AN ACCOUNT OF OUR **STEWARDSHIP**

MONETARY **POLICY**

"The economy's strong performance owes much to the sound policy framework and its skillful implementation. Inflation targets have helped to anchor expectations and permitted a forceful injection of monetary stimulus in the face of last year's shocks."

2003 Article IV Consultation, Statement of the IMF Mission (15 November 2002)

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

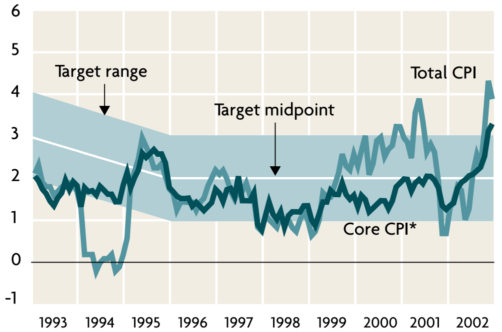
The keystone of our framework for monetary policy is an inflation-control target range for the consumer price index (CPI) centred on a 2 per cent target midpoint. This target has resulted not only in stable and more predictable inflation, but in a stronger and more stable economic environment in general.

Monetary policy is implemented by changing the 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 affect total spending, which in turn, eventually has an impact on inflation. Thus, the influence of the Bank's action on inflation typically builds up slowly over a period of 18 months to 2 years.

Inflation-Control Targets and Economic Stability

A major source of pressure on inflation is the degree of overutilization or underutilization of the country's production capacity. Monetary policy aimed at stabilizing inflation will therefore tend to stabilize capacity pressures as well. Since capacity evolves only slowly through time, this means that output growth will also tend to be steadier. This is, indeed, what has been observed in Canada since the adoption of inflation-control targets in 1991. Output growth has been much more stable than it was in the 1980s, and capacity pressures have been steadier as well.

Consumer Price Index
Year-over-year percentage change



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

Meeting the Inflation Target

The Bank's core measure of inflation, which is used as an operating guide, began the year just below the 2 per cent target and then hovered around 2.2 per cent from February to July. It subsequently rose, reaching a peak of 3.1 per cent in November, largely because of a number of one-time factors related to electricity prices, automobile insurance premiums, and a rebound from temporarily low prices for certain goods a year earlier. Total CPI inflation increased more rapidly, to rates above the target range in the last three months of the year, because of rising petroleum prices and tobacco tax hikes coming on top of the increase in core inflation.

The increases in both measures of inflation in late 2002 were, however, larger than the Bank had been anticipating. This reflected both more persistence in insurance premium increases and some broadening of price pressures. By January 2003, the Bank concluded that the higher-than-expected rates of inflation, together with various measures of capacity pressures, were indicating that the Canadian economy was likely operating closer to capacity than previously assessed.

However, expectations of inflation over the medium term and for longer time horizons, whether based on average private sector forecasts or on the spread between the yields on conventional and inflation-indexed bonds, remained near 2 per cent.

Early in 2002, concerns persisted as to how rapidly the Canadian and U.S. economies would recover from the 2001 slowdown and the decline in consumer and business confidence following the September 2001 terrorist attacks. As a result, the Bank lowered its target for the overnight interest rate by 25 basis points to 2 per cent on its January fixed announcement date. Over the next three months, it became apparent not only that there had been no increase in economic slack in the Canadian economy in the fourth quarter of 2001, but that both the Canadian and U.S. economies had grown strongly in the first quarter of 2002. On its April fixed announcement date, the Bank therefore began to gradually reduce the large amount of economic stimulus in the system. A 25-basis-point increase in the target overnight rate on that date was followed by two similar moves in June and July, taking the target rate to 2.75 per cent, as Canadian economic growth remained strong in the second quarter.

In subsequent months, uncertainty regarding the pace of recovery in the U.S. and global economies increased. Uncertainty also rose in financial markets, connected partly with U.S. scandals in corporate governance and accounting. As well, there were growing geopolitical risks related to the situation in the Middle East. Largely as a result of these factors, the rate of economic expansion slowed in the second half of 2002 to close to the Bank's estimate of potential growth of 3 per cent, and the Bank held its target rate constant through the last five months of the year and into early 2003. As we go forward, with an appropriate reduction in the amount of monetary stimulus, the *level* of output is expected to remain close to capacity during 2003 and into 2004, and core inflation is projected to return to the 2 per cent target over this time horizon.

