



MESSAGE FROM THE GOVERNOR



In the year just ended, the global economy faced a number of exceptional challenges, reflecting a wide range of economic, financial, and geopolitical risks and uncertainties. These included the fallout from the September 2001 terrorist attacks, corporate accounting scandals, stock market volatility, and developments in the Middle East. Despite this global backdrop, the Canadian economy outperformed virtually all other industrial economies, growing by about 3 1/4 per cent and creating 560,000 jobs, while inflation expectations remained well anchored to the Bank of Canada's 2 per cent inflation-control target.

One reason why our economy performed as well as it did in 2002 is the macroeconomic policy framework that we have in place in Canada—a framework focused on maintaining low, stable, and predictable inflation and sound public finances. Indeed, the events of the past year have underlined the importance of establishing and maintaining sound policy and decision-making frameworks to deal not only with today’s challenges, but also with those of the future.

For the Bank, dealing effectively with the risks and uncertainties of 2002 was crucial to meeting our responsibilities, not just for monetary policy, but also for financial system stability, funds management, and currency. In 2002, business-continuity planning and risk management were a key focus of our internal management.

While the subsequent sections of our *Annual Report* provide more detail, I would like to highlight here some of the activities and decisions taken by the Bank in 2002 to help us meet our commitment to Canadians.

Meeting the Policy Challenges of 2002

Fostering Confidence in the Value of Money

The best contribution the Bank can make to good economic performance is to preserve confidence in the future value of money. This means that Canadians should not have to worry about the effects of inflation when they make everyday decisions as consumers, business people, savers, and investors. It means that they should be able to go about their affairs confidently, knowing that they can count on the Bank of Canada to do whatever is necessary to keep inflation low, stable, and

predictable. To deliver this confidence, the Bank targets the 2 per cent midpoint of its 1 to 3 per cent range for inflation control.

But since monetary policy actions take from 18 to 24 months to register their full effect on inflation, it is essential for the Bank to take a medium-term approach, looking well beyond current events. Good policy-making should, of course, always be forward-looking. When we say that monetary policy is forward-looking, we mean that our actions are based on our best judgment about future inflation pressures—not just today’s.

The Canadian economy has also been benefiting from the improved fiscal framework put in place over the past several years to reduce Canada’s burden of deficits and public debt. And it has profited from freer trade and various structural reforms carried out in both the public and private sectors to enhance the growth of productivity and our ability to compete in world markets.

As 2002 progressed, it became clear that the Canadian economy was growing strongly and moving close to its full production capacity. With its medium-term inflation-control objective in mind, the Bank began reducing the substantial monetary stimulus that had been provided over the previous year by raising the target overnight interest rate on each of its April, June, and July policy announcement dates. But in the second half of the year, global uncertainties intensified, with financial confidence undermined by high-profile corporate governance and accounting failures in the United States. In addition, geopolitical risks were rising, particularly in relation to the Middle East. As a result, economic growth was expected to slow, and the Bank responded by holding the overnight rate steady for the rest of the year and into early 2003.

Towards year-end, however, rates of inflation began to come in higher than expected. Although the Bank had anticipated a spike upwards in consumer price inflation in the fourth quarter in response to several one-off price movements, these became more persistent. In addition, consistent with various other indicators that the economy was operating closer to capacity at year-end than had been expected, there was evidence of some broadening of price pressures. With the stance of monetary policy very stimulative, the Bank has signalled the need for a reduction of stimulus in order to return inflation to the 2 per cent target over the medium term.

The Bank's commitment to openness and public accountability is also integral to achieving its key policy objectives. The better and more widely monetary policy is understood, the better it can work. During the year, the Bank stepped up its efforts to explain its conduct of monetary policy and to provide perspective on related issues.

