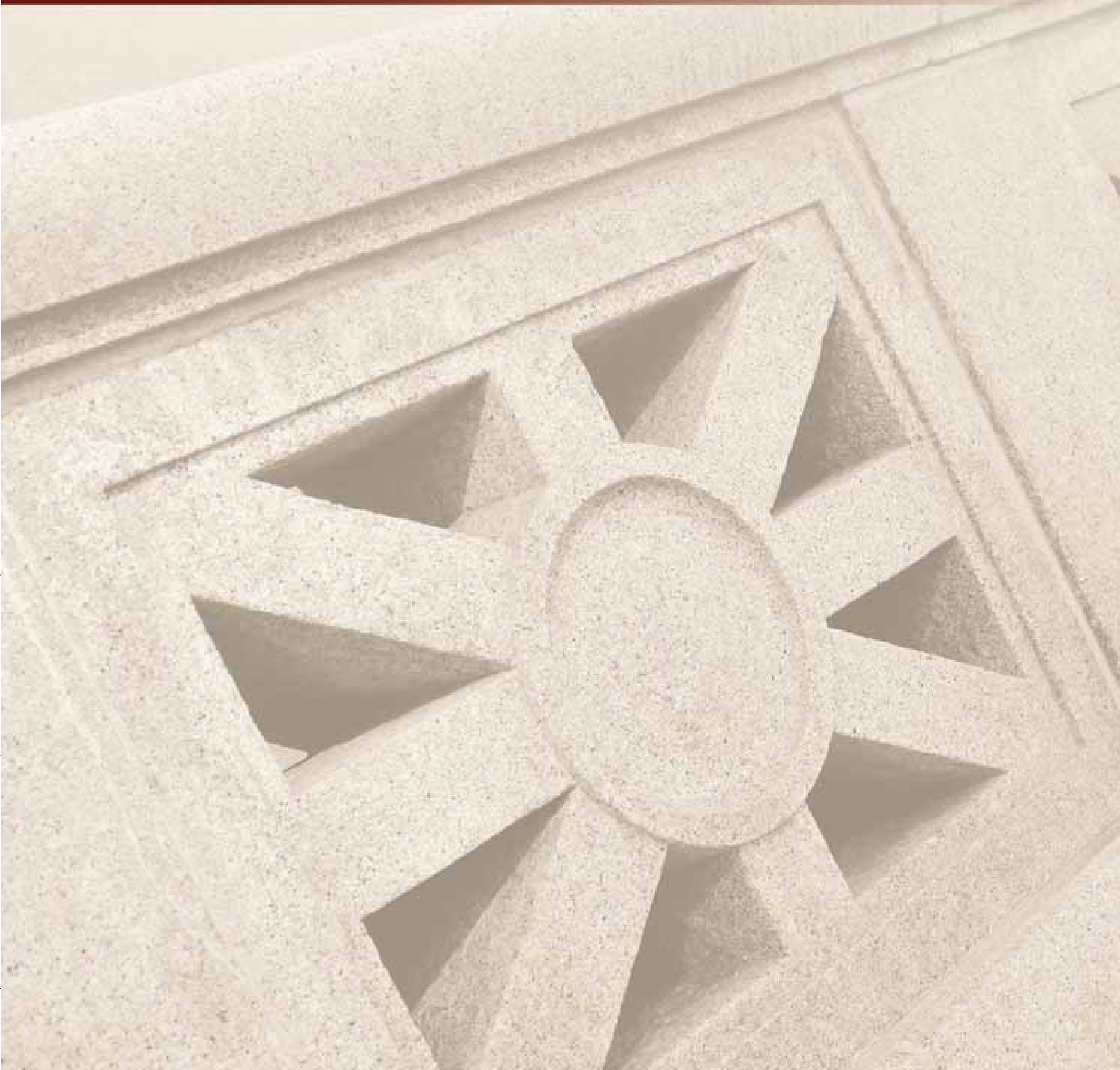
AN ACCOUNT OF **OUR STEWARDSHIP**



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.

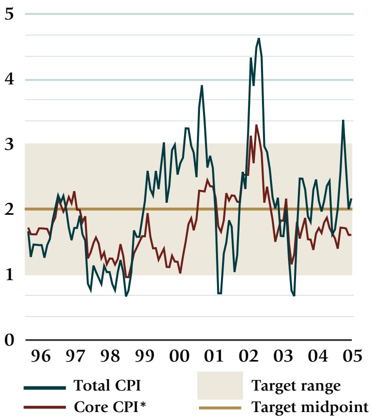
In 2005, despite volatility in the prices for crude oil and natural gas, CPI inflation remained within the target range except for one month. Continued close assessment of international and domestic developments, supported by a base of longer-term research, contributed importantly to this outcome.

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.




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.

