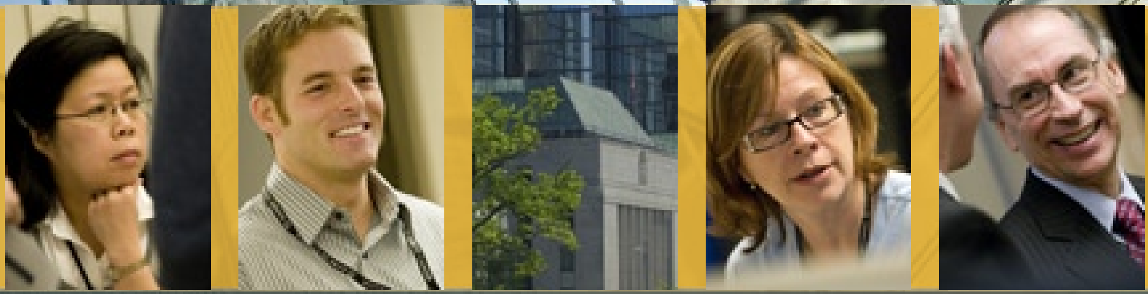
BANK OF CANADA
BANQUE DU CANADA

ANNUAL REPORT 2008



www.bankofcanada.ca

THE BANK'S COMPASS

As a public institution and a workplace, we take our bearings from our commitment to Canadians, to excellence, and to one another.

Our commitment to Canadians

To promote the economic and financial welfare of Canada, we

- conduct monetary policy in a way that fosters confidence in the value of money
- promote the safety and efficiency of Canada's financial system
- supply quality bank notes that are readily accepted and secure against counterfeiting
- provide efficient and effective funds-management services
- communicate our objectives openly and effectively and stand accountable for our actions

Our commitment to excellence

Building on our strengths, we aim to meet our commitment to Canadians through performance that is second to none among the central banks of the world.

We strive for excellence through leading-edge research and analysis, through partnerships within the Bank and with outside organizations, and through

- innovation in all aspects of our work
- leadership that spurs us on to new success
- integrity in our business and in our actions
- diversity of people and ideas

Our commitment to one another

We aim to achieve our best in a workplace where we

- communicate clearly and openly
- share knowledge and experience
- develop our talents and careers
- recognize those who live up to our commitments
- respect one another and our lives outside work

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Ottawa, Ontario K1A 0G9

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BANK OF CANADA
BANQUE DU CANADA

Mark Carney
Governor – Gouverneur

27 February 2009

The Honourable James M. Flaherty
Minister of Finance
140 O'Connor Street
21st Floor
Ottawa, Ontario
K1A 0G5

Dear Minister,

In accordance with the provisions of the Bank of Canada Act, I am submitting the Bank of Canada's Annual Report for the year 2008 and the Bank's audited financial statements as at 31 December 2008.

Yours sincerely,

The Year at a Glance

In a year marked by a severe global financial crisis and an abrupt slowdown in the domestic and global economies, the Canadian financial system stood up remarkably well. The Bank was very active, both in responding to events as they unfolded and in helping with the design of a more sustainable global financial system.

- *The Bank's new Governor, Mr. Mark Carney, began a seven-year term in February.*
- *To mitigate the effects of the financial crisis, the Bank expanded existing liquidity facilities, introduced new facilities, and increased the range of acceptable collateral.*
- *To improve the resilience of the financial system, the Bank participated in various international forums and contributed to the G-7 Action Plan announced in October, as well as to the G-20 process to reform the international financial system.*
- *The Bank kept the overnight interest rate close to its target, with substantial injections of liquidity into the financial system.*

The Bank also made steady progress on the priorities identified in its 2007–09 medium-term plan.

