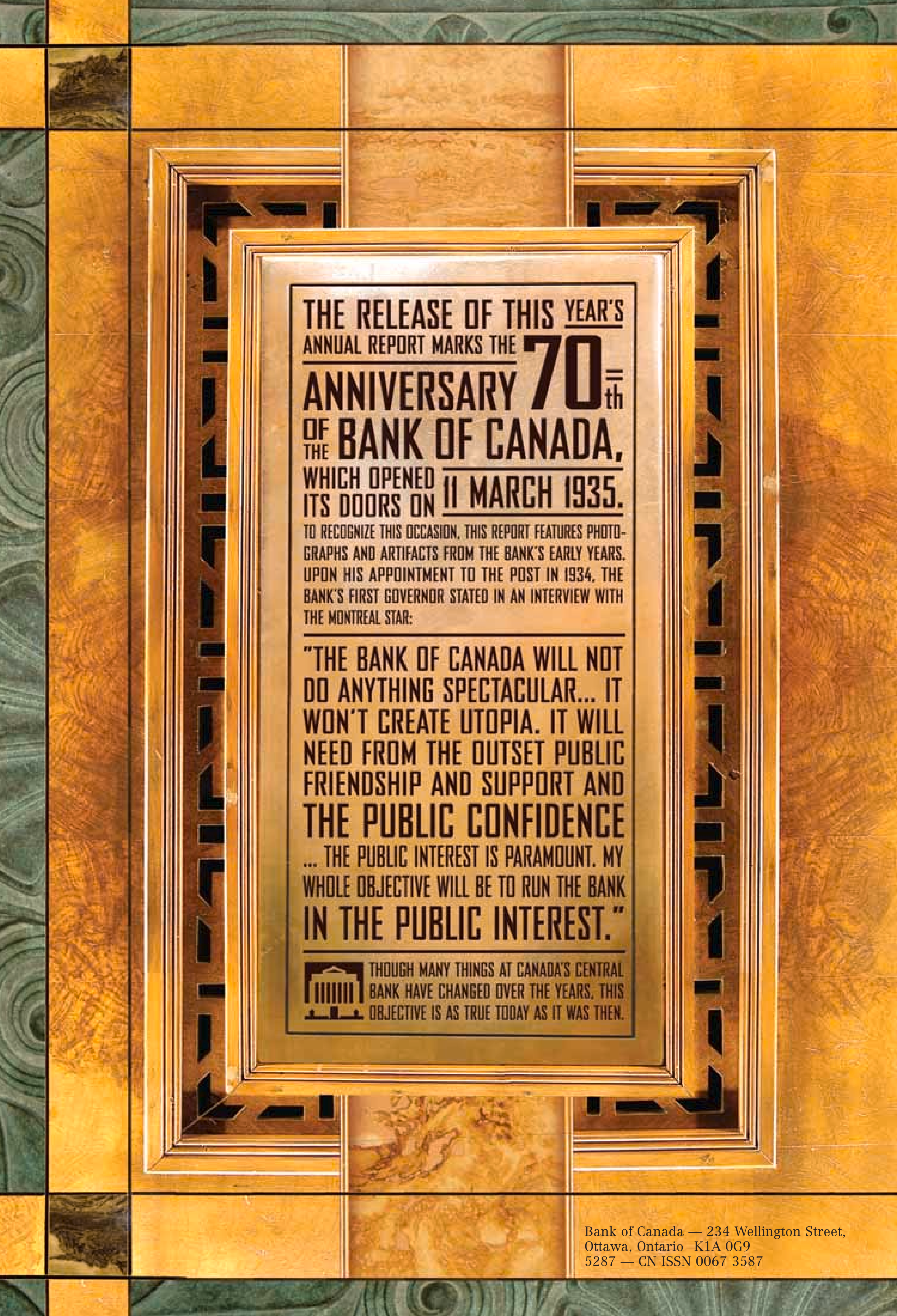
CELEBRATING 70 YEARS 1935–2005

BANK OF CANADA ANNUAL REPORT

2004



Bank of Canada — 234 Wellington Street,
Ottawa, Ontario K1A 0G9
5287 — CN ISSN 0067 3587

Bank of Canada · Banque du Canada

Ottawa K1A 0G9

David A. Dodge
Governor - Gouverneur

23 February 2005

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

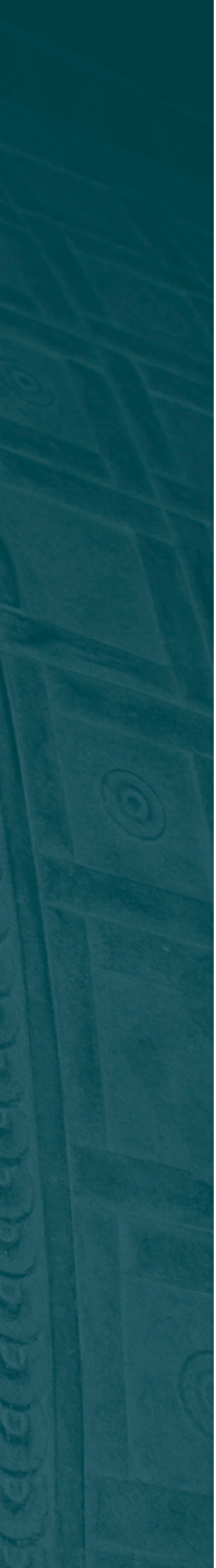
Dear Mr. Goodale,

In accordance with the provisions of the Bank of Canada Act, I am submitting the Bank of Canada's *Annual Report* for the Year 2004 and the Bank's audited financial statements as at 31 December 2004.

Yours sincerely,

OUR COMMITMENT TO CANADIANS

- To contribute to the economic well-being of Canadians by
  - conducting monetary policy in a way that fosters confidence in the value of money
  - promoting the safety and soundness of Canada's financial system
  - supplying quality bank notes that are readily accepted without concerns about counterfeiting
- To provide efficient and effective central banking and debt-management services
- To communicate our objectives openly and effectively and to be accountable for our actions



This year's cover features the new $20 and $50 notes. Depicted on the back of the $20 note are four works by Haida artist Bill Reid chosen to illustrate the note's theme of arts and culture. The theme of the $50 note, nation building, is illustrated by the statue of Canada's Famous Five, a depiction of the 1929 newspaper headline "Women Are Persons," the Thérèse Casgrain volunteer award, and an excerpt from the Universal Declaration of Human Rights.

MESSAGE FROM THE GOVERNOR

The Bank of Canada has played an integral role in Canadian society for 70 years. When the Bank opened its doors in the spring of 1935, this country was struggling to define itself and to survive the economic and social turmoil of the Great Depression. Like Canada's economy, its central bank has evolved and grown over the years. It has faced critical challenges and embraced change. But the Bank's mandate has not changed. It is now, as it was then, to provide an effective, national monetary authority for Canada.

As we celebrate our 70th anniversary, we are reflecting on our role at the centre of Canada's economy, on the improvements we continue to make, and on our evolution as a public institution. In this message, I want to reflect on the progress that the Bank is making on its medium-term plan—an ambitious agenda for leadership that we mapped out in 2002.

In 2004, the Bank reached the midpoint of the medium-term plan, which sets out our strategic priorities for fulfilling policy requirements and corporate responsibilities. Throughout 2004, the Bank remained focused on achieving the outcomes identified in the plan. As described in greater detail in the stewardship sections of this report, we invested in a number of the Bank's core responsibilities, further strengthened our leading-edge research and analysis, worked with other agencies to support the safety and efficiency of Canada's financial system, and continued to improve the effectiveness of operations across all our business lines.

We have every reason to believe that, by the end of 2006, we will have achieved our plan's strategic objectives.

This message reviews some of the highlights from 2004 and briefly addresses some of the key issues facing the Bank and the economy as we look ahead.

Monetary Policy

Promoting the economic and financial welfare of Canada has always been the central part of the Bank's mandate, and our conduct of monetary policy is our most important tool in fulfilling that mandate. The experience of the past 70 years has taught us that monetary policy best contributes to solid economic performance and rising living standards for Canadians by keeping inflation low, stable, and predictable.

The Bank of Canada's top-calibre research and analysis program supports our monetary policy objectives. Improving our research capacity is one of the goals of our medium-term plan, because solid research is the basis upon which we conduct monetary policy that continues to meet our mandated goals.

We have learned that monetary policy is more effective when Canadians understand what their central bank is doing and why. Therefore, we devote considerable effort to communicating our objectives and explaining our actions so that we stand accountable to Canadians.

In 2004, we continued to focus on keeping supply and demand in the economy roughly in balance in order to maintain inflation near the 2 per cent midpoint of our target range. A major challenge was the strong appreciation in the value of the Canadian dollar. We spent considerable effort analyzing the impact of this currency movement on the economy and on inflation, in order to take appropriate monetary policy action.

During 2005, our research and analysis will continue to focus on this challenge and on preparing for the renewal of our inflation-targeting agreement with the Government of Canada in 2006.

We will also be closely examining the broad economic forces and trends that Canada will face in the years ahead. For example, the rising economic powerhouses of China and India are integrating rapidly into the global economy. Their rapid growth is creating competitive challenges, as well as new markets and opportunities for Canadian companies.

A related challenge is the buildup of global economic and financial imbalances among countries. The United States is running a massive current account deficit with the rest of the world. Mirroring the U.S. current account deficit are large surpluses elsewhere, particularly in Asia. These global imbalances will be resolved through shifts in the global pattern of saving and consumption and through associated changes in real exchange rates. Adjustment will also be supported by open trade and by fostering stronger growth in industrialized countries. In 2005, the Bank will continue to analyze the implications of these global developments for the international monetary order, and for the Canadian economy and monetary policy in the years ahead.

Financial System

Throughout its history, the Bank has taken a keen interest in promoting a safe and efficient financial system. In the 1950s, the Bank supported the development of domestic money markets. Today, we oversee Canada's major payment, clearing, and settlement systems, with an eye to minimizing systemic risk. We work with federal and provincial agencies, regulators, and market participants to foster the soundness and efficiency of the financial system.

The Bank of Canada is also the "lender of last resort"—the ultimate provider of liquidity to the financial system. In 2004, we updated and published our policies regarding this role in Canada's financial system.

The year 2004 also marked the second full year of publication of our *Financial System Review,* which shares with financial system participants and the

Governor Dodge and Finance Minister Ralph Goodale present a $20 note to Michael Kergin (left), Canadian Ambassador to the United States, in appreciation of permission to use an image of the sculpture *The Spirit of Haida Gwaii* on the new note. The sculpture is located in front of the Canadian Embassy in Washington, DC.

Canadian public the Bank's research, analyses, and judgments on various issues and developments concerning the financial system. Through the *Review,* and through many Bank-hosted workshops and seminars each year, the Bank contributes to greater understanding of such issues and encourages a more informed discussion of policy and developments in Canada and abroad.

During 2005, we will continue to devote research attention to these issues as countries around the world, including Canada, strive to improve financial system efficiency. This involves reducing impediments to the efficient operation of markets and improving the regulations under which markets and financial institutions operate. The Bank of Canada is contributing to this goal by enhancing Canadians' confidence in the value of their money, by reducing risks to the safety and stability of the financial system, by participating in international efforts to improve efficiency, and by drawing attention to areas where policy improvements are needed.

In addition to our responsibilities in Canada's financial system, the Bank of Canada also acts as fiscal agent for the Government of Canada. We manage the government's foreign reserves, treasury, and domestic debt, and provide financial risk management. We have increased our research and analytic capacity in these areas, and have invested in corporate infrastructure to enhance our decision making and risk management.

Currency

In 1935, the Bank of Canada began issuing paper currency. A decade later, we became this country's sole issuer of bank notes. In 2004, we issued new $20, $50, and $100 bank notes to complete the *Canadian Journey* series—the sixth series of bank notes released since 1935. These new high-denomination notes incorporate enhanced security features that make them quick and easy for Canadians to verify and difficult for counterfeiters to copy. Putting three new bank notes into circulation in one year was a tremendous challenge, but it was a crucial step in our continuing fight against counterfeiters. And in May 2005, we will issue an upgraded $10 note in the *Canadian Journey* series, with security features similar to those of the higher-denomination notes.

In 2004, as we launched our new high-denomination notes, we embarked on a cross-country education campaign to help familiarize Canadians with the new security features and how to use them to verify genuine bank notes. In the fight against counterfeiting, the Bank works closely with bank note designers, as well as with its partners in law enforcement, financial institutions, and the retail and hospitality sectors. I'd like to thank all of them for helping to achieve three very successful note launches in 2004. And in 2005 and beyond, we will continue to rely on their expertise, their co-operation, and their outstanding commitment to protecting Canadians and Canada's economy against counterfeiting.