Volatile Energy Prices and the CPI

Energy prices have been the major source of volatility in the total CPI in recent years. From late 1997 to early 1999, declining energy prices kept CPI inflation at or below the bottom of its target range of 1 to 3 per cent for much of that period. Then, from mid-1999 to mid-2001, a significant rise in energy prices pushed total CPI inflation well above core inflation for two years. The most recent cycle in energy prices drove total CPI inflation below target in late 2001 and above target in late 2002. Because of the lags between policy actions and their effects on inflation, such largely unpredictable and typically short-lived movements in energy prices cannot be offset by monetary policy. These movements illustrate why the Bank focuses on a core inflation measure—which excludes volatile price components—as its operating guide.

Assessing International Developments

As in 2001, most of the shocks affecting the Canadian economy in 2002 had their origins abroad, particularly in the United States. The exchange of information within the international groups in which Bank officials participate continued to be invaluable. These include meetings of 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 International Monetary and Financial Committee of the International Monetary Fund, the G-20, the G-10, and the G-7. Canada chaired the meetings of G-7 finance ministers and central bank governors in 2002, hosting a meeting in the National Capital Region in

November 2002 Research Conference Speakers: (top) Michael Devereux, University of British Columbia; (bottom, left to right) Martin Eichenbaum, Northwestern University; Beverly Lapham, Queen's University; Sharon Kozicki, Federal Reserve Bank of Kansas City

February. The Bank also initiated the use of video teleconferencing for selected international meetings, including discussions among G-7 central bank deputies.

Bank staff continue to provide insights and advice on the use of inflation targeting in the context of a flexible exchange rate regime through international meetings in which emerging-market countries participate, as well as through technical assistance offered at the Bank and abroad.

Promoting an Understanding of Monetary Policy

In 2002, the Bank continued to expand communications regarding its conduct of monetary policy and the roles of the exchange rate and Canada's floating exchange rate regime. It used speeches, presentations, and numerous *Review* articles to explain the Bank's procedures and continuing research in these areas.

The Bank places a high priority on an ongoing dialogue with industry, government, and academia about economic and monetary policy issues. Regional staff are actively involved in this process. They also assist the Governing Council and the Directors with their communications activities across Canada.

Fellowship Program Announced

Launched in 2002, the Bank of Canada Fellowship Program will contribute importantly to the Bank's objective of fostering leading-edge research through partnerships with outside organizations and individuals. Fellowships will be offered to academics with a proven track record of excellence in a field of research critical to the Bank's mandate and who have the potential to continue to make an outstanding contribution in their area of research. A Fellowship consists of a salary stipend, as well as funds for research assistants and related expenses. The first fellowships will be awarded early in 2003. The Bank's new Fellowship Program will bring Fellowship recipients to the Bank for three days each year to discuss their research findings with Bank researchers and policy-makers.

(For further information, see www.bankofcanada.ca/fellowship)

Carrying Out Research and Analysis

Research and analysis are key to formulating and implementing monetary policy. Bank researchers actively took part in some 90 academic and central bank seminars and conferences in 2002. During the year, the Bank participated in a number of formal partnerships with foreign central banks,

Communications Conference: Manfred Körber, European Central Bank, and David Hawley, International Monetary Fund

Bank Hosts Communications Conference

The first international central bank communications conference was hosted by the Bank in October 2002. It brought together communications professionals from major central banks around the globe. The conference addressed a number of themes that in one way or another occupy all central banks in communicating monetary policy: strategic communications, dealing with the media, communicating with the general public, public education, crisis communications, current and future uses of central bank Web sites, and performance measurement. The presentations and discussion confirmed the common challenges communicators face in an environment of increasing openness and transparency, as well as different views on how to approach these challenges.

academic research institutes, and individual academics. There were also about 40 informal relationships with academic researchers who made presentations at Bank-sponsored seminars, workshops, and conferences.

The Bank's annual research conference in 2002 assessed the current state of knowledge on how price- and wage-setting decisions are affected by monetary policy and vice versa. As an inflation-targeter, the Bank continues to place a high priority on this area of research. In this context, the Bank has begun a survey of the price-setting behaviour of firms in Canada.

A listing of the Bank's economic research, published both internally and externally, appears in the annual booklet, *Bank of Canada Publications Catalogue,* introduced in 2002. During the year, the Bank published a record 42 working papers.