- *Against a backdrop of volatile world commodity prices, CPI inflation averaged close to the 2 per cent control target.*
- *Work continued on a multi-year research program to examine possible improvements to the current inflation-targeting regime.*
- *Research was carried out on a variety of issues to strengthen the Bank's work in monetary policy, the financial system, funds management, and currency.*
- *Counterfeiting declined further, and research and development continued in preparation for the next generation of bank notes, scheduled for issue starting in 2011.*
- *Despite market pressures arising from dislocations in global credit markets, funds-management operations ran smoothly.*
- *The Bank made steady progress in enhancing its information technology infrastructure.*

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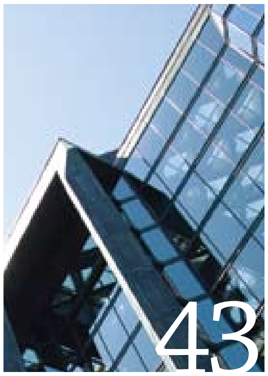

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Message from the Governor

It has been a difficult year. The financial turmoil that began mid-2007 deteriorated into a full-blown global financial crisis through 2008. While the resilience and soundness of the Canadian financial system were in many respects exceptional, the scale of the financial crisis and the subsequent global recession had an increasing impact by year's end on our financial system and our economy.

The Bank of Canada actively managed monetary policy to achieve the 2 per cent inflation target against the backdrop of a deteriorating economic outlook. The Bank intervened with exceptional operations to provide liquidity in order to keep money markets functioning. The Bank's efforts to keep inflation low and stable, and to encourage credit creation to keep the economy moving are described in detail in this report.

At the close of this tumultuous year, it is instructive to consider what went wrong and what the Bank of Canada, other central banks, and national governments can do to prevent future shocks.

Mark Carney, Governor

In hindsight, at least three significant flaws in market structure triggered the turmoil:

- a lack of transparency associated with highly structured products, poorly informed investors, and overreliance on rating agencies;
- misaligned incentives within global financial institutions; and
- inadequate liquidity, reflecting both fundamental concerns about the solvency of counterparties and the procyclicality of collateral margins.

More fundamentally, the crisis has been the inevitable correction of a period of global imbalances. There was excess saving and underconsumption in major emerging markets, and negative saving, rapid credit expansion, and asset-price booms in many western economies. Inflexible exchange rates and an over-reliance on export-led growth in Asia, together with the U.S. response to the bursting of the tech bubble, contributed to persistently low interest rates. The result was enormous risk taking and leverage across markets and currencies, followed by a desperate rush for shelter in 2008.

Few saw these flaws or forecast the paralysis of markets and the failure of financial systems that resulted. Central banks, ministries of finance, and international financial institutions all assumed that risks were being adequately managed or that vulnerabilities lay elsewhere. Banks around the world seemed to comply with, and many exceeded, their regulatory capital requirements. Clearly, though, risks were not being managed properly, and capital was inadequate.

Central banks and national authorities responded with an exceptional degree of coordination to stabilize financial markets, restore the flow of credit, and support global economic growth. In October, the G-7 countries agreed on measures to prevent the failure of any systemically important financial institution and committed to providing sufficient public and private capital to restore confidence. Central banks, for their part, committed to provide exceptional liquidity. These internationally coordinated initiatives of autumn 2008 marked the start of a new degree of public sector involvement in re-establishing the resiliency of banks so that they, in turn, could resume their market-making roles.

The crisis has underscored the critical importance of continuously open markets. The transition from a bank-based to a market-based global financial system has increased the importance of core money markets—including interbank lending, commercial paper, and repo markets for high-quality securities. More than ever, these core money markets must remain continuously open even under stress. In the financial turbulence of the past year, they did not. Especially in economies with weak banks and large non-bank sectors, the massive liquidity provided by central banks did not readily cascade, as it should have, through the financial system and, ultimately, through private credit creation to the real economy. This was partly because non-bank participants—such as money market funds, pension funds, and hedge funds—feared that liquidity might not be continuously available. Structural changes to markets will be needed to restore confidence, including, perhaps, greater use of clearing houses, standardization of margining, and changes in the scale and frequency of central bank liquidity operations.