Organization and Management

We continue to strengthen our mechanisms for governance and accountability at the Bank. Ongoing efforts are being made to improve our operational efficiency, to strengthen our planning and risk management, and to promote research excellence. All of this helps us meet our imperative to be effective, open, and accountable to Canadians.

We introduced a new service-delivery system for human resources in 2004, and our Financial Services Department and our Financial Risk Office recently completed their first full year of operation. As well, management sharpened its focus on business-continuity and succession planning.

All of these efforts during 2004 benefited from the continued commitment and leadership of the Bank's Board of Directors. The dedicated men and women on our Board make a real and sustained contribution to our ongoing work to achieve and maintain excellence. We are grateful for their guidance.

There were a few changes in our senior management in 2004. Mark Carney, who was appointed a Deputy Governor in 2003, left the Bank in November 2004 to become Senior Associate Deputy Minister at the federal Department of Finance. We are grateful to Mark for his important contribution to the Bank during his time with us.

To fill the resulting vacancy on the Governing Council, the Board of Directors appointed Tiff Macklem as a Deputy Governor of the Bank. Tiff first joined the Bank in 1984 as an economist and was appointed to increasingly senior positions, including Chief of the Research Department and Adviser to the Governor. Tiff returned to the Bank in December from an executive interchange at the Department of Finance.

The year 2004 also saw the passing of Gerald Bouey, former Bank of Canada Governor. Gerry's outstanding leadership from 1973 to 1987, through one of the most challenging periods in the Bank's history, contributed importantly to the evolution of monetary policy and to Canada's economic growth and development.

Conclusion

The Bank has changed a great deal from 70 years ago, when its first Governor, 37-year-old Graham Towers, and his small staff were busy replacing Dominion bank notes with Bank of Canada notes and wrestling with the effects of the Great Depression. But one thing that has not changed is the professionalism and dedication of the Bank's staff. I am very proud of, and grateful for, their commitment to excellence.

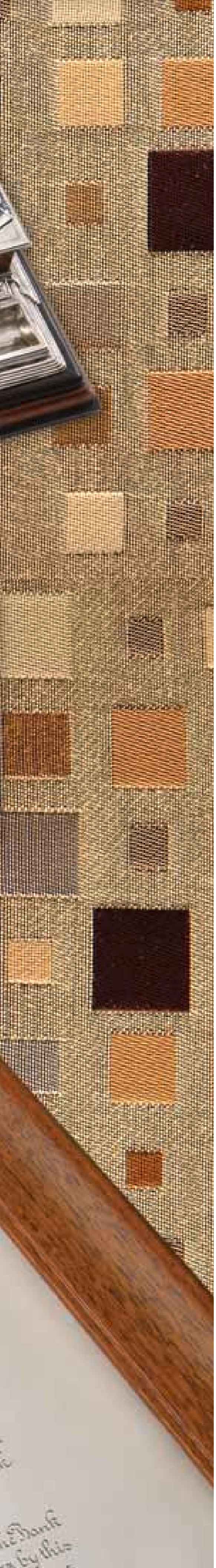
Throughout the changes of the past 70 years, the Bank of Canada's commitment to promoting the economic and financial welfare of Canadians has remained steadfast. In the years ahead, we will continue to evolve and to improve, always with the goal of being second to none among the world's central banks. And, in all that we do, as a workplace and as a public institution at the centre of Canada's economy, we will continue to be accountable to Canadians.

David A. Dodge

ORGANIZATION AND GOVERNANCE

CEREMONIAL SILVER INKWELL
PRESENTED TO THE BANK BY THE BANK OF ENGLAND AND USED TO SIGN CHARTER

CHARTER AUTHORIZING THE BANK OF CANADA
TO COMMENCE BUSINESS, 11 MARCH 1935



THE BUSINESS **OF THE BANK**

The Bank of Canada contributes to the economic well-being of all Canadians by keeping inflation low, stable, and predictable, by supplying safe and secure bank notes, and by promoting a stable and efficient financial system. The Bank is also the Government of Canada's fiscal agent and conducts operations related to the government's foreign exchange reserves and the public debt.

Progress on the Medium-Term Plan

The year 2004 was the second in the Bank's three-year strategic plan. Significant progress was made towards achieving the plan's objectives in the areas of leading-edge research, building partnerships with outside organizations and individuals, improving the security of bank notes, and continuing to increase the Bank's effectiveness as a public institution.

Nevertheless, when taking stock of headway made towards the ambitious objectives of the plan, the Bank decided to extend the plan by another year. This provided an opportunity to review priorities and to determine how resources could be allocated over a longer time frame, while still meeting the plan's objectives.

The promotion of accountability and transparency is very important to the effectiveness of the Bank. Further commitment to this principle was demonstrated by expanding background information about the Bank on the website and by enhancing the policy regarding the disclosure of wrongdoing.

Director Kit Chan speaking at the launch of the $50 note in Calgary.

Director Barbara Hislop in Vancouver at the launch of the new $20 note.

In March, Director Armin Martens (left) and Deputy Governor Pierre Duguay, together with staff from the Calgary regional office, met with representatives of Loewen, manufacturers of windows and doors, at their plant in Steinbach, Manitoba.

CORPORATE GOVERNANCE: **PROVIDING GUIDANCE**

Board of Directors

Under the Bank of Canada Act, the Board of Directors exercises its responsibilities for the governance of the Bank mainly in the areas of finance, human resources, and administration. More specifically, the Board is responsible for appointing and evaluating senior management, overseeing the strategic planning and budget processes, promoting effective corporate governance practices, monitoring internal control frameworks, and providing oversight and advice on how the Bank can best fulfill its responsibilities under the Act. The Governor is responsible for monetary policy and the other business of the Bank.

Board Governance Practices

The Board incorporates best governance practices and works to ensure that all its members are well informed on current issues and best practices in corporate governance. The Board has six standing committees and two advisory groups to deal with matters brought before it for consultation or decision.

- Executive Committee, Chair – David Dodge (Governor)
- Corporate Governance and Nominating Committee, Chair – Spencer Lanthier (Lead Director)
- Human Resources and Compensation Committee, Chair – Daniel Gallivan
- Audit Committee, Chair – Spencer Lanthier
- Planning and Budget Committee, Chair – Aldéa Landry
- Pension Committee, Chair – Paul Jenkins (Senior Deputy Governor)
- Advisory Group on Currency, Chair – Spencer Lanthier
- Advisory Group on Pension Litigation, Chair – James Hinds

To ensure that the Board operates independently of management, the Lead Director chairs private sessions of outside directors at the conclusion of each Board meeting.

Directors are paid according to a fee structure recommended by the government and approved by Order-in-Council. For 2004, the total remuneration to outside directors was $258,300.

Board Stewardship in 2004

In 2004, the Board's Corporate Governance Committee assumed the additional responsibilities of a Nominating Committee consistent with new guidelines by the federal government for the nomination of directors to the Board. The Committee engaged an executive recruitment firm, clarified the process with the respective departments of government, reviewed potential candidates, and made recommendations to the Minister of Finance.

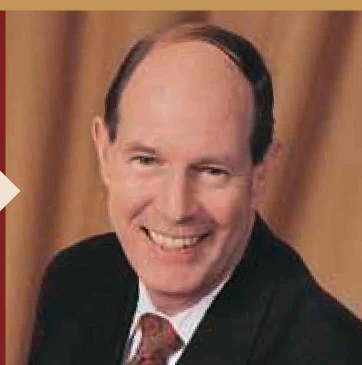
The Board also established a Selection Committee to consider candidates to fill the position of Deputy Governor, following the resignation of Mark Carney, who accepted a position with the Department of Finance. Tiff Macklem was appointed Deputy Governor in December. This process reinforced the importance of the Board's ongoing role in succession planning to ensure effective continuity in the management of the Bank.

The Board guided the Bank's evaluation of its progress towards achieving the objectives of the medium-term plan and supported the extension of the plan for another year through 2006. One initiative, the strategy to improve the security of bank notes, saw many Board members involved in launching three new high-denomination notes. The Board's Advisory Group on Currency was also actively involved in this initiative.

Another initiative in which the Board had a keen interest involved a major change in the approach to the service delivery of human resources. The Board's Human Resources and Compensation Committee monitored the project, which used technology to streamline services, while improving the consistency of their delivery to staff.

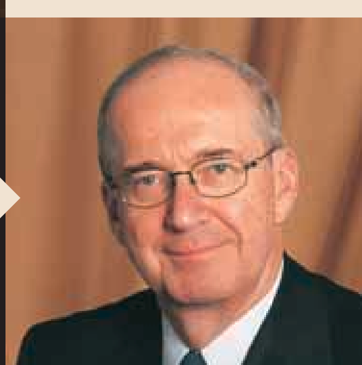
THE BOARD OF **DIRECTORS**

David Dodge
Governor



Paul Jenkins
Senior Deputy Governor

J. Spencer Lanthier
Lead Director
Corporate Director
Toronto, Ontario
Appointed in
March 2000



Kit Chan
President, Canada
Education Inc.
Calgary, Alberta
Appointed in
April 1999

Jean-Guy Desjardins
Chairman and CEO,
Centria Inc.
Montréal, Quebec
Appointed in
March 2003

Paul Dicks
Counsel,
Benson Myles
St. John's, Newfoundland and Labrador
Appointed in December 2002

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

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

Barbara Hislop
President and CEO,
Genus Resource Management Technologies Inc.
Vancouver, British Columbia
Appointed in March 1998

Ronald J. Keefe
President, Diagnostic Chemicals Limited
Charlottetown, Prince Edward Island
Appointed in October 2003

Aldéa Landry
President, Landal Inc.
Moncton, New Brunswick
Appointed in March 1996

Armin Martens
President and CEO,
Marwest Development Corporation
East St. Paul, Manitoba
Appointed in December 2002

Ian E. Bennett
Deputy Minister of Finance
Member *Ex Officio*

Biographical notes on the Directors are available on the Bank's website at: ‹www.bankofcanada.ca/en/manage.htm›.

Two positions were vacant on 31 December 2004.

Governing Council (left to right) Standing: Deputy Governor Pierre Duguay, Senior Deputy Governor Paul Jenkins, Governor David Dodge, Deputy Governor Tiff Macklem. Seated: Deputy Governor Sheryl Kennedy, Deputy Governor David Longworth. The Governing Council takes collective responsibility for monetary policy. The Governing Council, along with the General Counsel/Corporate Secretary (Mark Jewett), the Chief of the Communications Department (Denis Schuthe), and the Adviser responsible for Regulatory Analysis (Clyde Goodlet), make up the Bank's Financial System Committee.

Executive Management Committee (left to right) Standing: Deputy Governor Tiff Macklem, Deputy Governor Sheryl Kennedy, General Counsel/ Corporate Secretary Mark Jewett, Governor David Dodge, Chief of Financial Services Sheila Vokey, Senior Deputy Governor Paul Jenkins. Seated: Adviser on Strategic Planning and Risk Management Janet Cosier, Deputy Governor David Longworth, Deputy Governor Pierre Duguay, Chief of Corporate Services Sheila Niven. The Executive Management Committee is responsible for matters related to the strategic direction and management of all the functions of the Bank.