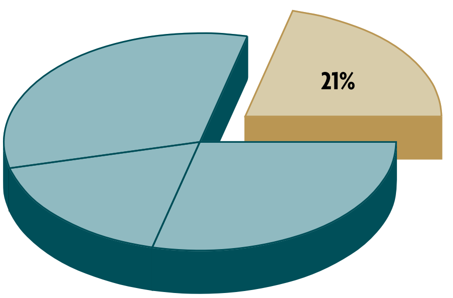
With the adoption of its new medium-term plan, the Bank began to broaden its research on the structural and sectoral issues that affect the Canadian macroeconomy. These include issues related to aggregate productivity and labour markets. The plan also placed a high priority on research to assess the implications of the changing structure of credit markets in the transmission of monetary policy.

In the medium term, the Bank's regional staff will be expanded to strengthen the research and analysis related to regional surveys, as well as to other regional and industrial topics.

Operating Expenses

Operating expenses for monetary policy in 2002 increased from 2001 levels, consistent with plans for this function. The Bank spent $51.1 million in 2002, approximately 21 per cent of its total operating expenses (before restructuring and related expenses) on formulating and implementing monetary policy, compared with $43.4 million in 2001. Part of the increase in expenses relates to planned increases in staff resources associated with increased research on structural and sectoral issues, as well as enhanced communications efforts.

Monetary Policy Activities as a Proportion of Total Bank Expenses

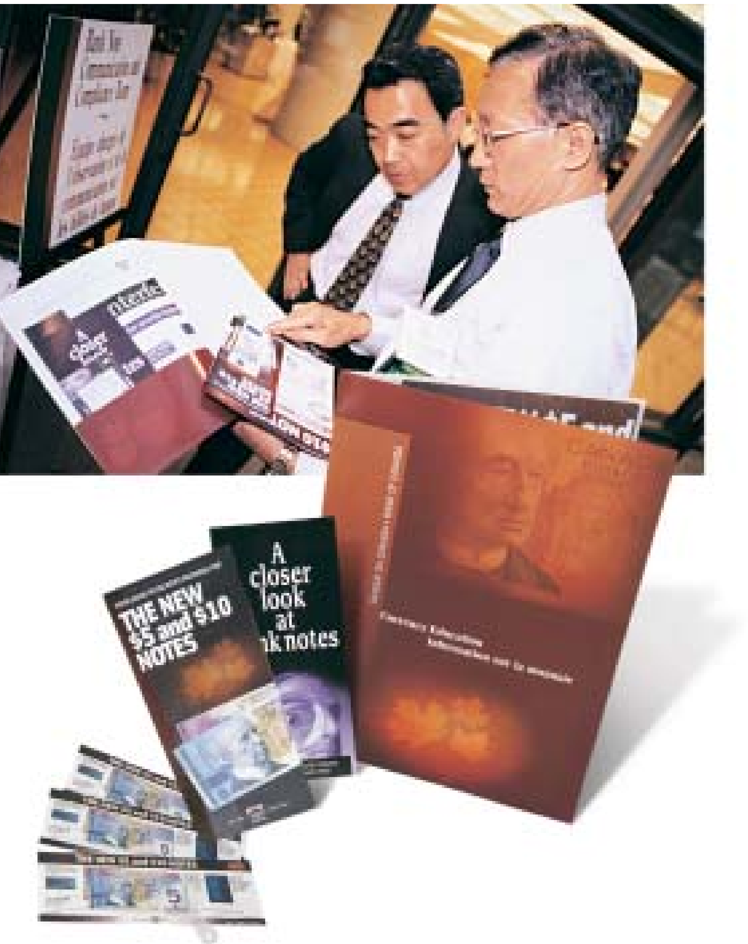


Launch of the new $5 note: Celebrated Canadian author, Roch Carrier, with excerpt from his well-loved tale, *The Hockey Sweater.* Inset: Hockey legend, Jean Béliveau and Kim St. Pierre, goalie of Canada's gold medal women's hockey team.