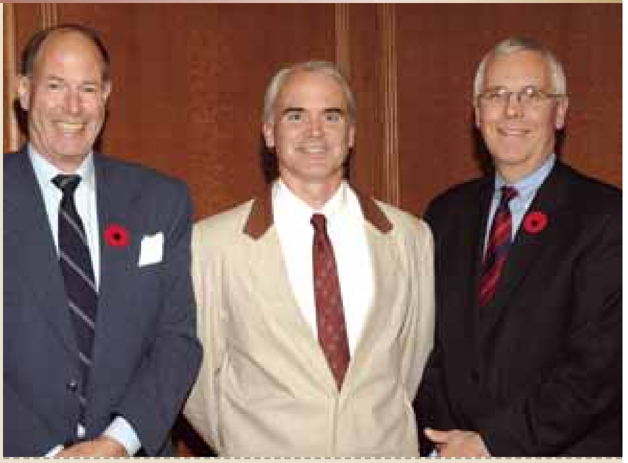
To make efficient use of the Bank's international resources, it is important to focus them on areas and issues of particular interest. The relevant set will evolve through time, although some issues, such as the performance of the U.S. economy, are always important for Canada. Issues that received special 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.

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.

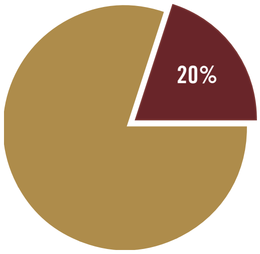
Operating Expenses

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.

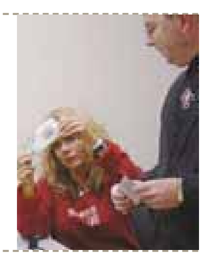
The Bank monitors public awareness of bank note security, as well as the behaviour and attitudes of retailers. While Canadians are aware of counterfeiting, they appear relatively confident in their bank notes and express no significant concerns about bank notes as a readily accepted, reliable means of 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.*

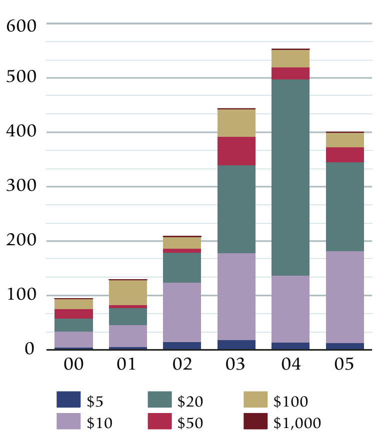
Getting Results: Incidence of Counterfeiting

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.

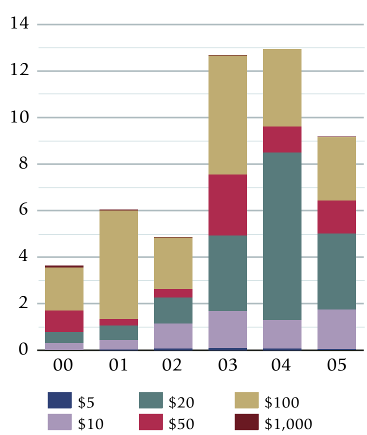
Number of Counterfeit Bank Notes Found in Circulation

Thousands of notes



Value of Counterfeit Bank Notes Found in Circulation

$ millions



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.

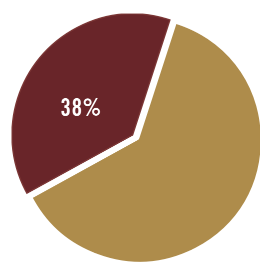
Operating Expenses

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.

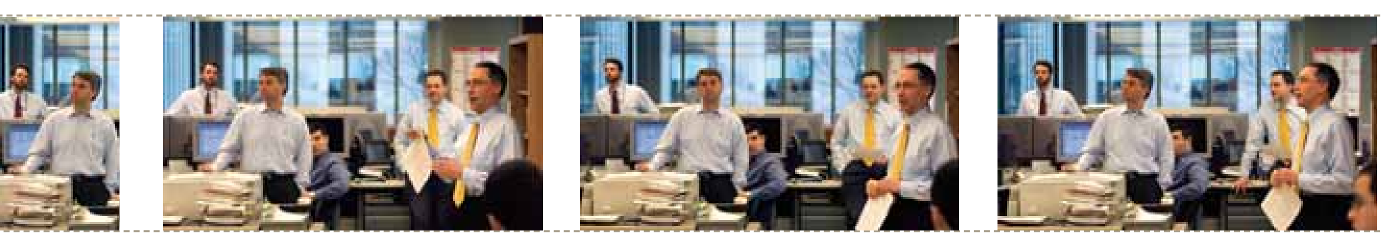
This discussion reflects a desire for the IMF to remain a key player in international financial matters, while responding to concerns about sizable IMF lending to a small number of countries and a need to realign IMF operations with changing global economic realities. The Bank has carried out research 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.

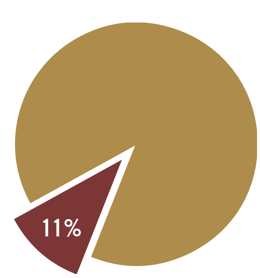
Operating Expenses

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