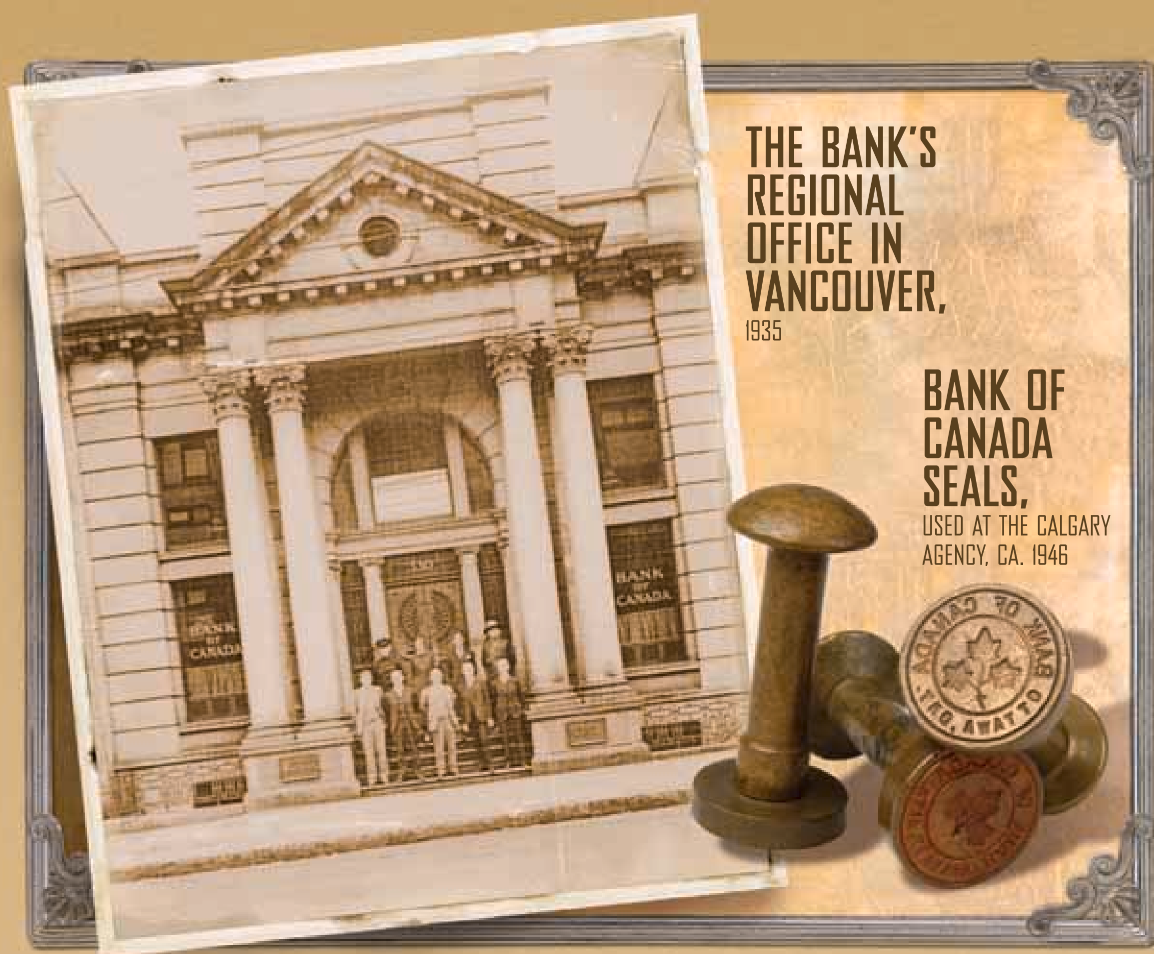
As part of the Board's oversight of financial matters and risk management, several Board members sit on the Pension Committee, which completed its first year of operation in 2004. The Pension Committee is a governance structure for the administration of the Bank's pension plan, as well as for the investment function. The Board also received updates on the Bank's own business-continuity planning, as well as on the Bank's contribution in furthering contingency plans throughout the financial system more broadly.

Part of the Board's broad oversight responsibility includes monitoring the effectiveness of the process for formulating monetary policy. To this end, the Board met in private session with Special Adviser, John Helliwell, an academic well versed in monetary policy, who worked with Bank management for a one-year period ending in July 2004.

Finally, in 2004, the Board continued the annual practice of evaluating its stewardship to ensure that best practices of corporate governance are being achieved.

REGIONAL OFFICES

Over the past year, the Bank's regional offices played a large role in launching three new bank notes and in the related communications initiatives. The work of the regional offices is also featured in a new quarterly publication, the *Business Outlook Survey*. Introduced in 2004, it highlights the results of interviews with about 100 firms across Canada conducted by staff located in Halifax, Montréal, Toronto, Calgary, and Vancouver. As well, the Bank has financial markets representatives in Toronto, Montréal, and New York.



THE BANK'S REGIONAL OFFICE IN VANCOUVER, 1935

BANK OF CANADA SEALS, USED AT THE CALGARY AGENCY, CA. 1946

REGINA AGENCY,
1937

MONTRÉAL AGENCY,
1950

TORONTO AGENCY,
CA. 1937

BUNN TYING MACHINE,
USED TO PACKAGE BANK NOTES AT THE TORONTO AGENCY, CA. 1958

AN ACCOUNT OF

OUR STEWARDSHIP

VICTORIA BUILDING

AT THE CORNER OF WELLINGTON AND O'CONNOR STREETS IN OTTAWA, 1935, WHICH HOUSED THE BANK'S HEAD OFFICE UNTIL 1938

DESK OF BANK'S FIRST GOVERNOR,

GRAHAM TOWERS (BANK OF CANADA ARCHIVES)

MONETARY **POLICY**

"The Canadian economy has delivered solid performance for nearly a decade with increased resilience to economic shocks, demonstrating the benefits of a well-designed macroeconomic framework and the pay-off from a range of structural reforms implemented since the late 1980s."

Economic Survey Canada 2004, OECD, 28 October 2004 (p. 7)

Experience has shown that the best contribution that the Bank of Canada can make to the economic well-being of the country is to pursue a policy of low, stable, and predictable inflation, thereby preserving the value of money and promoting good economic performance. A key element in achieving this goal and in furthering the Bank's accountability to Canadians is the inflation-control target range for the consumer price index (CPI), jointly established by the government and the Bank of Canada. By consistently targeting the 2 per cent midpoint of this 1 to 3 per cent range, the Bank promotes greater economic stability and eliminates the distortions associated with high and unpredictable inflation.

Meeting the Inflation Target

Over the past year, the Canadian economy outperformed most other major industrial economies, despite experiencing a number of external shocks and having to cope with the difficult adjustments that these imposed on many sectors and regions of the country. Employment continued to expand steadily, and the labour force participation rate reached historic highs. Output levels remained close to the economy's production capacity through most of the year, and real GDP growth averaged 2.7 per cent—only slightly below Canada's estimated potential growth rate. Although inflation, as measured by the 12-month change in the total CPI, was volatile and briefly moved below the 1 to 3 per cent target range, most of this movement was caused by swings in world oil prices. Trend inflation, as measured by the Bank's "core" inflation rate, stayed within a relatively narrow range of 1.1 to 1.9 per cent, finishing the year at 1.7 per cent.

Senior Deputy Governor Paul Jenkins (left) and Governor Dodge at a press conference following the release of the October *Monetary Policy Report*

Three major international developments influenced the Canadian economy in 2004. These included a sharp rebound in world economic growth and an associated increase in world commodity prices in the first half of the year; the growing importance of emerging-market economies, such as China and India; and the continuing realignment of world currencies, which saw the Canadian dollar briefly hit a 12-year high of 85 cents (US) before easing to about 83 cents (US) by year-end. These developments have meant considerable adjustment for many sectors of the Canadian economy. The Bank facilitates this adjustment process by aiming to keep inflation at the 2 per cent midpoint of the target range, thereby helping to keep the economy operating at potential.

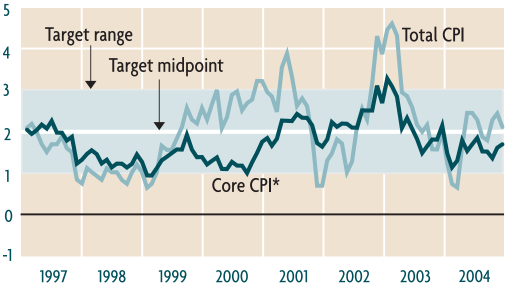
In the opening months of 2004, both total CPI inflation and core inflation were falling, and a modest amount of excess supply had opened up, owing to weaker-than-expected growth in the second half of 2003. The Bank responded by reducing the target overnight interest rate on three occasions, from 2.75 per cent in January to a low of 2 per cent in April. The added monetary stimulus was intended to strengthen domestic demand and support the adjustment of the Canadian economy to international developments, with a view to keeping inflation on target.

Although first-quarter economic growth was marginally weaker than expected and slightly below the Bank's 3 per cent estimate of potential output growth, stronger-than-anticipated growth in exports in the second quarter helped move the economy back close to its production potential by mid-year.

In September 2004, the Bank began removing some of the monetary stimulus provided earlier, as evidence started to emerge of continued strong growth, together with little slack in the economy. These steps were taken in recognition of the long lags associated with monetary policy and were designed to help keep inflation near its 2 per cent target over the medium term. The target overnight interest rate was raised by 25 basis points on 8 September and by another 25 basis points on 19 October, to a level of 2.5 per cent. Subsequently, the Canadian dollar traded in a higher range. Largely reflecting the potential dampening effects of that appreciation, the Canadian economy was expected to operate a little further below its full capacity in 2005 than had been anticipated in October. Against this background, the Bank left its target rate unchanged in December and January.

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

Assessing Domestic and International Developments

Monetary policy decisions depend on the timely and thorough assessment of information drawn from both domestic and international sources. As a relatively small, open economy, Canada is more exposed to international influences than many other industrial economies, and the Bank therefore devotes considerable time to analyzing and forecasting global developments. Some of the information needed for this work is obtained from international meetings organized by institutions and groups such as the Bank for International Settlements, the International Monetary Fund, the Organisation for Economic Co-operation and Development, the G-7, and the G-20, where important issues are reviewed and debated by representatives from around the world. International issues of primary interest during 2004 included the strength and sustainability of the U.S. recovery, the factors underlying recent major currency realignments, the future direction of world commodity prices, and the near-term prospects for continued growth in China and East Asia.

Analysis of international developments is combined with information drawn from the domestic economy to construct a baseline projection for Canada, as well as several alternative risk scenarios. Specific sectors are also monitored and analyzed to produce a more detailed view of the forces operating on the economy and influencing its near-term prospects. To gain a broader perspective on how the economy might evolve, alternative models are constructed using data from financial markets such as monetary and credit aggregates, movements in asset prices, and the interest rate expectations of market participants. Analytic issues that received particular attention in 2004 included the role of commodity prices in the Canadian economy and the impact of the stronger Canadian dollar both on the economy as a whole and on different regions and industrial sectors.

Another important source of information is the survey of business activity that staff in the Bank's five regional offices conduct each quarter. Staff visit approximately 100 firms every three months and ask them a standard set of questions focused on their expectations for sales, employment, investment, and price developments over the next 12 months. Special topics are often identified and explored through additional questions. The Bank began publishing the results of these visits in the spring of 2004 in its *Business Outlook Survey,* along with occasional summaries of information obtained on special topics, such as the effects of the Canadian dollar's appreciation on business operations.

Carrying Out Longer-Term Research

The Bank's staff devotes considerable energy to longer-term research. Although the payoff from this work is not always immediately apparent, the returns—more reliable projections, a better understanding of how the economy works, and a more effective framework for monetary policy—do become evident over time. The Bank's medium-term plan stresses the importance of expanding

THE BANK'S FIRST GOVERNOR, GRAHAM TOWERS, IN HIS OFFICE, 1935. APPOINTED IN SEPTEMBER 1934, TOWERS WAS ONLY 37 YEARS OLD BUT HAD EXTENSIVE EXPERIENCE WITH THE ROYAL BANK BOTH IN CANADA AND ABROAD. HE REMAINED GOVERNOR UNTIL 1954. (BANK OF CANADA ARCHIVES) the range of relevant topics that researchers might pursue and the need to form closer working relationships with outside academics and research institutions. This plan continues to guide the Bank's longer-term research activities and puts particular emphasis on structural and sectoral analyses of the Canadian economy.

In 2004, much of this work fell within the following subject areas: (i) productivity growth and the determinants of potential output; (ii) development of new projection models for the Canadian and U.S. economies; (iii) regional and sectoral effects of exchange rate movements on the Canadian economy; (iv) analysis of the price-setting behaviour of Canadian firms and the influence of inflation targeting on price pass-through; and (v) alternative approaches to explaining and modelling exchange rate movements. A more detailed description of the Bank's research program is available on the Bank's website at <www.bankofcanada.ca/en/fellowship/highlights_res.htm>.

The Bank's annual research conference for 2004, titled "Canada in the Global Economy," examined the real and financial linkages between Canada and the rest of the world. The Bank also hosted seven workshops during the year, four of which

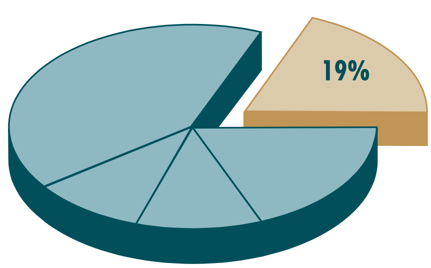
Participants at the November conference, "Canada in the Global Economy"

covered the following monetary policy topics: alternative methods of estimating the neutral rate of interest; dynamic models of the economy and policy-making; housing and the macroeconomy; and alternative techniques for forecasting short-term movements in prices and output. The Bank also sponsored sessions at the annual meetings of the Canadian Economics Association and the Canadian Macroeconomic Study Group, and participated in a joint Bank of Canada/Simon Fraser University/University of British Columbia workshop on "New Directions in Macroeconomics."