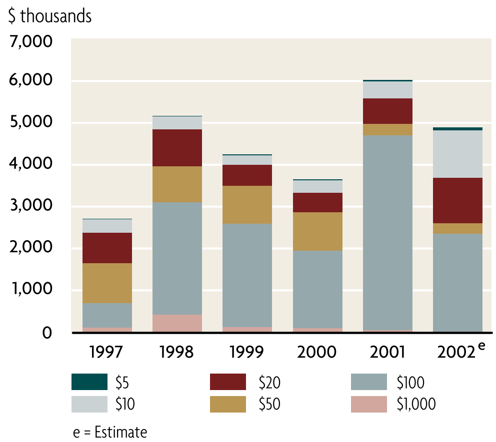
CURRENCY

Canadians depend on the Bank of Canada to supply bank notes in which they can have confidence and to make these notes available readily and economically. An ongoing challenge facing the Bank is counterfeiting, which has increased in recent years with the use of new and more sophisticated technologies.

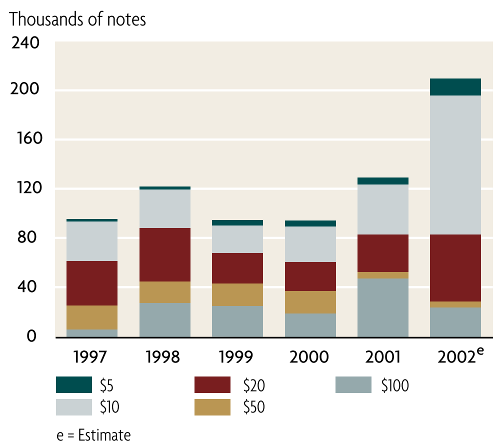
The Bank has responded aggressively to this threat by investing in programs aimed at raising public awareness of counterfeit-detection practices, deterring counterfeiting through initiatives with enforcement agencies, and enhancing the security features in bank notes.



Value of Counterfeit Bank Notes Found in Circulation



Number of Counterfeit Bank Notes Found in Circulation



The Incidence of Counterfeiting

The *number* of counterfeit notes increased from 130,000 in 2001 to an estimated 210,000 in 2002, driven by a substantial rise in the number of counterfeit $10 notes.

At the same time, the *value* of counterfeit notes fell from $6.0 million in 2001 to an estimated $5 million in 2002. This decline is due to a drop in the number of counterfeit $100 notes detected in circulation, following the arrest, in July 2001, of those responsible for a major counterfeiting operation.

Although the number of counterfeit notes found in circulation is very small relative to the 1.4 billion genuine notes, the cost to Canadians from counterfeiting can be significant. It goes beyond the direct loss borne by those accepting counterfeit notes. Most important is the potential loss of trust in bank notes as a means of payment if individuals worry that the bank notes they are using are not genuine or will not be readily accepted.

Raising Public Awareness

One of the best defences against counterfeiting is a well-informed public. Bank notes include many security features, but these are effective only if the public recognizes them and knows how to use them.

In March 2002, the Bank issued its new $5 note, the second denomination in the *Canadian Journey* series launched in January 2001. The introduction of the $5 note, titled *Children at Play,* provided an opportunity to further promote public awareness and understanding of the security features on all existing notes. A national media launch, held in Montréal, was supported by same-day technical briefings for the media in various regions, followed by post-launch education seminars across the country.

Over the course of the year, some 450 presentations on counterfeit-detection techniques were made to cash handlers in the retail and financial services sectors, as well as to business and civic groups, educational institutions, and law-enforcement agencies. This represents a 50 per cent increase over 2001.

These presentations were complemented by other initiatives: media interviews; responses to public inquiries; and the distribution of posters, leaflets, training videos, information kits, DVDs, and CD-ROMs. The Bank also introduced an Internet-based training video as an alternative method of delivering information about bank note security.

Partnerships were also formed with national and regional associations that have a particular interest in counterfeit detection, such as the Retail Council of Canada and the Conseil québécois du commerce de détail. A coordinated public awareness and compliance campaign was successfully implemented in collaboration with the Calgary Police Service through their Downtown Business Liaison Program. Work is underway to expand such partnerships into a more integrated national program.

The Currency Museum

The Currency Museum's travelling exhibit, *The Colour of Your Money,* introduced in 2001, opened in Montréal concurrently with the launch of the new $5 note, before moving to Kenora and Fort Frances. Since December 2002, part of the Museum's collection can be accessed on-line, through the Bank's Web site. This is expected to significantly expand the Museum's reach beyond the 40,000 visitors to its Ottawa location each year.

Promoting Improved Deterrence and Compliance

In 2002, the Bank began to work more closely with agencies that enforce Canada's anti-counterfeiting laws. This involved presentations to Crown prosecutors on the social and economic significance of counterfeiting and the provision of information to police officers to help them in effectively pressing charges.