Perhaps the clearest conclusion to be drawn from the global crisis is that financial regulation has been too narrowly focused on institutions and that there is a crucial need for oversight of the system as a whole. The G-20 has led in finding new approaches to international coordination and regulation that encompass systemically important institutions and the markets. The focus in the future must be on macroprudential surveillance and macroprudential regulation, in order to address the buildup of risks to the financial system and the entire economy. Central banks, with their economy-wide perspective, are well suited to guiding a macroprudential approach, in particular because they have a vested interest in a stable financial system to serve as an efficient transmission mechanism for monetary policy actions.

The consequences of the crisis have been closely integrated into the work of the Bank of Canada. The Bank established a new internal structure in 2008 to focus more clearly on a safe and sound financial system, to streamline management processes, and to strengthen research activities. This new alignment will more effectively link research and policy issues, and it will facilitate an increased emphasis on long-term applied research.

The Bank contributes to the well-being of Canadians by keeping inflation low, stable, and predictable; promoting a stable, efficient financial system; ensuring an adequate supply of bank notes that inspire confidence; and providing efficient and reliable banking services to the Government of Canada and to the financial system. The staff of the Bank are to be commended for never losing sight of these commitments during troubled times.

The underlying strength of the Canadian economy, our solid financial system, and the resiliency of the Bank's inflation-targeting framework should give Canadians confidence that 2009 will mark the start of the recovery and, globally, of drawing lessons from the crisis. In many ways, the year ahead will owe much to the year past.

Governance

The Bank's Mandate

As set out in the Bank of Canada Act, the Bank's mandate as Canada's central bank is to contribute to the economic well-being of Canadians. It does this by aiming to keep inflation low, stable, and predictable; promoting a stable and efficient financial system; supplying secure, quality bank notes; and overseeing key clearing and settlement systems. As the Government of Canada's fiscal agent, the Bank manages foreign exchange reserves, the public debt, and treasury activities.

Corporate Governance

The Bank's corporate governance is guided by the Bank of Canada Act, which defines the roles and responsibilities of the Board of Directors, the Governor, the Senior Deputy Governor, and the federal government.

To fulfill its mandate, the Bank relies on a corporate governance framework based on strategic planning, risk management, transparency, and clear accountability for the priorities established and for the results achieved. The Bank regularly reviews and considers the relevant best practices of other public institutions, central banks, and private sector organizations with a view to continuously improving and achieving excellence in its corporate governance.

The Bank's medium-term plan is central to its corporate governance framework. The Board of Directors approves the strategic direction and the three-year plan that sets the desired goals, priorities, and financial strategies that will drive the Bank's activities during that period. The analysis of risks and key performance measures is integral to the plan and is used to monitor its implementation. The Board conducts an annual review of the Bank's stewardship to evaluate the progress on and achievement of the plan's goals. The Bank is currently developing its new medium-term plan for the period 2010 to 2012.

Risk-management practices are well established at the Bank and are overseen by the Board. The Bank identifies, manages, and monitors business, reputational, financial, operational, and project risks by business function. Senior managers in each function annually assess the key risks that could prevent the Bank from fulfilling its responsibilities and achieving its objectives, and establish measures to mitigate and manage these risks.

Risks and investment performance arising from the management of the government's debt and foreign reserves are monitored and reported. The Bank shares oversight of the results of this monitoring with the Department of Finance, which represents the interests of the government.

The Bank has contingency plans in place that ensure the continuity of critical operations and the safety of staff in the event of a disruption to regular business. Senior managers monitor the risk strategies established, and these are periodically reviewed by the internal Audit Department.

The Bank is committed to transparency, with open and effective communication as a critical component of its corporate governance framework. The Governor and Senior Deputy Governor appear before committees of the House of Commons and the Senate, and they and other senior Bank officials deliver speeches throughout the year. The Bank strives to demonstrate its accountability in achieving its public policy objectives through its extensive publishing program and by posting a wide variety of information and research on its website: <http://www.bankofcanada.ca>.