Operating Expenses

Operating expenses for the monetary policy function were $54.3 million in 2004, or approximately 19 per cent of the Bank's total operating expenses. This amount was a slight reduction from the $54.6 million in expenses for 2003, reflecting slower hiring than planned.

Monetary Policy Activities as a Proportion of Total Bank Expenses



Working in Partnership with Other Researchers

The Bank's medium-term plan places special emphasis on the research activities of its staff and on encouraging collaborative work with outside academics. The additional resources devoted to these priorities have been reflected in a growing number of research papers, greater participation in conferences, and a more ambitious work program. In 2004, research staff from all the Bank's functional areas made 160 presentations at conferences and workshops—an increase of 44 per cent over 2003. They also worked jointly with 47 external research partners and hosted 55 external lectures. More than 80 papers were published by Bank economists in books, refereed journals, and other public documents.

CURRENCY

In 2004, the Bank issued three new high-denomination bank notes incorporating enhanced security features. These new notes are at the heart of the Bank's strategy to secure Canada's bank notes. Other elements of the strategy involve communication and compliance. The Bank acted to increase counterfeit detection among cash-handlers and the public and partnered with law enforcement to monitor and respond to counterfeiting threats. This three-pronged strategy forms the basis of the Bank's response to the rising threat from counterfeiting brought on by the widespread availability of advanced reprographic technology.

Launching the new $50 note: Flanked by RCMP Corporals Kevin Flood and Sylvain Roussel, Governor Dodge is joined by (left to right) Kim Smith, great, great, grandniece of Henrietta Muir Edwards; Senator Joyce Fairbairn; and Renée Casgrain-Nadeau, daughter of the late Thérèse Casgrain.

Incidence of Counterfeiting

The importance of the Bank's actions is underscored by the increased incidence of counterfeiting, which reached new highs in 2004.

The *number* of counterfeit notes detected in circulation rose significantly to 553,000 notes from 443,000 notes in 2003. The *value* of notes counterfeited rose only slightly, however, to $13 million from $12.7 million in 2003, reflecting a shift to lower-denomination notes. The $20 and $10 notes were the denominations most targeted by counterfeiters. While the vast majority of counterfeits were of notes from the *Birds of Canada* series, first issued in 1986, the $10 note from the *Canadian Journey* series (introduced in 2001) has also been counterfeited in large numbers, and counterfeit $100 notes from a much earlier series (*Scenes of Canada*) appeared in significant quantities in Western Canada. (See box below.)

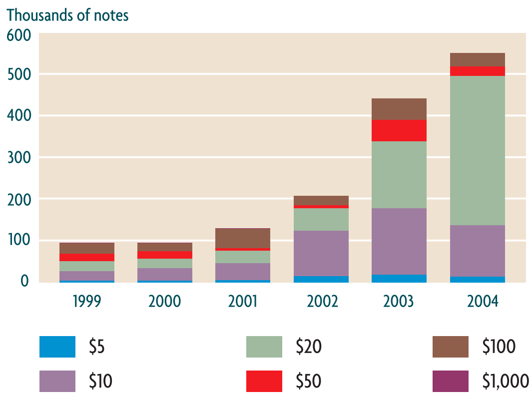
Enhancing Bank Note Security

In 2004, the Bank achieved a major goal by issuing new $20, $50, and $100 notes, which feature four new, sophisticated security elements that are easy to recognize, as well as enhanced ultraviolet (or black light) features. (See page 29.) The $100 note, with its theme of exploration and innovation, was the first high-denomination note to be issued in the *Canadian Journey* series. It was followed in September by the most widely used denomination, the $20 note, with the theme of arts and culture. The $50 note, which features nation building as its theme, was issued in November.

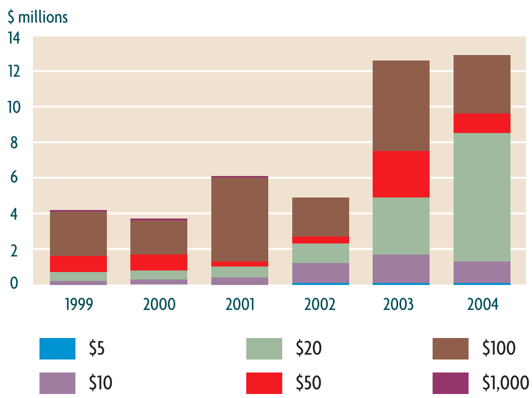
As part of its commitment to strengthen the security of Canadian bank notes, the Bank will issue an upgraded $10 note in May 2005. This note will incorporate security features similar to those used for the high-denomination notes.

In 2004, the Bank began to focus some of its research on the next generation of bank notes. This work will continue over the next several years to help Canada stay ahead of future counterfeiting threats. The Bank will be seeking ways to encourage Canadian research and innovation to support these efforts.

Number of Counterfeit Bank Notes Found in Circulation



Value of Counterfeit Bank Notes Found in Circulation



Counterfeit *Scenes of Canada* Notes

In 2004, counterfeiting of $100 notes from the *Scenes of Canada* series increased significantly. This series, introduced between 1969 and 1979, preceded the series that featured Canadian birds. The Bank estimates that very few genuine $100 notes from this series remain in active circulation. Since these notes do not include optically variable security features, they are less secure than notes from either the *Birds of Canada* or the *Canadian Journey* series and are thus 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.

Security Features on High-Denomination Notes in the *Canadian Journey* Series

1 Holographic stripe

As the angle of the note changes, brightly coloured numerals (100, 50, or 20) 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. The holographic stripe won a commendation from the International Hologram Manufacturers Association for its exceptional clarity and brightness, as well as for its integration in overall bank note design.

2 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.

3 See-through number

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

4 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.

5 Enhanced ultraviolet feature

Under ultraviolet light, the text BANQUE DU CANADA 100 (or 50 or 20) 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 recommends checking more than one feature. To view these features, visit the Bank’s website at ‹www.bankofcanada.ca/en/banknotes›.

Deputy Governor Pierre Duguay introduces the new $100 note at a luncheon talk in Saint-Boniface, Manitoba.

The Bank is also actively involved in various initiatives with other note-issuers and with manufacturers and suppliers of reprographic and note-handling equipment. These collaborative efforts have led to the establishment of a survey of international manufacturers of note-handling equipment that provides information on technological developments. The Bank is a member of three international forums that collaborate on currency-related issues, including the Central Bank Counterfeiting Deterrence Group, established in 1993 by the governors of the G-10 central banks. This group's main task has been to develop a system to prevent personal computers and digital-imaging tools from being used to copy bank notes. The deployment of this system continued in 2004 with its voluntary adoption by several leading manufacturers of hardware and software for personal computers.

Building Awareness of Security Features

The best security features will be effective only to the extent that the public knows how to use them. In 2004, the Bank undertook a national communications campaign directed at ensuring a high level of awareness of the security features on the new $20, $50, and $100 notes among retailers, financial institutions, and law-enforcement agencies. These organizations, in turn, implemented their own programs, using the Bank's initial training and materials. Representatives from the Bank's five regional offices conducted over 700 training and information sessions with over 20,000 participants.

The Bank's Currency Museum continued to play an important role in highlighting historical and contemporary currencies and economic themes, drawing upon significant artifacts in the National Currency Collection. More than 33,000 visitors enjoyed the Museum's exhibitions and school programs in Ottawa, including a new exhibit featuring counterfeit notes produced by the infamous Johnson family in the 1870s and 1880s. An additional 60,000 visitors viewed the Museum's travelling exhibits at various locations across Canada, while the Museum's website received 206,000 visits. In 2004, the Museum won a Canadian Numismatic Association Award for its outstanding contribution to numismatic education in Canada.

Promoting Compliance

The Bank worked with federal, provincial, and territorial Crown prosecutors to develop tools (e.g., an educational video and information resources) to assist prosecutors in dealing with counterfeiters. Each province has appointed a dedicated Crown prosecutor who acts as a channel between the Bank and other Crown prosecutors in their home province.

In 2003, the Bank developed a policy on the reproduction of bank note images. A significant reduction in the unauthorized use of bank note images was observed following implementation of the policy, with strong compliance from the advertising industry.

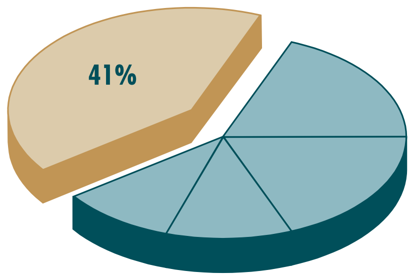
In August 2004, the Bank presented its first Law-Enforcement Award of Excellence for Counterfeit Deterrence at the annual meeting of the Canadian Association of Chiefs of Police in Vancouver. From left to right: Senior Analysts Michael Duncan and John Mackenzie, Senior Deputy Governor Paul Jenkins, Detective Staff Inspector Tony Crawford; award recipients Detective Constable Harjit Sangha, Detective Constable Thomas Hancock, and Detective Carmine Palermo; and RCMP Commissioner Giuliano Zaccardelli.

Operating Expenses

In 2004, operating expenses for the currency function were $115.7 million or approximately 41 per cent of the Bank's total operating expenses. This amount represents an increase of $13.8 million over 2003. The increase is primarily accounted for by the higher cost of producing notes with sophisticated security features.

The new security features have added about 3 cents to the unit cost of bank notes, which prospectively adds about $12 million to the annual note order, once the features are incorporated in the new $10 note. Two other elements of the currency strategy developed in 2001—increased currency education and compliance efforts, as well as increased research and development—have raised annual operating expenses by a further $5 million.

Currency Activities as a Proportion of Total Bank Expenses

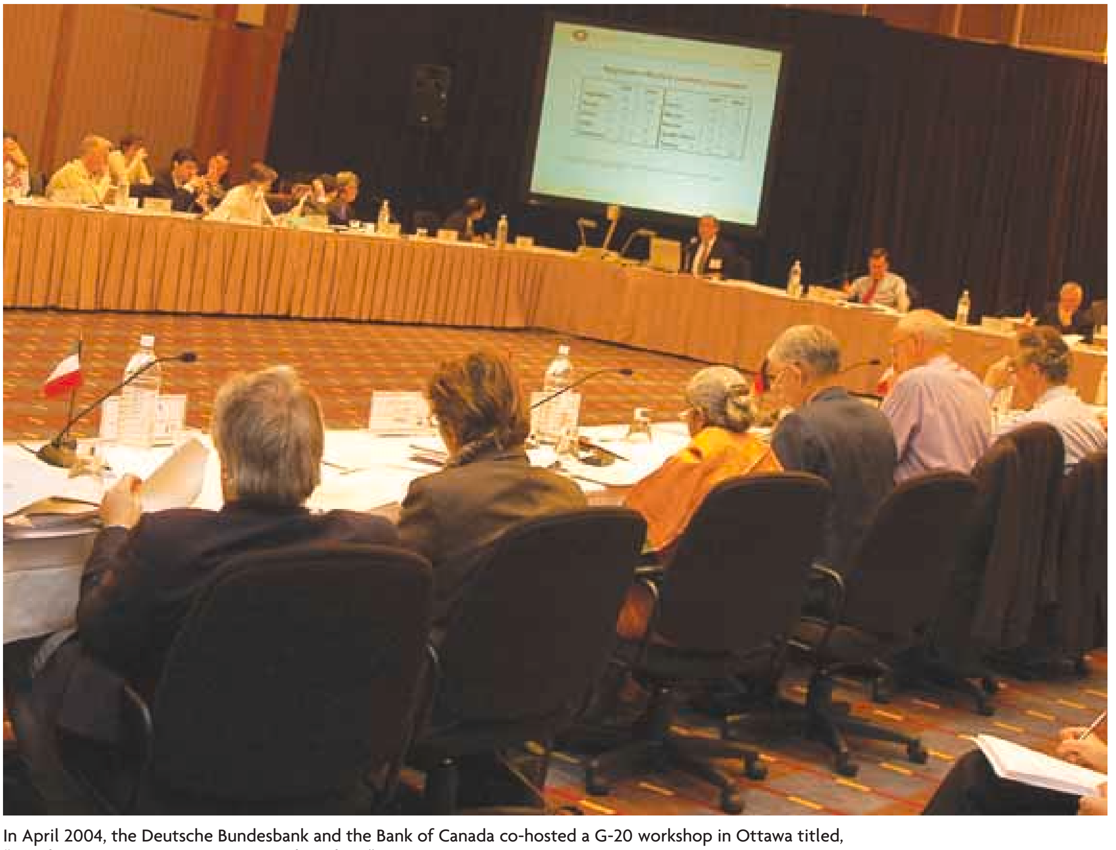


THE FIRST $20 AND $50 NOTES

ISSUED IN 1935 BY THE BANK OF CANADA. THESE FIRST NOTES WERE UNILINGUAL, AND ALL DENOMINATIONS IN THE ISSUE WERE AVAILABLE IN EITHER ENGLISH OR FRENCH. THE FRONT OF THE $20 NOTE FEATURED PRINCESS ELIZABETH, WHILE THE $50 NOTE CARRIED A PORTRAIT OF HER FATHER, PRINCE ALBERT, DUKE OF YORK, WHO LATER BECAME KING GEORGE VI. THE BACKS OF THE NOTES FEATURED ALLEGORICAL FIGURES.