The Bank also increased its contacts with provincial and municipal law-enforcement agencies to monitor local counterfeiting, support enforcement initiatives, and coordinate education activities. We continued to work closely with the Royal Canadian Mounted Police to monitor and analyze counterfeiting across the country.

Checking out exhibits at the Bank's Currency Museum

Improving Security

As the threat of counterfeiting continues to grow, the Bank is moving to a higher level of security for higher-denomination notes — the $20, $50, and $100. A reassessment of possible security features for these notes was undertaken during 2002, drawing upon expertise from other central banks and developers of bank note security products. These efforts led to the selection of a suite of new and more sophisticated security features that will be easier for the public to recognize and that will make it more difficult to counterfeit genuine notes.

The design of the high-denomination notes of the *Canadian Journey* series is now well underway, with the launch of one denomination planned for the first half of 2004 and the remaining two over the subsequent 12 months.

As an international threat, counterfeiting demands a coordinated international response. Accordingly, the Bank is actively involved in several initiatives with other central banks, note-issuing authorities, and equipment manufacturers and suppliers. These initiatives range from providing a forum for the exchange of views on all aspects of the design, production, and distribution of bank notes to active co-operation in developing, assessing, and implementing new bank note technology.

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 defeat computer-based counterfeiting. In 2002, there was significant deployment of the system in digital reprographic equipment and software.

Meeting the Demand for Bank Notes

It is not enough for bank notes to be secure; they must also be available when and where Canadians need them. For the Bank, this means anticipating demand, managing inventories, and dealing with the complexities of distributing a new series of notes. We work closely with financial institutions to ensure that the national bank note distribution system operates efficiently. By the end of 2002, there were $41.1 billion of notes in circulation, a 6 per cent increase over the previous year.

In 2002, the Bank initiated a review of its bank note inventory strategy with an academic from the University of Alberta. We also conducted research that confirmed that the public is better able to use the security features, and thus to ascertain if a bank note is genuine, when the note is in good condition. As a result, we plan to replace worn notes more quickly in order to improve the overall condition of notes in circulation. The effects of this change in strategy will be seen over the next few years.

How to Reach the Bank Note Communication and Compliance Program

OTTAWA:

Bank Note Communication and Compliance Team

Tel: 1-888-513-8212
Fax: (613) 782-7533
e-mail: education@bankofcanada.ca
Web site: www.bankofcanada.ca

Currency Museum

Tel: (613) 782-8914
Fax: (613) 782-7761
e-mail: museum-musee@bankofcanada.ca

Contact information for the Bank's regional offices can be found on page 70.

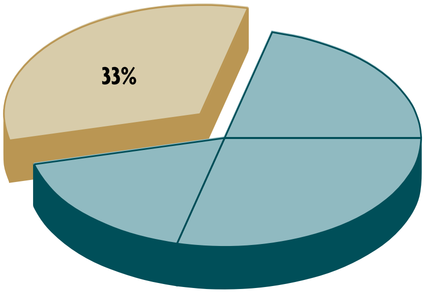
Operating Expenses

Operating expenses for the currency function in 2002 were $78.8 million, about 33 per cent of the Bank's total operating expenses (before restructuring and related expenses). This represents an increase of $13.2 million from 2001.

Much of this increase relates to the production and distribution of bank notes to meet demand and to increase inventory levels ahead of the launch of the new $5 note.

Additional funds were also allocated to the expansion of public education initiatives to deter counterfeiting and to the development of improved security features to protect the integrity of our currency.

Currency Activities as a Proportion of Total Bank Expenses



The Bank's Trading Room

CENTRAL BANKING **SERVICES**

This function involves two major activities: promoting financial stability and providing efficient funds-management services to the federal government.

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 the Bank of Canada and other public sector bodies.

Financial Stability Initiatives in 2002

As part of its promotion of financial stability, the Bank

- began publication of its *Financial System Review*. This new semi-annual publication is intended to increase public knowledge of, and discussion about, changes and developments in the Canadian financial system.
- increased the resources devoted to issues concerning financial stability and started organizing a conference on these issues to be held in the second half of 2003.