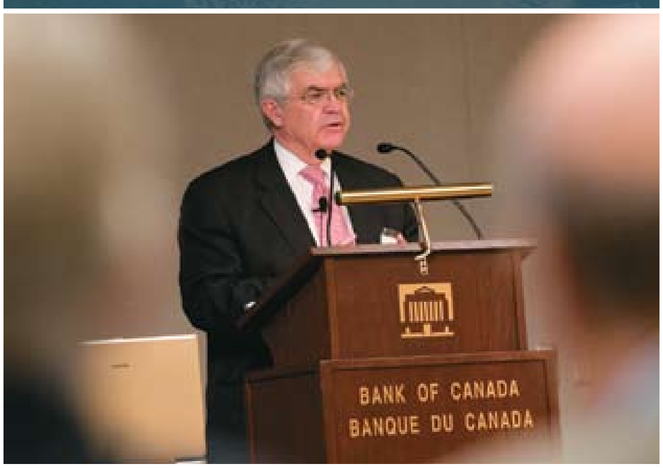
Highlights in 2008

Mr. Mark Carney became Governor upon the retirement of Mr. David Dodge on 1 February 2008. Mr. Dodge was recognized extensively by the financial, government, diplomatic, and academic communities for his contributions to the Canadian public good.

In the second year of its three-year medium-term plan, the Bank focused on its strategic priorities, while adjusting its work plans and allocation of resources so that the Bank could most effectively address the global financial situation. Bank management and the Board of Directors also looked beyond 2009 and began setting the direction for the next medium-term plan.

To better achieve its policy objectives in an increasingly complex economic environment, the Bank of Canada's organizational structure was more closely aligned with its four functions: monetary policy, financial system, currency, and management of the Government of Canada's and the Bank of Canada's funds. The Bank's corporate responsibility and accountability framework was also clarified to support the new structure.

Corporate governance associated with the Board of Directors evolved in 2008. The Board restructured its committees and aligned the terms of reference of the committees and of the Lead Director accordingly.



Professor John B. Taylor of Stanford University delivers the Keynote Address at the Festschrift honouring David Dodge.

Board of Directors

As defined by the Bank of Canada Act, the Board of Directors oversees the management of the Bank and its administrative functions, as well as the process by which the Bank manages its responsibilities. Among other things, the Board is responsible for reviewing succession plans and appointing senior management, approving strategic plans and budgets, promoting effective corporate governance practices, and monitoring internal control frameworks.

The Board is composed of 12 non-executive Directors, the Deputy Minister of Finance (who has no vote but provides an important link with the Department of Finance), the Governor (who by statute is the Chairman of the Board), and the Senior Deputy Governor. The 12 non-executive Directors are appointed by the Minister of Finance (with the approval of the Governor-in-Council) for renewable three-year terms. In 2008, four new Directors joined the Board and attended orientation meetings with Bank staff in order to become familiar with the Bank's functions, operations, and plans.

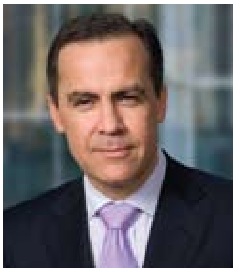
The non-executive Directors elected Mr. William Black as the new Lead Director, following the departure of Mr. Jean-Guy Desjardins. In this role, Mr. Black oversees the corporate governance practices of the Board and the Bank. The Lead Director also chairs private meetings of the non-executive Directors at each Board meeting and leads the Board's annual self-assessment process, an exercise that facilitates a full discussion of the Board's practices and its satisfaction with management's provision of information and support.

The Board modified its Committee structure in 2008, dissolving the Planning and Budget Committee and expanding the role of the Audit Committee to become the Audit and Finance Committee. The Information Technology Committee, which was created for a defined duration to provide a forum for discussion of several specific IT-related issues, was dissolved. There are currently five standing committees, which are summarized in the table on page 11.