FINANCIAL **SYSTEM**

The financial system is made up of financial institutions, markets, and clearing and settlement systems. Its safe and efficient operation is crucial to economic activity, both in Canada and abroad. The Bank promotes the safety and efficiency of the financial system.



In April 2004, the Deutsche Bundesbank and the Bank of Canada co-hosted a G-20 workshop in Ottawa titled, "Developing Strong Domestic Financial Markets."

Promoting Financial Stability

The Bank of Canada as Lender of Last Resort

In common with central banks around the world, the Bank routinely provides liquidity to facilitate the settlement of payments and also responds to the liquidity needs of financial institutions in exceptional situations.

During the past few years, the Bank has intensively reviewed its policies regarding its role as a lender of last resort. This review was completed in 2004, and the Bank concluded that while no major changes to its policies were needed, a greater degree of transparency was highly desirable. Consequently, a statement of the policies governing its activities as lender of last resort was published in the December 2004 issue of the *Financial System Review*, and an article explaining the background to these policies appeared in the Winter 2004–05 issue of the *Bank of Canada Review.* A separate section on the Bank's role as lender of last resort has also been developed for the Bank's website. This increased transparency regarding this particular role will provide a clearer basis on which the Bank can be held accountable for its actions.

The policies published by the Bank indicate the classes of financial institutions that are eligible for various types of liquidity support; the nature of the situations in which the Bank would consider providing liquidity support; the terms and conditions of such support; and the internal and external processes that the Bank would follow in the provision, monitoring, and termination of any liquidity provided to eligible borrowers.

Controlling Risk in Clearing and Settlement Systems

The Bank is responsible for the oversight of Canada's key clearing and settlement systems. Its objective is to be satisfied that the risk-control mechanisms in these systems virtually eliminate the possibility that a disruption in their operation could have severe repercussions across the financial system and the economy as a whole.

The Bank sees its role as monitoring how these systems control risks, particularly systemic risk, and intervening only when it appears that private sector actions may not produce the appropriate outcome in terms of controlling risks. The Bank

Recent Developments in Major Clearing and Settlement Systems Overseen by the Bank

CDSX: Operated by The Canadian Depository for Securities Ltd. (CDS), CDSX settles virtually all debt and equity trades in Canada. Introduced in 2003, the system successfully completed its year-long transition phase in September 2004. The Bank's oversight work during 2004 focused on proposed enhancements to the system and on proposed changes to the cross-border securities-settlement services offered by CDS.

CLS (Continuous Linked Settlement) Bank: Introduced in 2002, the CLS Bank settles foreign exchange trades in 15 currencies. The volumes and values of trades settled through the CLS Bank continue to grow briskly. During 2004, Canadian banks began to take steps to settle a greater proportion of their eligible Canadian-dollar foreign exchange transactions through the CLS Bank. Four additional currencies were made eligible for settlement in the system in December 2004. A co-operative arrangement of central banks (led by the Federal Reserve Bank of New York and including the Bank of Canada) continues to monitor the operation of the CLS Bank, in particular the mitigation of potential systemic risk.

Large Value Transfer System (LVTS): The Canadian Payments Association (CPA) operates the LVTS, which was introduced in 1999. The system handles large-value or time-sensitive Canadian-dollar payments. During 2004, the volume and value of payments processed continued to grow, partly because of a CPA rule change requiring virtually all payments in excess of $25 million to be made electronically through the LVTS. Previously, these payments could have been made using cheques and were settled in a system that does not have the high-quality risk controls of the LVTS. The Bank of Canada, CDS, and the Canadian Securities Administrators continue to encourage the migration of cheque-based large-value or time-sensitive payments to the LVTS.

relies on private sector system operators and participants for the detailed development and operation of systems that are well designed to control risks and that are operationally robust and efficient. This approach allows the Bank to carry out its oversight activities with a small staff focused on risk issues, while collaborating with the private sector to bring about safe and efficient systems. The Bank's current oversight policies and practices seem to be yielding positive results. Over the past few years, assessments of these key systems by external parties have concluded that they meet or exceed applicable international standards. The Bank continues to review its oversight processes with a view to making further improvements.

As part of its oversight activities, the Bank is developing Memorandums of Understanding (MOUs) designed to govern the relationship between the Bank as the oversight agency and the system operators that are responsible for the safe and efficient operation of these systems. During 2004, the Bank and CDS signed such an MOU.

Business-Continuity Planning for Key Clearing and Settlement Systems

During the past five years, Canada's financial system has faced several events that highlighted the importance of building systems capable of withstanding, or quickly recovering from, a wide range of operational shocks. Key clearing and settlement systems (where transactions worth hundreds of billions of dollars are settled every day) are at the centre of Canada's financial system, and their reliable operation is important not only to their participants, but also to other parts of the economy that rely on them. Business-continuity plans, which lay out the tools and processes available to deal with operational shocks, have received heightened attention from system overseers around the world, including the Bank of Canada.

Following a January 2003 meeting convened by the Bank of Canada to highlight this issue, the CPA and CDS agreed to jointly lead a working group on business-continuity issues associated with the operation of Canada's key clearing and settlement systems. The group completed the first phase of its work in 2004. Phase one formally documented the interdependencies among these systems and the Bank of Canada (which provides them with critical services), completed a detailed threat-assessment analysis, harmonized recovery time frames should a disruption occur, and began a detailed examination of possible improvements to business-continuity plans. Phase two will involve the system participants and their role in keeping these systems operational during a wide range of possible disruptions.

The Bank continuously examines its own business-continuity plans as they relate to the services it provides to key clearing and settlement systems and to the federal government. In 2004, the Bank took further steps to increase the effectiveness of the operations at its backup site and to strengthen its internal and external communications arrangements. It also successfully tested its ability to quickly recover from operational disruptions.

ENTRANCE TO THE BANKING ROOM AT THE OTTAWA AGENCY, 1942

THE BANK'S AGENCIES IN OTTAWA AND ACROSS CANADA CARRIED OUT TRANSACTIONS WITH FINANCIAL INSTITUTIONS, WHICH INCLUDED DISTRIBUTING BANK NOTES AND GOVERNMENT SECURITIES. (PHOTO: YOUSUF KARSH, BANK OF CANADA ARCHIVES)

The Bank and International Financial Stability

During 2004, the Bank continued to support activities designed to promote international financial stability. It participates in international groups, such as the G-7, the G-20, and the Financial Stability Forum, as well as in several Bank for International Settlements committees and working groups. These groups address a wide range of topics related to financial institutions, financial markets, and clearing and settlement systems. The Bank has also contributed to international work on two major issues: the impact and resolution of major trade imbalances and their associated capital movements (often called "global imbalances"); and the impact of China's emergence as a major economic power and its more complete integration into the world's trade and foreign exchange arrangements. Finally, the Bank provides technical assistance to countries by participating in various activities of the IMF, including the Financial Sector Assessment Program.

Promoting Efficiency

An efficient financial system that helps allocate scarce resources to their most productive uses contributes importantly to the economic welfare of Canadians. The Bank supports efficiency in the financial system by maintaining a low, stable, and predictable rate of inflation, and through its promotion of clearing and settlement systems that provide real-time certainty that transactions will settle while economizing on the resources necessary to operate these systems. The Bank also actively fosters financial system efficiency by conducting and publishing research and providing advice to various bodies.

The Bank works actively with other interested parties to promote the efficiency of Canadian financial institutions and markets. It maintains working relationships with regulatory and public sector agencies, as well as with market participants and their associations, to support analysis and research underpinning system-wide efficiency initiatives and to discuss business-continuity planning. The Bank hosts a quarterly meeting to facilitate dialogue among the various regulatory authorities in securities markets, including the Department of Finance, the Office of the Superintendent of Financial Institutions, and members of the Canadian Securities Administrators. The Bank also participates in several international committees that monitor and evaluate current market developments and promote initiatives.

Two significant themes of the Bank's work on the efficiency of Canadian financial markets are integrity and transparency. Through its participation in the Canadian Foreign Exchange Committee and its relationship with the Investment Dealers Association of Canada, the Bank contributed to

Basel II: A Revised Framework for the International Convergence of Capital Measurement and Capital Standards

Over the past six years, the Basel Committee on Banking Supervision has been developing a revised framework for the international convergence of capital measurement and capital standards.[1] The Committee's fundamental objective has been to replace the 1988 Capital Accord with a framework that would further strengthen the soundness and stability of internationally active banks. The Committee expects to generate sufficient international convergence in the regulation of capital adequacy that such regulation will not result in competitive inequality among these banks.

Published in June 2004, the revised framework is based on three pillars: minimum capital requirements, supervisory review of banks' capital adequacy, and greater disclosure to promote market discipline. The G-10 countries are expected to start implementing the revised framework at the beginning of 2007. Other countries will implement the framework as domestic circumstances warrant. In the interim, commercial banks and supervisors are devoting considerable resources to enhancing their systems and processes so that they will be ready to implement the new framework.

1. The Office of the Superintendent of Financial Institutions and the Bank of Canada are both members of the Basel Committee on Banking Supervision.

changes to, and the promotion of, codes of conduct governing behaviour in foreign exchange markets and fixed-income markets. In February, the Bank hosted a workshop to discuss transparency that brought together both Canadians and international academics, regulators, and market participants. The Bank also hosted an initial meeting of the Bond Market Forum, a group of investors, dealers, and service-providers interested in promoting well-functioning fixed-income markets.

Governor Dodge and Director Aldéa Landry with Fellowship recipient Professor René Garcia

Bank of Canada's Fellowship Program

The 2004 Fellowship was awarded to Professor René Garcia of the Université de Montréal, who is internationally recognized for his work in the fields of finance, macroeconomics, and financial economics.

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, as well as additional funds for research assistance and related expenses.

The next Fellowship will be awarded early in 2005.

Research and Communication

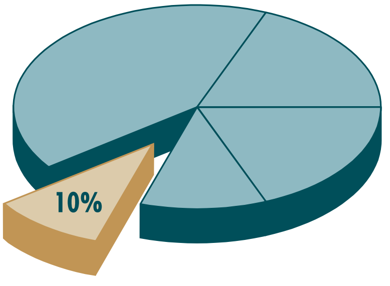
Promoting active debate on issues affecting the financial system is an important aspect of the Bank's work. The *Financial System Review*, first published in December 2002, is becoming an increasingly important vehicle for providing information on topics of interest to market participants, policy-makers, regulators, and academics. The Bank also hosts conferences and workshops to discuss financial system issues. In 2004, workshops were held on the operation of hedge funds in Canada, market transparency, and Canadian fixed-income markets.

During 2004, Bank staff published working papers on various topics related to the financial system. These included an examination of the literature on competition in the banking sector, the potential for cyclicality of bank capital under the proposed Basel II capital framework, capital market issues, and financial conditions indexes for Canada. The Bank also began to work with the Bank of Finland and other central banks to extend the usefulness of a model that simulates the behaviour of participants in a payments system.

Operating Expenses

Operating expenses for the financial system function in 2004 were $26.6 million, approximately 10 per cent of the Bank's total operating expenses. In 2003, expenses for this function were $24.4 million. In accordance with the Bank's medium-term plan, the increase reflects the growing importance of this function as it relates to promoting safe and efficient domestic and international financial systems, with much of the increase related to the redevelopment of the automated systems that support operations.

Financial System Activities as a Proportion of Total Bank Expenses



FUNDS MANAGEMENT

The Bank of Canada's most significant role in the area of funds management is as fiscal agent for the Government of Canada. Its operations, complex business decisions, research and analysis, provision of policy advice, and investment in systems and resources also extend to asset-management activities associated with the Bank of Canada's balance sheet and its pension fund.

Foreign exchange trading room, 1989

Participants at the 2004 Borrowers' Conference

Borrowers' Conference

Maintaining ongoing relationships with stakeholders, including issuers, in domestic debt markets is an important part of the Bank's funds-management activities. The Bank of Canada and the Department of Finance work in partnership with market participants so that debt markets in Canada function well.