Clearing and Settlement Systems*

Overseeing major systems

The Bank of Canada contributes to financial stability through its oversight of major clearing and settlement systems under the Payment Clearing and Settlement Act (PCSA). The Bank was particularly active in this role during 2002. Perhaps most important was the commencement of operations by the CLS (Continuous Linked Settlement) Bank. The CLS Bank is a special-purpose bank designed to virtually eliminate the risk associated with the settlement of foreign exchange trades.

Since the Canadian dollar is one of the currencies initially settling in the CLS Bank, the Bank of Canada was part of a group of central banks that examined the proposed risk-control measures. In early September 2002, the Governor of the Bank of Canada designated the CLS Bank as subject to oversight under the PCSA. The Bank of Canada's primary responsibility is to satisfy itself that all risks associated with the settlement of transactions involving the Canadian dollar are adequately addressed.

During 2002, The Canadian Depository for Securities Ltd. (CDS) continued its work to create an enhanced securities clearing and settlement system that would settle virtually all securities trades in Canada, including exchange-traded equities. Built on the sound risk-control arrangements of the Debt Clearing Service (DCS), the new system, called CDSX, is likely to become operational in the first half of 2003 and is expected to be designated for oversight under the PCSA.

The Canadian Payments Association (CPA) operates two payments systems, the Large Value Transfer System (LVTS) and the Automated Clearing Settlement System (ACSS). The ACSS now processes and settles primarily retail payments, since most of the large-value payments that used to be processed through this system have migrated to the LVTS. After extensive analysis by Bank staff, the Governor decided that the operation of the ACSS does not pose systemic risk. Thus, the ACSS will not be designated for oversight under the PCSA. The Bank is continuing to encourage CPA members to move any remaining large-value payments settling through the ACSS to the LVTS. In this regard, effective February 2003, the CPA will prohibit paper cheques with a value of $25 million or more from settling in the ACSS.

* The Bank's Web site (www.bankofcanada.ca) provides detailed information on payments and other clearing and settlement systems.

Updating guidelines for clearing and settlement systems

In 2002, the Bank updated its guidelines and minimum standards for payment and other clearing and settlement systems that are subject to oversight under the PCSA. The new minimum standards incorporate international standards published recently by the Bank for International Settlements and the International Organization of Securities Commissions.

Providing operational support for clearing and settlement systems

The Bank makes a unique contribution to the safe and efficient operation of clearing and settlement systems by providing them with various services, including accounts to settle obligations among participants in these systems and liquidity to system operators and their participants. Thus, the Bank has agreed to act as banker for the CLS Bank, receiving and making payments on its behalf. In addition, the Bank has worked with the CLS Bank and its Canadian participants to provide contingency arrangements should there be operational disruptions in the LVTS or at LVTS participants. Since the CLS Bank began operations, the Bank of Canada, along with the CPA and the CDS, has begun its operational day just after midnight—seven hours earlier than previously.

Examining Systemwide Business-Continuity Planning

The ability of the Canadian financial system to withstand and recover from disruptions in its operations is important not just for system participants, but also for other agents in the economy. Events such as the 1998 ice storm in Eastern Ontario and Quebec, Y2K, and the terrorist attacks of 11 September 2001 in the United States have highlighted the significant degree of interdependence among participants in the financial system with regard to business-continuity plans. In 2002, the Bank began to facilitate discussions among certain financial sector participants regarding the robustness of business-continuity planning in those parts of the financial system that are critically important to the operation of the system and to the economy as a whole. The Bank has also re-examined and enhanced its own contingency arrangements and business-continuity plans.

Promoting International Financial Stability

The Bank continued to be actively involved in developing a framework for the resolution of international financial crises. Of note, an Action Plan published by the G-7 in the spring aimed at increasing the predictability of official policy actions to address problems in emerging-market economies. In the Action Plan, agreement was reached on the need to limit official-sector lending unless clear criteria and procedures are met that justify an exception. The Action Plan also proposed that a two-track approach to facilitate crisis resolution be pursued. One approach would include collective-action clauses in contracts between borrowing countries and lenders, while the second approach would see the adoption of a more formal process, the proposed Sovereign Debt Restructuring Mechanism.