Promoting the Safety, Soundness, and Efficiency of Canada's Financial System

Sustaining a healthy pace of economic activity also depends critically on maintaining confidence and trust in financial institutions, markets, and clearing and settlement systems. In 2002, the Bank worked with its partners in the financial system on a number of fronts to contribute to the safe and efficient operation of these key components of the system.

Canada has made significant progress over the past few years in reducing the potential for unexpected events to threaten the operation of the Canadian financial system. This past year was no exception. A new clearing and settlement arrangement began operation in Canada and six other countries to reduce or eliminate the very significant risks

associated with the settlement of foreign exchange trades. This system, together with the existing well-risk-proofed systems for transferring large-value payments and for settling almost all securities trades in Canada, has made the financial system much safer than it was five years ago. These systems provide a solid foundation on which we can continue to promote financial stability.

Another initiative aimed at strengthening the safety of the Canadian financial system is a heightened focus on business-continuity planning for operations that are crucial to the system as a whole, as well as to the economy. As part of this effort, we enhanced our own contingency arrangements in support of the essential services that we provide to payment and other clearing and settlement systems.

Internationally, we contributed actively to a number of groups working on international stability issues, including the G-20 and the Financial Stability Forum, with a strong emphasis on improving the framework for preventing and resolving financial crises.

In addition to increasing our research on financial system issues, the Bank moved to increase public knowledge and discussion of the subject by launching a new publication, the *Financial System Review*. Published semi-annually, it will highlight developments and changes in the Canadian financial system. More broadly, the Bank participated in discussions aimed at maintaining trust and confidence in the Canadian financial system and supported initiatives to enhance the efficiency of Canadian capital markets.

Supplying Secure Bank Notes

Throughout the year, the Bank faced continuing challenges in its efforts to keep ahead of the use of advanced technology to counterfeit Canadian bank notes.

The Bank acted on several fronts in 2002 to protect Canada's currency from counterfeiting. Because counterfeiting is an international issue, we continued to work with other central banks, note-issuing authorities, and equipment manufacturers and suppliers on a wide range of issues, including the design, production, and distribution of bank notes, as well as bank note technology and security issues.

In addition to working closely with the Royal Canadian Mounted Police on counterfeiting issues, we increased contacts with provincial and municipal law-enforcement agencies to support enforcement and education activities. More broadly, the Bank stepped up its public education program on the security features of bank notes, emphasizing both national and regional partnerships with interested groups.

Finally, we developed improved security features to be incorporated in the high-denomination notes of the *Canadian Journey* series. The launch of the first higher-denomination note is planned for the first half of 2004, with the remaining two to follow over the subsequent 12 months.

Managing the Bank

Effective internal management of the Bank is vital to our ability to deliver on our commitment to Canadians, and is all the more so during highly uncertain times. A priority in the post-11-September environment has been the ongoing strengthening of our operations through greater security and business-continuity planning in all critical areas.

After an extensive review of the Bank's strategic direction and priorities, the Board of Directors adopted a new medium-term plan in 2002. Covering the years 2003 to 2005, the plan sets out key initiatives that will sharpen the Bank's focus on its core functions and foster excellence in all its work.

We will continue to build on our culture of learning and knowledge-sharing across all functions. We will enhance our efforts to attract and retain talented staff. Our already strong emphasis on innovative research and sound analysis will be increased, as will our efforts to work through partnerships that extend our capabilities and share knowledge. And we will continue to strive for clear, open communication inside and outside the Bank. I want to highlight here one of our important new corporate initiatives that has a more public face. This is the Bank of Canada Fellowship Program, which we launched in 2002 to advance leading-edge research and build new partnerships beyond the Bank.



In 2002, the Bank's employees were again called on to rise to a number of challenges—some planned and some emerging from the turbulent environment around us. I want to thank all of our employees for their considerable efforts during the year. I also want to extend my appreciation to the Board of Directors for their support. As a result of all these efforts, the Bank of Canada was able to deliver on its commitment to Canadians in 2002, while enhancing its capacity to meet future challenges.

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