In the context of its responsibility for succession planning, the Board made a number of senior management appointments to support the organizational alignment initiative, as well as to fill vacancies created by staff departures.

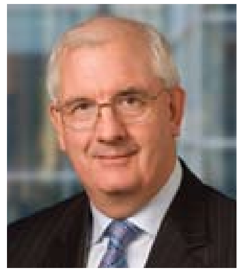
While not responsible for monetary policy, the Board has an oversight role to monitor the effectiveness of the process for formulating monetary policy. To obtain an independent view of this process, the Board met in a private session with Special Adviser Paul Masson, an economist from the Rotman School of Management, whose knowledge and expertise in the area of monetary policy contributed to the Bank's ongoing research program on Canada's inflation target and monetary policy framework during his one-year appointment, ending in August 2008. The Board was also briefed on

Board of Directors



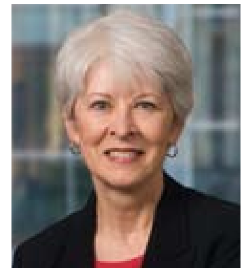
Mark Carney
Governor
Appointed in 2008

Paul Jenkins
Senior Deputy Governor
Appointed in 2003

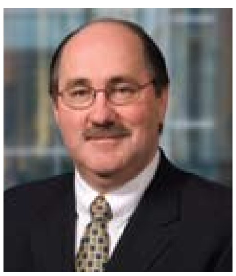


William Black
Lead Director
Corporate Director
Halifax, Nova Scotia
Appointed in October 2006

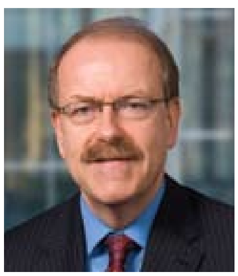
Philip Deck
Chairman and CEO, MKS Inc.
Toronto, Ontario
Appointed in October 2006



Bonnie DuPont
Group Vice-President,
Corporate Resources, Enbridge Inc.
Calgary, Alberta
Appointed in October 2006

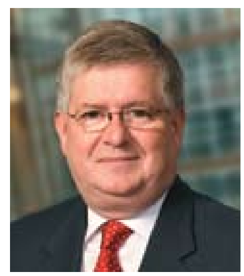


Douglas Emsley
Chairman and President,
Agriculture Development
Corporation
Regina, Saskatchewan
Appointed in June 2007

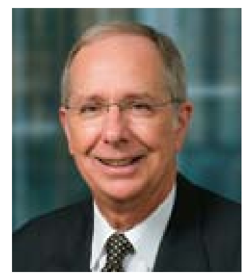


Jock Finlayson
Executive Vice-President, Policy,
Business Council of
British Columbia
Vancouver, British Columbia
Appointed in June 2007

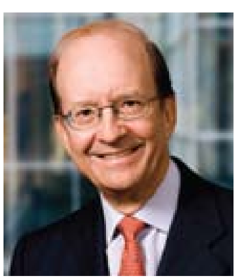
Carol Hansell
Senior Partner, Davies Ward
Phillips & Vineberg LLP
Toronto, Ontario
Appointed in October 2006



Brian Henley
President and CEO
Alec G. Henley & Associates Ltd.
St. John's, Newfoundland
and Labrador
Appointed in March 2008

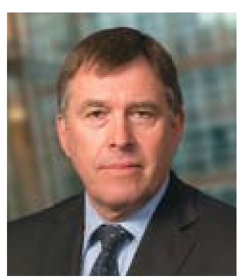


Daniel Johnson
Counsel, McCarthy Tétrault LLP
Montréal, Quebec
Appointed in April 2008

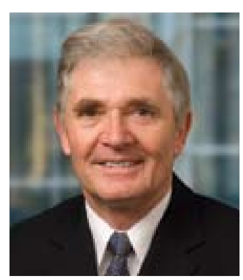


David Laidley
Chairman Emeritus, Deloitte &
Touche LLP (Canada)
Montréal, Quebec
Appointed in June 2007