In June, the Bank of Canada and the Department of Finance hosted the 2004 Borrowers' Conference. This is an annual forum where issues of mutual interest to government borrowers in Canada are discussed. Hosting of the annual event is shared among borrowers that represent the federal, provincial, and territorial governments across Canada. Topics discussed at this year's conference included policies and strategies for debt issuance, the evolution of electronic fixed-income trading platforms, trends and implications of financial market consolidation, risk management, and straight-through processing of securities trades.

As the government's fiscal agent, the Bank works closely with the Department of Finance and provides banking, treasury, and debt- and reserve-management services. It also operates an independent Financial Risk Office to monitor the risk positions and performance activities of these services. An external review of the governance arrangements overseeing these activities, conducted in 2004, concluded that the framework met the standards of good governance.

Program Changes

The federal government's domestic debt program continued to be guided by efforts to support the liquidity of Government of Canada markets in the face of a declining market debt stock. The focus continued to be on maintaining the liquidity of benchmark bonds through the buying back of less-liquid, older maturities and the increased issuance of benchmark bonds. In addition, a review of the government's debt-distribution framework was initiated in 2004 to assess the effectiveness of the current framework, as well as the impact of potential changes on the breadth and contestability of participation in primary and secondary Government of Canada fixed-income markets.

In line with the government's objective of reducing the share of its fixed-rate debt to 60 per cent by 2007/08, the stock of treasury bills increased marginally to \$117 billion, while the stock of market bonds declined by \$13.5 billion. Despite this decline, gross issuance of benchmark bonds, supported by buyback operations, was roughly \$38.5 billion.

The efficiency of the auction process was enhanced in April 2004 to reduce the length of time that auction participants are exposed to risk. The Bank now releases auction results on a best-efforts basis rather than at a fixed time. The average turnaround time for regular auctions was reduced from 10 minutes to 2.8 minutes and for buyback operations from 15 minutes to 6.9 minutes.

The government's foreign-currency reserves, held in the Exchange Fund Account to provide the government with general foreign-currency liquidity and to provide funds to help promote orderly conditions in the foreign exchange market, decreased by US\$1.8 billion to US\$34.5 billion. The issuance of \$3.1 billion in cross-currency swaps partially offset \$5.9 billion in maturing debt.

Under the direction of the new Financial Risk Office, an enhanced system for reporting on the investment returns and financial-risk exposures of the Exchange Fund Account was implemented on a pilot basis.

Unclaimed Balances

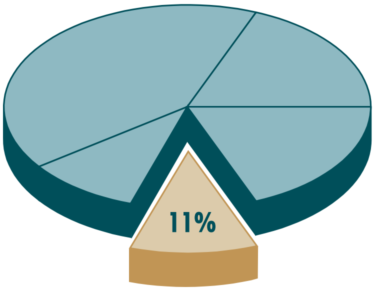
Chartered banks and federally chartered trust and loan companies are required to transfer to the Bank of Canada all unclaimed balances maintained in Canada in Canadian currency that have been inactive for a period of 10 years. The owners of these accounts can have their money returned once they provide the Bank with proof of ownership.

During 2004, financial institutions transferred $33 million in unclaimed balances to the Bank. There were about 47,000 general inquiries, and the Bank paid a total of $11.1 million to satisfy 8,500 claims.

Operating Expenses

Operating expenses for the funds-management function in 2004 were $31.3 million, approximately 11 per cent of the Bank's total operating expenses. This amount represents a moderate increase compared with the $31.0 million in expenses for 2003.

Funds-Management Activities as a Proportion of Total Bank Expenses



Managing the Bank's Balance Sheet

The size of the Bank's balance sheet is driven by the growth of its bank note liabilities. The primary assets held as counterparts to these liabilities are Government of Canada (GoC) securities. In the mid-1990s, these assets consisted primarily of treasury bills that would be available for open-market operations in the implementation of monetary policy. As the framework for the implementation of policy increasingly focused on the overnight interest rate, open-market treasury bill operations were no longer conducted. In 1996, the Bank announced that it would acquire assets under a neutral approach so that its holdings would broadly align with the structure of the government's outstanding stock of domestic marketable debt. This was achieved through a gradual increase in Bank participation at bond auctions and a reduction in its net participation at treasury bill auctions, on a non-competitive basis. The 2003 Federal Budget outlined the plan to reduce the fixed-rate share of government debt from two-thirds to 60 per cent over the medium term. The Bank is consequently adjusting its acquisition of assets at securities auctions. As at 31 December, the Bank's holdings of treasury bills had risen to 31.5 per cent of its holdings of GoC securities, an increase of 1.1 percentage points.

H.L. BECKER FILS & CIE SCALE AND WEIGHTS

USED TO WEIGH GOLD COINS TO VERIFY THEIR GOLD CONTENT, CA. 1935 (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.

Processing war savings stamps, Public Debt Division, ca. 1942 (Bank of Canada Archives)

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.

As fiscal agent for the government, 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 the strategic direction of the business, as well as the management of products, sales, marketing, and public relations.

Achieving Cost-Effective Back-Office Operations

During the past year, the Bank continued to undertake activities that promote cost-effective back-office operations for the retail debt program. Despite ongoing increases in transactions volumes, investments over the past several years were successful in reducing operations costs. In 2004, total costs decreased by $10 million, or 16 per cent on a year-over-year basis.

- The web-based system for inquiries and redemptions, which permits customers who purchase bonds through payroll deductions to carry out transactions directly using a lower-cost process, resulted in 30 per cent of the redemption transactions being handled through self-service.
- The re-tendering in 2003 of the contract for back-office operations for bonds held in registered plans (RRSPs and RRIFs) resulted in a first-year saving of $0.8 million. The transition was completed in 2004, and it is expected that these operations will continue to meet planned cost-saving objectives.
- Anticipated cost reductions were achieved in accordance with the contract for outsourced operations signed in 2001 with EDS Canada.

In 2004, greater emphasis was placed on initiatives intended to improve cost-effectiveness and on mandatory operational changes. The move to The Canadian Depository for Securities Ltd. of the register for retail debt holdings sold and held on behalf of customers by investment dealers was completed. This strategic initiative uses the existing processes and infrastructure of the investment-dealer community and moves the business towards greater use of non-certificated debt. Savings are anticipated to begin next year, and a payback on the investment will take approximately 2 years, almost a full year less than the original estimate.

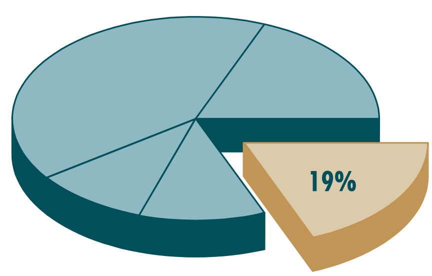
Program Evaluation

As part of its regular Treasury Evaluation Program, the Department of Finance is currently assessing the Retail Debt Program. In the context of a continuing Canada Savings Bonds Program, efforts are focusing on ways to update the program to meet the evolving needs of the government and of Canadians.

Operating Expenses

Operating expenses for retail debt services were $53.8 million, or 19 per cent of the Bank's total operating expenditures. Expenses in 2004 decreased by $10 million, or 16 per cent on a year-over-year basis, reflecting a combination of efficiency gains from outsourced operations and the introduction of cost-effective innovations.

Retail Debt Activities as a Proportion of Total Bank Expenses



FINANCE MINISTER DOUGLAS ABBOTT

DRAWS A LETTER TO DETERMINE WHICH GROUP OF WAR LOAN BONDS WILL BE CALLED FOR REDEMPTION. LOOKING ON ARE (LEFT TO RIGHT) DR. W. CLIFFORD CLARK, DEPUTY MINISTER OF FINANCE, GOVERNOR GRAHAM TOWERS, AND G. LOWE, DEPARTMENT OF FINANCE. (1949, BANK OF CANADA ARCHIVES)

MEDAL PRESENTED TO GOVERNOR TOWERS IN 1946

FOR HIS SERVICE ON THE NATIONAL WAR FINANCE COMMITTEE. THE MEDAL WAS PRODUCED FROM NAVAL AND AIR EQUIPMENT USED IN THE SECOND WORLD WAR. (BANK OF CANADA ARCHIVES)

FINANCIAL **SUMMARY**

MATHEMATON,
(ELECTRIC CALCULATOR) CA. 1932

MONROE CALCULATOR,
1935

REVENUE AND EXPENSES

Revenue from Investments

Total revenue from investments in 2004 was $1.9 billion, down from $2.0 billion in 2003. The main source of revenues is interest earned on holdings of federal government securities. After expenses, the net revenue paid to the Government of Canada in 2004 was $1.7 billion, compared with $1.8 billion in 2003.

Net revenue is not a good indicator of the Bank's management performance. The Bank deals in financial markets to achieve policy goals, not to maximize its revenues. For this reason, the level of operating expenses is a better indicator of the Bank's stewardship of public resources.

Operating Expenses

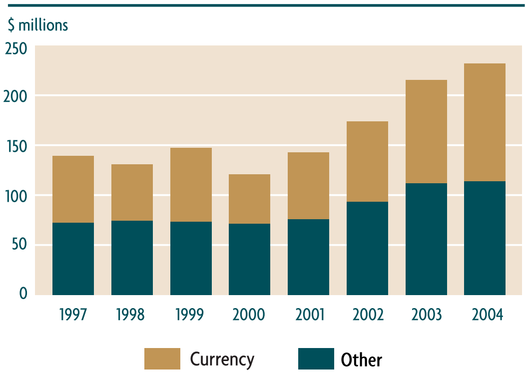
In 2002, the Bank developed a medium-term plan, which set out its strategic priorities for meeting policy requirements and corporate responsibilities. Throughout 2004, the Bank remained focused on delivering the outcomes consistent with this plan. As noted earlier in this report, this included investments in a number of the Bank's core responsibilities, as well as working to continue to improve the effectiveness of its operations across all business lines. During the year, the Bank focused on three key areas: the launch of three new, more secure, high-denomination bank notes; the broadening of its research and analysis of macroeconomic and financial issues; and updating the technology that supports its key operational systems.

For the Bank's main functions—monetary policy, currency, financial system, and funds management—total operating expenses in 2004 were $228 million, an increase of $16 million from 2003. Three-quarters of this increase was directly attributable to the bank note order. The remainder of the increase was attributable to the higher cost of salaries and benefits, partially offset by other reductions.

Bank Notes

In response to concerns about bank note security, the Bank has undertaken a three-pronged strategy for securing Canada's bank notes. This strategy includes significant investments in note security, education, and compliance initiatives. During 2004, the increased cost of fulfilling these requirements was approximately $14 million. The direct cost of designing, producing, and shipping the

Operating Expenses
Monetary policy, currency, financial system, and funds management

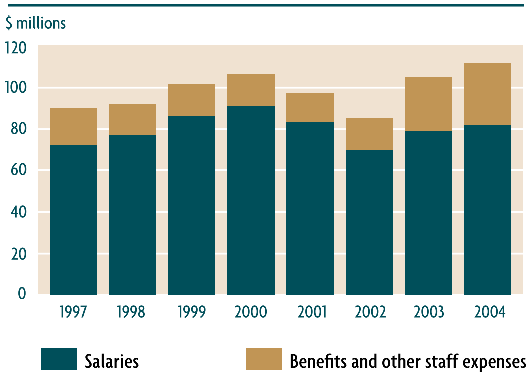


bank notes accounts for $12 million of this increase. The remainder relates to the significant investment in communications and education required for each new note launch. For 2004, the total direct cost of producing bank notes for distribution, which is the largest component of the currency function, was $51 million. This cost is not expected to increase or decrease significantly in 2005.

Salaries and Benefits

The Bank's compensation strategy offers a market-competitive total compensation package aimed at attracting and retaining staff. The Bank's total salary and benefit expenses increased by $7 million from 2003, of which $3 million is attributable to an increased provision for employee future benefits. Three main factors account for the rest of the increase: annual salary increases, which ranged from 2 to 2.5 per cent; a shift towards the skilled resources necessary to broaden the research and analysis conducted to support public policy; and additional requirements for technological staff to support initiatives related to operational systems.