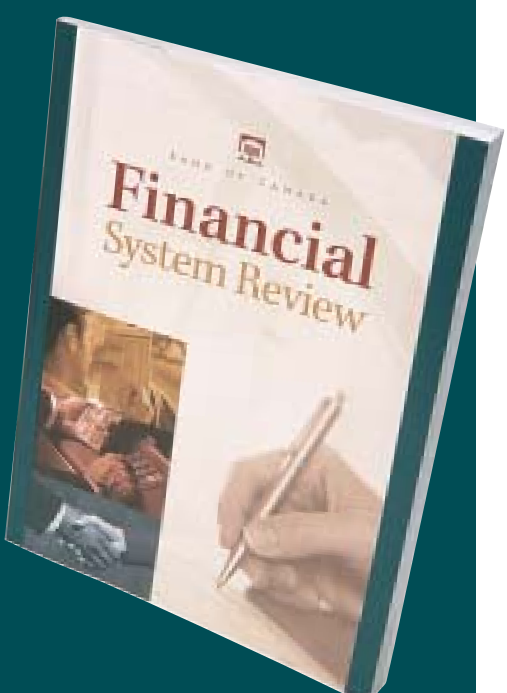
The Bank participates in several international groups that work on international financial-stability issues, including the G-20 and the Financial Stability Forum (FSF). In 2002, the G-20, which met in India in November, focused on globalization issues, as well as on crisis resolution and combatting terrorist financing. The Bank co-hosted the autumn FSF meeting in Toronto. The FSF promotes international financial stability, the improved

Financial System Research

To meet the objectives of the medium-term plan, the Bank continues to build its capacity to conduct research into financial system issues. In some cases, this work is conducted with researchers from outside the Bank. Recent work has included

- developing models on financial contracting and contagion
- considering the effects of consolidation within the financial sector on market liquidity and systemic risk
- developing models of payments systems that can be used to assess the possibility of systemic-risk events
- examining the behaviour of participants and operational-risk issues in clearing and settlement systems
- documenting and analyzing recent trends in capital markets

One particular focal point has been work aimed at improving data related to Canadian capital markets and research examining the efficiency of Canadian capital markets.



functioning of markets, and the reduction of systemic risk through information exchange and international co-operation in financial supervision and surveillance.

As in previous years, Bank staff provided technical assistance to a number of countries in 2002, and participated in selected Financial System Assessment Programs conducted by the IMF.

Financial Markets

One of the main issues facing financial markets during 2002 was the restoration of confidence in their integrity following the collapse of Enron and other corporate scandals in the United States. The Bank contributed to discussions of this issue through speeches by the Governor and participation in a number of public policy forums.

The Bank also works in partnership with other government agencies and market participants to enhance the functioning of Canadian markets, particularly fixed-income markets. For instance, in 2002, the Bank worked with the Investment Dealers Association of Canada, the Montréal Exchange, and other market participants to enhance the methodology for determining daily interest rate settings. These interest rate settings are, in turn, used to price interest rate derivatives and other financial instruments. The Bank also assisted the Canadian Securities Administrators in their efforts to develop appropriate regulation of alternative trading systems in fixed-income markets and supported the Canadian Capital Markets Association in its efforts to promote straight-through processing in Canadian financial markets.

Funds Management

In its role as fiscal agent, the Bank provides the government with treasury and banking services and also advises the government on the management of the federal public debt. These services aim to meet the government's debt-management objective of stable, low-cost funding.

Providing Treasury and Banking Services and Advice

Debt-management initiatives in 2002 centred on improving the Bank's analytic capabilities in this field and further refining the bond-buyback program. Research was conducted to support a sophisticated simulation-based approach for analyzing debt structure cost and risk trade-offs. Refinements to the bond-buyback program were implemented, following consultations with market participants. These refinements included the introduction of measures enabling investors to exchange outstanding debt issues for new issues of current benchmark securities, as well as an expansion of the basket of eligible bonds in the buyback program. In addition, the time between the deadline for the submission of bids and the release of regular auction results was further reduced this year—from 15 minutes to 10 minutes. This followed a reduction from 30 minutes in 2001.

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 $15 billion, typically rising to the upper end of this range prior to quarterly principal and interest payments. A new investment framework for morning auctions of government cash balances was implemented in 2002. It involves the use of collateral to facilitate broader participation in the auctions and to reduce exposure to credit risk.

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.