Leo Ledohowski
President and Chairman,
Canad Inns
Winnipeg, Manitoba
Appointed in March 2008



Richard McGaw
Professor
Department of Economics,
University of New Brunswick
Fredericton, New Brunswick
Appointed in March 2008



Michael O'Brien
Business Advisor,
McInnes Cooper Law Firm
Charlottetown,
Prince Edward Island
Appointed in October 2006

Robert Wright
Deputy Minister of Finance
Member ex officio

Governing Council (left to right): John Murray, Deputy Governor; Pierre Duguay, Deputy Governor; Timothy Lane, Deputy Governor; Mark Carney, Governor; Paul Jenkins, Senior Deputy Governor; David Longworth, Deputy Governor. Inset: Sheryl Kennedy, Deputy Governor

an external evaluation of the Bank's economic research program. (See <http://www.bankofcanada.ca/en/pdf/ext_review.pdf> for details on the external evaluation.)

Directors are paid according to a fee structure established by the government, approved by the Governor-in-Council, and published in the *Canada Gazette*. The total of fees paid to non-executive Directors was $297,005 in 2008, compared with $312,125 in 2007. (See <http://www.bankofcanada.ca/en/about/board.html> for details on Directors' fees and Directors' attendance at meetings.)

Governing Council

Under the Bank of Canada Act, the Governor is responsible for directing Bank business, including monetary policy. In practice, however, the Governor shares this responsibility with fellow members of the Bank's Governing Council: the Senior Deputy Governor and four Deputy Governors. As the Bank's policy-making body, the Governing Council is responsible for decisions related to monetary policy, financial stability, and the strategic direction of the Bank. It works by consensus to formulate, implement, and communicate its policy decisions with the support of the Bank's economics and communications departments.

Governing Council draws on the policy advice and recommendations of two key steering committees: the Monetary Policy Review Committee and the Financial System Review Committee.

The accountability framework for monetary policy is based primarily on the agreement between the Bank and the federal government on the inflation-control target. This agreement, which targets the 2 per cent midpoint of a 1 to 3 per cent inflation-control range, has been renewed four times since 1991, and the current agreement ends 31 December 2011. Monetary policy decisions on the appropriate setting of the policy interest rate consistent with delivering the inflation target over the medium term are normally taken on eight pre-announced fixed dates each year. The decisions are communicated in press releases and in the *Monetary Policy Report* and *Update*, which discuss economic and financial trends in the context of Canada's inflation-control strategy.

***Corporate Management Committee** (left to right): Sheila Vokey, Chief, Financial Services; Colleen Leighton, Chief, Corporate Services; Paul Jenkins, Senior Deputy Governor; Janet Cosier, Adviser on Strategic Planning and Risk Management; Carole Briard, Chief, Information Technology Services; Sheila Niven, Adviser; W. John Jussup, General Counsel and Corporate Secretary; Brigid Janssen, Chief, Communications*

In November, the Board began the selection process for a new Deputy Governor, following the resignation of Sheryl Kennedy to pursue other interests. The process resulted in the appointment of Timothy Lane on 18 February 2009.

Corporate Management Committee

The newly formed Corporate Management Committee (which replaces the Executive Management Committee) is chaired by the Senior Deputy Governor and is responsible for overseeing corporate operations and corporate policy. Composed of the departmental chiefs and advisers associated with corporate administration, it provides leadership and guidance on corporate policies and on management and communication issues.

Management Forum

Consisting of the Governing Council and the Corporate Management Committee, as well as other advisers and department chiefs, the Management Forum is an information-sharing and consultative body concerned with corporate policy and management initiatives.