Salaries and Benefits
Monetary policy, currency, financial system, funds management, and retail debt services

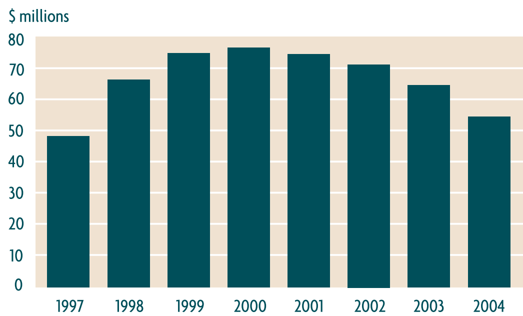


Retail Debt Services

The Bank has provided "back-office" services to Canada Investment and Savings—the agency of the Department of Finance responsible for the government's retail debt program—since the agency's inception in 1996.

In 2004, expenses for retail debt operations continued to decline, as they have done each year since 2001, when the Bank outsourced its retail debt operations to EDS Canada. Direct expenses for the retail debt program, including amounts invoiced by EDS Canada, are recovered from the Government of Canada.

Operating Expenses
Retail debt services



FINANCIAL **STATEMENTS**

(Year Ended 31 December 2004)

BANK OF CANADA

FINANCIAL REPORTING RESPONSIBILITY

The accompanying financial statements of the Bank of Canada have been prepared by management in accordance with Canadian generally accepted accounting principles and contain certain items that reflect best estimates and judgment of management. The integrity and reliability of the data in these financial statements is management's responsibility. Management is responsible for ensuring that all information in the Annual Report is consistent with the financial statements.

In support of its responsibility, management has developed and maintains financial and management control systems and practices to provide reasonable assurance that transactions are properly authorized and recorded, that financial information is reliable, that the assets are safeguarded and liabilities recognized, and that the operations are carried out effectively. The Bank has an internal Audit Department, whose functions include reviewing internal controls, including accounting and financial controls and their application on an ongoing basis.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control and exercises this responsibility through the Audit Committee of the Board. The Audit Committee is composed of members who are neither officers nor employees of the Bank and who are financially literate. The Audit Committee is therefore qualified to review the Bank's annual financial statements and to recommend their approval by the Board of Directors. The Audit Committee meets with management, the Chief Internal Auditor, and the Bank's external auditors who are appointed by Order-in-Council. The Audit Committee has established processes to evaluate the independence of the Bank's external auditors and reviews all services provided by them. The Audit Committee has a duty to review the adoption of, and changes in, accounting principles and procedures that have material effect on the financial statements, and to review and assess key management judgments and estimates material to the reported financial information.

These financial statements have been audited by the Bank's external auditors, Deloitte & Touche LLP and Ernst & Young LLP, and their report is presented herein. The external auditors have full and unrestricted access to the Audit Committee to discuss their audit and related findings.

D.A. Dodge, Governor

S. Vokey, CA, Chief Accountant

Ottawa, Canada

AUDITORS OF THE BANK OF CANADA

AUDITORS' REPORT

To the Minister of Finance, registered shareholder of the Bank of Canada

We have audited the balance sheet of the Bank of Canada as at 31 December 2004 and the statement of revenue and expense for the year then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Bank as at 31 December 2004 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

The financial statements as at 31 December 2003 and for the year then ended were audited by Deloitte & Touche LLP and Raymond Chabot Grant Thornton, General Partnership who expressed an opinion without reservation in their report dated 20 January 2004.

Deloitte & Touche LLP

Ernst & Young LLP

DELOITTE & TOUCHE LLP

Chartered Accountants

ERNST & YOUNG LLP

Chartered Accountants

Ottawa, Canada
21 January 2005

BANK OF CANADA

STATEMENT OF REVENUE AND EXPENSE

Year ended 31 December 2004

(Millions of dollars)

	2004	2003
REVENUE		
Revenue from investments, net of interest paid on deposits of $38.2 million ($42.4 million in 2003)	**1,928.9**	1,971.5
EXPENSE by function (notes 1 and 3)		
Monetary policy	**54.3**	54.6
Currency	**115.7**	101.9
Financial system	**26.6**	24.4
Funds management	**31.3**	31.0
	227.9	211.9
Retail debt services–expenses	**53.8**	63.8
Retail debt services–recoveries	**(53.8)**	(63.8)
	227.9	211.9
NET REVENUE PAID TO RECEIVER GENERAL FOR CANADA	**1,701.0**	1,759.6

(See accompanying notes to the financial statements.)

BANK OF CANADA

BALANCE SHEET

As at 31 December 2004

(Millions of dollars)

ASSETS	2004	2003
Deposits in foreign currencies		
U.S. dollars	**507.2**	532.9
Other currencies	**5.5**	8.4
	512.7	541.3
Advances to members of the Canadian Payments Association	**0.5**	–
Investments (note 4)		
Treasury bills of Canada	**13,628.8**	12,511.2
Other securities issued or guaranteed by Canada maturing within three years	**9,153.9**	8,534.3
Other securities issued or guaranteed by Canada not maturing within three years	**20,408.1**	20,130.5
Other investments	**2.6**	2.6
	43,193.4	41,178.6
Bank premises (note 5)	**129.3**	130.9
Other assets		
Securities purchased under resale agreements	**2,519.1**	1,902.1
All other assets (note 6)	**375.8**	365.0
	2,894.9	2,267.1
	46,730.8	44,117.9

(See accompanying notes to the financial statements.)

LIABILITIES AND CAPITAL	2004	2003
Bank notes in circulation (note 7)	**44,240.6**	42,190.6
Deposits		
Government of Canada	**1,062.7**	533.0
Banks	**382.1**	359.5
Other members of the Canadian Payments Association	**118.8**	140.8
Other deposits	**382.8**	337.2
	1,946.4	1,370.5
Liabilities to the Government of Canada		
U.S. dollars	**383.5**	403.0
Other liabilities		
All other liabilities	**130.3**	123.8
	46,700.8	44,087.9
Capital		
Share capital (note 8)	**5.0**	5.0
Statutory reserve (note 9)	**25.0**	25.0
	30.0	30.0
	46,730.8	44,117.9

D.A. Dodge, Governor

S. Vokey, CA, Chief Accountant

On behalf of the Board

J.S. Lanthier, CM, FCA,
Chair, Audit Committee and Lead Director

A. Landry, Q.C.
Chair, Planning and Budget Committee

(See accompanying notes to the financial statements.)

BANK OF CANADA

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2004

(Amounts in the notes to the financial statements are in millions of dollars, unless otherwise stated).

1. The business of the Bank

The Bank of Canada's responsibilities focus on the goals of low and stable inflation, a safe and secure currency, financial stability, and the efficient management of government funds and public debt. These responsibilities are carried out as part of the broad functions described below. Expenses in the *Statement of revenue and expense* are reported on the basis of these five corporate functions as derived through the Bank's allocation model.

Monetary policy

Contributes to solid economic performance and rising living standards for Canadians by keeping inflation low, stable, and predictable.

Currency

Designs, produces, and distributes Canada's bank notes, focusing on counterfeit deterrence through research on security features, public education, and partnership with law enforcement; replaces and destroys worn notes.

Financial system

Promotes safe, sound, and efficient financial system, both within Canada and internationally.

Funds management

Provides high-quality, effective, and efficient funds-management services for the government, as its fiscal agent; for the Bank; and for other clients.

Retail debt services

Ensures that all holders of Canada Savings Bonds, Canada Premium Bonds, and Canada Investment Bonds have their information registered and their accounts serviced through efficient operations and systems support. The Bank recovers the cost of retail debt operations from the Canada Investment and Savings Agency.

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

2. Significant accounting policies

The financial statements of the Bank are in accordance with Canadian generally accepted accounting principles (GAAP) and conform to the disclosure and accounting requirements of the Bank of Canada Act and the Bank's bylaws. A cash flow statement has not been prepared since the liquidity and cash position of the Bank and other cash flow information regarding the Bank's activities may be derived from the *Statement of revenue and expense* and the *Balance sheet*.

The significant accounting policies of the Bank are:

a) Accounting estimates

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and the notes to the financial statements. These estimates, mostly in the area of pension and other employee future benefits, are based on management's best knowledge of current events. Actual results may differ from those estimates.

b) Revenues and expenses

Revenues and expenses are accounted for on an accrual basis.

c) Employee benefit plans

The Bank sponsors a number of defined-benefit plans that provide pension and other post-retirement and post-employment benefits to its eligible employees. The Bank accrues its obligations under these benefit plans and the related costs, net of plan assets. The costs and the obligations of the plans are actuarially determined using the projected benefit method and using management's best estimate of the expected investment performance of the plans, salary escalation, retirement ages of employees, and expected health care costs.

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

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

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

d) Translation of foreign currencies

Assets and liabilities in foreign currencies are translated to Canadian dollars at the rates of exchange prevailing at the balance sheet dates. Investment income is translated at the rate in effect at the date of the transaction. The resulting gains and losses are included in the *Statement of revenue and expense*.

e) Advances

Advances to members of the Canadian Payments Association are liquidity loans that are fully collateralized and generally overnight in duration. The Bank charges interest on advances under the Large Value Transfer System (LVTS) at the Bank Rate.

f) Investments

Investments, consisting mainly of Government of Canada treasury bills and bonds, are recorded at cost and are adjusted for amortization of purchase discounts and premiums using the constant-yield method for treasury bills and bankers' acceptances and the straight-line method for bonds. The amortization, as well as gains and losses on disposition, is included in the *Statement of revenue and expense* as revenue.

g) Securities Lending Program

The Bank operates a Securities Lending Program to support the liquidity of Government of Canada securities by providing a secondary and temporary source of these securities to the market. These securities-lending transactions are fully collateralized and are generally overnight in duration. The securities loaned continue to be accounted for as investment assets. Lending fees charged by the Bank on these transactions are included in revenue at the date of the transaction.

h) Bank premises

Bank premises, consisting of land, buildings, computer hardware/software, and other equipment, are recorded at cost less accumulated depreciation. Depreciation is calculated using the straight-line method and is applied over the estimated useful lives of the assets, as shown below.

Buildings	25 to 40 years
Computer hardware/software	3 to 7 years
Other equipment	5 to 15 years

i) Securities purchased under resale agreements

Securities purchased under resale agreements are repo-type transactions in which the Bank offers to purchase Government of Canada securities from designated counterparties with an agreement to sell them back at a predetermined price on an agreed transaction date. These agreements are treated as collateralized lending transactions and are recorded on the balance sheet at the amounts at which the securities were originally acquired plus accrued interest.

j) Deposits

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

k) Securities sold under repurchase agreements

Securities sold under repurchase agreements are reverse repo-type transactions in which the Bank offers to sell Government of Canada securities to designated counterparties with an agreement to buy them back at a predetermined price on an agreed transaction date. These agreements are treated as collateralized borrowing transactions and are recorded on the balance sheet at the amounts at which the securities were originally sold plus accrued interest.

l) Insurance

The Bank does not insure against direct risks of loss to the Bank, except for potential liabilities to third parties and where there are legal or contractual obligations to carry insurance. Any costs arising from these risks are recorded in the accounts at the time they can be reasonably estimated.

3. Expense by class of expenditure

	2004	2003
Salaries	**82.1**	79.2
Benefits and other staff expenses	**29.7**	25.7
Currency costs	**58.6**	46.6
Premises maintenance	**20.5**	21.5
Services and supplies	**83.9**	93.4
Depreciation	**17.0**	19.3
	291.8	285.7
Recoveries		
Retail debt services	**(53.8)**	(63.8)
Other	**(10.1)**	(10.0)
Total	**227.9**	211.9

Recoveries represent the fees charged by the Bank for a variety of services.

4. Investments

	2004			2003		
Securities	Amortized cost	Fair value	Average yield %	Amortized cost	Fair value	Average yield %
Treasury bills of Canada	**13,628.8**	**13,634.1**	**2.6**	12,511.2	12,521.3	2.8
Other securities issued or guaranteed by Canada maturing within 3 years	**9,153.9**	**9,480.1**	**5.3**	8,534.3	8,842.5	5.4
Other securities issued or guaranteed by Canada maturing in over 3 years but not over 5 years	**5,910.4**	**6,271.1**	**5.2**	5,760.2	6,147.5	5.6
Other securities issued or guaranteed by Canada maturing in over 5 years but not over 10 years	**8,954.2**	**9,786.5**	**5.7**	9,027.9	9,749.5	5.8
Other securities issued or guaranteed by Canada maturing in over 10 years	**5,543.5**	**6,469.4**	**6.0**	5,342.4	6,026.9	6.2
	43,190.8	**45,641.2**		41,176.0	43,287.7	
Shares in the Bank for International Settlements	**2.6**	**200.4**		2.6	195.1	
	43,193.4	**45,841.6**		41,178.6	43,482.8	

The Bank typically holds its investments in treasury bills and bonds until maturity. The amortized book values of these investments approximate their par values. There were no securities loaned under the Securities Lending Program as at 31 December 2004.