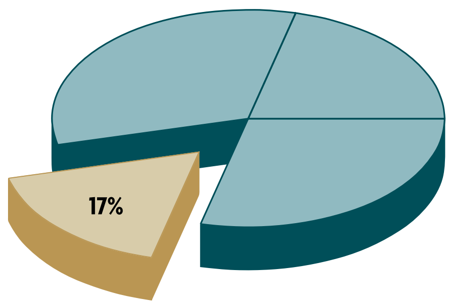
Members of the public can use the search facility on the Bank's Web site at www. bankofcanada.ca to find out if there is an unclaimed balance to which they may be entitled and for information on making a claim. Information on unclaimed balances can also be obtained from any of the Bank's regional offices (see page 70 for addresses), by calling the Bank's toll-free line at 1-888-891-6398, or by e-mail at ucbalances@bankofcanada.ca.

During 2002, financial institutions transferred $31.0 million in unclaimed balances to the Bank. In addition, the Bank handled more than 21,100 general inquiries, completed more than 43,000 searches, and paid a total of $7.5 million to satisfy 6,900 claims.

Foreign exchange reserves are held to provide general liquidity for the government and to provide funds to help promote orderly conditions in the Canadian-dollar foreign exchange market. Foreign exchange reserves stood at US$37.2 billion at the end of 2002, up from US$34.2 billion at the end of 2001, primarily owing to a revaluation resulting from the appreciation of the euro against the U.S. dollar. Work in this area was directed at three large initiatives. The first was the renewal of the government's standby arrangements with foreign banks. The others were aimed at improving risk management in the portfolio of the Exchange Fund Account. One project involved implementing a new collateral-management framework, including the development of a repo program, to better manage the credit risk associated with the government's exposure to financial institution counterparties in its cross-currency swaps, forward contracts, and deposit investments. The other project saw the start-up of a new system for trading, portfolio management, risk management, and accounting in the Exchange Fund Account.

Operating Expenses

Central Banking Services Activities as a Proportion of Total Bank Expenses



Operating expenses for central banking services were $41.0 million in 2002, or about 17 per cent of the Bank's total operating expenses (before restructuring and related expenses). This represents an increase of $9.9 million from 2001, resulting from a number of factors. In 2002, the Bank experienced the first full year of costs arising from improved disaster-recovery arrangements for Bank systems that support the clearing and settlement of financial transactions. Staff resources devoted to financial stability also increased in 2002, and the Bank began publication of the *Financial System Review*. In the area of funds management, the Bank improved its analytic and operational capabilities and expanded its research related to the government's debt-management strategy.

A look at the past: Promotional posters for Canada Savings Bonds during the 1940s and 1950s, Bank of Canada Archives

RETAIL DEBT **SERVICES**

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

Outsourcing Objectives

- Lower overall costs for the retail debt program, while providing the same high-quality service
- Increased flexibility to respond to the changing needs of the program and marketplace, particularly emerging e-business opportunities
- Effective management of all risks associated with the outsourced retail debt operations
- Continued employment and improved job opportunities for most retail-debt-operations staff

As the government's fiscal agent, the Bank is responsible for providing operations and systems-support services, accounting, and advice for the retail debt program. The program is directed by the Department of Finance through its agency, Canada Investment and Savings, which is responsible for product offerings and sales and marketing strategies.

In 2001, the Bank outsourced the operations and systems-support services to EDS Canada Inc. This move was seen as providing more flexible and cost-effective "back-office" services for the retail debt program, while allowing the Bank to maintain its responsibilities as fiscal agent. And indeed, these outcomes were observed through the first full year of the contractual arrangement. Costs decreased by over 4 per cent, while the stipulated service levels were consistently met. Telephone and Internet infrastructure technologies were enhanced, making it possible to handle increased customer contacts cost-effectively, and a number of initiatives were begun to position the operations to take advantage of the emerging e-business opportunities.

The partnership developed between the Bank and EDS has set the stage for continued success. The risks typically associated with an outsourcing arrangement of this nature have been closely managed, and a significant percentage of the Bank's former staff continue to work for the retail debt business, ensuring the same high-quality service. The outsourcing objectives will continue to provide a road map for measuring the success of this business.

Operating Expenses

Operating expenses for retail debt services were $70.3 million, or 29 per cent of the Bank's total operating expenses (before restructuring and related expenses). The Bank's retail debt operations were outsourced in September of 2001 to EDS Canada Inc. Expenses in 2002 decreased by $3.3 million from 2001, reflecting savings generated from the new arrangement. All the expenditures required to support the retail debt program are recovered from the federal government.

Retail Debt Activities as a Proportion of Total Bank Expenses