The fair value of securities is based on quoted market prices.

In 1970, the Bank acquired 8,000 shares in the Bank for International Settlements (BIS) in order to participate in the BIS and in international initiatives generally. The shares are not traded, and the fair value has been estimated based on information in the financial statements of the BIS and exchange rates prevailing at the balance sheet dates.

5. Bank premises

	2004			2003		
	Cost	Accumulated depreciation	Net book value	Cost	Accumulated depreciation	Net book value
Land and buildings	**167.5**	**85.0**	**82.5**	167.5	81.6	85.9
Computer hardware/ software	**65.6**	**49.3**	**16.3**	57.7	43.0	14.7
Other equipment	**140.5**	**114.0**	**26.5**	136.8	107.7	29.1
	373.6	**248.3**	**125.3**	362.0	232.3	129.7
Projects in progress	**4.0**	**–**	**4.0**	1.2	–	1.2
	377.6	**248.3**	**129.3**	363.2	232.3	130.9

Projects in progress consists of capital improvements to the head-office building and the upgrade to the note-processing system and other computer systems.

The replacement of the HR service-delivery system was completed in 2004 and is included in the category Computer hardware/software.

6. All other assets

This category includes accrued interest on Canadian investments of $245.9 million ($257.9 million in 2003). It also includes the pension accrued benefit asset of $84.7 million ($78.6 million in 2003).

7. Bank notes in circulation

In accordance with the Bank of Canada Act, the Bank has the sole authority to issue bank notes for circulation in Canada. The denominational breakdown is presented below.

	2004	2003
$5	891.0	826.9
$10	1,018.3	972.1
$20	13,729.7	12,856.2
$50	6,681.9	6,623.3
$100	19,919.6	18,731.5
Other bank notes	2,000.1	2,180.6
	44,240.6	42,190.6

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

8. Share capital

The authorized capital of the Bank is $5.0 million divided into 100,000 shares with a par value of $50 each. The shares are fully paid and, in accordance with the Bank of Canada Act, have been issued to the Minister of Finance, who is holding them on behalf of the Government of Canada.

9. Statutory reserve

The rest fund was established in accordance with the Bank of Canada Act and represents the statutory reserve of the Bank. The statutory reserve was accumulated out of net revenue until it reached the stipulated maximum amount of $25.0 million in 1955.

10. Employee benefit plans

The Bank sponsors a number of defined-benefit plans that provide pension and other post-retirement and post-employment benefits to its eligible employees.

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

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

The Bank measures its accrued benefits obligations and fair value of plan assets for accounting purposes as at 31 December of each year. The most recent actuarial valuation for funding purposes of the Registered Pension Plan was done as of 1 January 2002, and the next required valuation will be as of 1 January 2005.

The total cash payment for employee future benefits for 2004 was $8.6 million ($9.7 million in 2003), consisting of $3.5 million ($3.1 million in 2003) in cash contributed by the Bank to its funded pension plans and $5.1 million (6.6 million in 2003) in cash payments directly to beneficiaries for its unfunded other benefits plans.

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

Plan assets, benefit obligation, and plan status

	Pension benefit plans		Other benefit plans	
	2004	**2003**	**2004**	**2003**
Plan assets				
Fair value of plan assets at beginning of year	**726.8**	639.2	–	–
Bank's contributions	**3.5**	3.1	–	–
Employees' contributions	**7.9**	5.2	–	–
Benefit payments and transfers	**(30.4)**	(26.2)	–	–
Actual return on plan assets	**91.6**	105.5	–	–
Fair value of plan assets at year-end[1]	**799.4**	726.8	–	–

1. The pension benefit plans' assets were composed of 58 per cent in equities, 27 per cent in bonds, 10 per cent in real return investments, 3 per cent in short-term securities and cash, and 2 per cent in real estate assets (unchanged from 2003).

	Pension benefit plans		Other benefit plans	
	2004	**2003**	**2004**	**2003**
Benefit obligation				
Benefit obligation at beginning of year	**663.3**	612.1	**112.7**	106.4
Current service cost	**22.2**	17.7	**4.5**	4.4
Interest cost	**35.2**	33.9	**6.1**	5.8
Benefit payments and transfers	**(30.4)**	(26.2)	**(5.1)**	(6.6)
Actuarial loss	**24.9**	25.8	**8.1**	2.7
Benefit obligation at year-end	**715.2**	663.3	**126.3**	112.7
Plan status				
Excess (deficiency) of fair value of plan assets over benefit obligation at year-end	**84.2**	63.5	**(126.3)**	(112.7)
Unamortized net transitional obligation (asset)	**(88.1)**	(100.6)	**25.8**	29.2
Unamortized cost of amendments	**21.9**	24.2	**4.0**	5.0
Unamortized net actuarial loss	**66.7**	91.5	**25.6**	18.2
Accrued benefit asset (liability)	**84.7**	78.6	**(70.9)**	(60.3)

The accrued benefit asset for the defined-benefit pension plans is included in the balance sheet category *All other assets*. The total accrued benefit liability for the other benefits plans is included in the balance sheet category *All other liabilities*.

Benefit plan expense (income)

	Pension benefit plans		Other benefit plans	
	2004	**2003**	**2004**	**2003**
Current service cost, net of employees' contributions	**14.3**	12.3	**4.5**	4.3
Interest cost	**35.2**	33.9	**6.1**	5.8
Actual return on plan assets	**(91.6)**	(105.5)	**–**	–
Actuarial loss	**24.9**	25.8	**8.1**	2.7
Curtailment loss	**–**	–	**–**	0.1
Benefit plan expense (income), before adjustments to recognize the long-term nature of employee future benefit costs	**(17.2)**	(33.5)	**18.7**	12.9
Adjustments				
Difference between expected return and actual return on plan assets for the year	**48.8**	64.4	**–**	–
Difference between amortization of past service costs for the year and actual plan amendments for the year	**2.3**	2.3	**1.0**	1.0
Difference between amortization of actuarial loss for the year and actual loss on accrued benefit obligation for the year	**(23.9)**	(25.4)	**(7.4)**	(2.3)
Amortization of transitional obligation (asset)	**(12.6)**	(12.6)	**3.5**	3.5
Benefit plan expense (income) recognized in the year	**(2.6)**	(4.8)	**15.8**	15.1

Significant assumptions

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

	Pension benefit plans		Other benefit plans	
	2004	**2003**	**2004**	**2003**
Accrued benefit obligation as at 31 December				
Discount rate	**5.00%**	5.25%	**4.80%**	5.30%
Rate of compensation increase	**4.00% +merit**	4.00% +merit	**4.00% +merit**	4.00% +merit

Significant assumptions (cont'd)

	Pension benefit plans 2004	Pension benefit plans 2003	Other benefit plans 2004	Other benefit plans 2003
Benefit plan expense for year ended 31 December				
Discount rate	**5.25%**	5.50%	**5.30%**	5.30%
Expected rate of return on assets	**6.00%**	6.00%	**–**	–
Rate of compensation increase	**4.00% +merit**	4.00% +merit	**4.00% +merit**	4.00% +merit
Assumed health care cost trend				
Initial health care cost trend rate			**9.63%**	9.63%
Health care cost trend rate declines to			**4.50%**	4.50%
Year that the rate reaches the ultimate trend rate			**2014**	2013

2004 sensitivity of key assumptions

	Change in obligation	Change in expense
Impact of 0.25% increase/decrease in assumptions		
Pension benefit plans		
Change in discount rate	(31.5) / 31.5	(1.7) / 3.4
Change in the long-term rate of return on plan assets	– / –	(1.8) / 1.8
Other benefit plans		
Change in discount rate	(4.9) / 5.2	(0.6) / 0.3
Impact of 1.00% increase/decrease in assumptions		
Other benefit plans		
Change in the assumed health care cost trend rates	16.8 / (12.8)	1.2 / (0.9)

11. Commitments, contingencies, and guarantees

a) Operations

The Bank has a long-term contract with an outsourced service provider for retail debt services, expiring in 2011. As at 31 December 2004, fixed payments totalling $96.6 million remained, plus a variable component based on the volume of transactions. The Bank recovers the cost of retail debt services from the Canada Investment and Savings Agency. Commitments relating to other processing services are $5.6 million, expiring in June 2006.

Commitments related to capital improvements to the head office building totalling $11.2 million are outstanding as at 31 December 2004. The work is expected to be completed in the next year.

b) Foreign currency contracts

The Bank is a participant in foreign currency swap facilities with the U.S. Federal Reserve for US$2 billion, the Banco de México for Can$1 billion, and with the Exchange Fund Account of the Government of Canada. There were no drawings under any of those facilities in 2004 or 2003 and, therefore, there were no commitments outstanding as at 31 December 2004.

c) Investment contracts

Sale investment contracts outstanding as at 31 December 2004, of $2,516.8 million, at an interest rate of 2.50 per cent under special purchase and resale agreements, were settled by 12 January 2005 ($1,899.7 at the end of 2003 at an interest rate of 2.75 per cent).

d) Contingency

The 8,000 shares in the BIS have a nominal value of 5,000 special drawing rights (SDR) of which 25 per cent; i.e., SDR1,250, is paid up. The balance of SDR3,750 is callable at three months' notice by decision of the BIS Board of Directors.

e) Legal proceedings

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

f) Guarantees

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

Large Value Transfer System (LVTS) Guarantee

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

Other Indemnification Agreements

In the normal course of operations, the Bank provides indemnification agreements with various counterparties in transactions such as service agreements, software licences, leases, and purchases of goods. Under these agreements, the Bank agrees to indemnify the counterparty against loss or liability arising from the acts or omissions of the Bank in relation to the agreement. The nature of the indemnification agreements prevents the Bank from making a reasonable estimate of the maximum potential amount that the Bank would be required to pay such counterparties.

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Sheryl Kennedy* **Tiff Macklem***

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Audit

David Sullivan	Chief Internal Auditor

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

Note: Positions as of 31 January 2005

FOR FURTHER INFORMATION ABOUT THE BANK OF CANADA

PUBLICATIONS

Monetary Policy Report* and *Updates
A detailed summary of the Bank's policies and strategies, as well as a look at the current economic climate and its implications for inflation. *Reports* published in April and October; *Updates* published in January and July. Without charge.

Business Outlook Survey
Published quarterly. Without charge.

Financial System Review
Brings together the Bank's research, analyses, and judgments on various issues and developments concerning the financial system. Published semi-annually. Without charge.

Bank of Canada Review
A quarterly publication that contains economic commentary and feature articles. By subscription.

Bank of Canada Banking and Financial Statistics
A comprehensive package of Canadian data. Published monthly. By subscription.

Weekly Financial Statistics
A 20-page package of banking and money market statistics. By subscription.

INTERNET
www.bankofcanada.ca
Provides timely access to press releases, speeches by the Governor, our major publications, and current financial data.

PUBLIC INFORMATION
For general information on the role and functions of the Bank, contact our Public Information Office.
Telephone: 1-800-303-1282
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For information on unclaimed balances:
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Telephone: (613) 782-8248
Email: publications@bankofcanada.ca

BANK OF CANADA REGIONAL OFFICES

Atlantic Provinces
1583 Hollis Street, 5th Floor
Halifax, Nova Scotia B3J 1V4

David Amirault, Senior Regional Representative (Economics)
Josée Nadeau, Senior Regional Representative (Currency)

Quebec
1501 McGill College Avenue, Suite 2030
Montréal, Quebec H3A 3M8

Thérèse Laflèche, Senior Regional Representative (Economics)
Pierre Laprise, Senior Regional Representative (Currency)

Ontario
150 King Street West, 20th Floor, Suite 2000
Toronto, Ontario M5H 1J9

Hung-Hay Lau, Senior Regional Representative (Economics)

5990 Explorer Drive
Mississauga, Ontario L4W 5G3

Paul de Swart, Senior Regional Representative (Currency)

Prairie Provinces, Nunavut, and Northwest Territories
404 - 6th Avenue SW, Suite 200
Calgary, Alberta T2P 0R9

Jean Mair, Senior Regional Representative (Economics)
Ted Mieszkalski, Senior Regional Representative (Currency)

British Columbia and Yukon
200 Granville Street, Suite 2710
Vancouver, British Columbia V6C 1S4

Farid Novin, Senior Regional Representative (Economics)
Lisa Elliott, Senior Regional Representative (Currency)

New York Office
Canadian Consulate General
1251 Avenue of the Americas
New York, NY 10020-1151
U.S.A.

Zahir Lalani, Consul and Senior Representative for the Bank of Canada

Note: Positions as of 31 January 2005