Committees of the Board of Directors

Committee and Mandate	**Composition** (31 December 2008)
The Executive Committee provides a forum for Bank management to seek advice on broad policy and planning matters relating to the administration of the Bank and makes decisions on behalf of the Board when it is not feasible to convene a full Board meeting. This Committee is provided for in the Bank of Canada Act.	M. Carney (Chair) P. Jenkins W. Black B. DuPont C. Hansell M. O'Brien R. Wright (*ex officio*)
The Corporate Governance Committee reviews the effectiveness of the Bank's governance practices and any relevant governance issues.	C. Hansell (Chair) P. Deck B. DuPont J. Finlayson D. Laidley
The Audit and Finance Committee ensures that the external and internal audit functions are carried out appropriately; reviews the adequacy of the Bank's risk-management, internal-control, and governance frameworks; and oversees the Bank's financial management, including the review of financial statements prior to Board approval and public disclosure.	M. O'Brien (Chair) D. Emsley D. Johnson D. Laidley L. Ledohowski
The Human Resources and Compensation Committee oversees the human resources and compensation functions of the Bank, including its total compensation arrangements and retirement benefits. The Committee also reviews management's succession plan.	B. DuPont (Chair) J. Finlayson D. Johnson L. Ledohowski R. McGaw
The Pension Committee* performs all acts required of the Bank in its capacity as administrator of the pension plan, supplementary pension arrangements, and trust funds.	P. Jenkins (Chair) B. Henley R. McGaw M. O'Brien

** In addition to Board members, the Pension Committee includes three other senior officers of the Bank appointed by the Board.*

Our People and Work Environment

The Bank relies on talented staff to conduct research, monitor and analyze complex issues, provide services, and manage operations. As a knowledge-based organization, the Bank strives to create a superior work environment, one that attracts and engages the best employees to achieve its goals.

Most of the Bank's 1,300 staff work at the head office in Ottawa. About 10 per cent of staff are at operations centres in Montréal, Toronto, and Ottawa, and in small regional offices in Vancouver, Calgary, Toronto, Montréal, and Halifax. Regional staff help the Bank to monitor economic and financial developments across the country and to deliver currency-education programs to retailers, law-enforcement agencies, and financial institutions.

Among the values that staff strive to demonstrate in their day-to-day work are commitments to excellence and to one another as colleagues. Clear and open communication, recognition, respect, and the sharing of knowledge are fundamental to these commitments. They contribute to a workplace in which staff are fully engaged, and where collaborative work and professional growth are part of the job.

The Bank is committed to, and benefits from, diversity, and its staff are drawn from a wide range of backgrounds. The Bank also encourages new ideas and creative approaches to the challenges of work. In 2008, the Bank held a Diversity Day—a celebration of the unique perspectives and talents of its workforce. Staff are supported in learning both official languages, and with about 65 per cent of staff functionally bilingual, both languages are used regularly in the workplace.

As part of its commitment to maintaining an excellent work environment, the Bank administers a regular staff survey. This survey collects the views of staff

In a year of financial turbulence, staff in the Toronto regional office helped the Bank to stay abreast of events. *(Left to right): Seated—Eric Tuer and Jane Voll; second row—Gabriel Imbert-Boyd, Heather Scott-Smith, Imelda Garcia, Mark Caplan, Jane Pinto, Michael Dolega, Nadja Kamhi, and Rob Ogrodnick; absent—Brigid Brady*

on the work environment, and allows the Bank to measure progress and set priorities for future improvement. More than 87 per cent of staff responded to the survey in 2008, demonstrating a high level of engagement within the organization, and the overall results compared favourably with those achieved by other organizations doing similar surveys. The survey showed that organizational strengths included communication, co-worker cohesion, bilingualism, recognition, and the benefits that are part of the Bank's "total compensation" package. Workload and pay were among the areas identified as needing attention.

In addition to striving for a superior work environment, the Bank provides its employees with a competitive total compensation package, together with distinctive learning and development opportunities. Further information about the Bank and career possibilities can be found on the Bank's website at <http://www.bankofcanada.ca/en/hr/index.html>.

Monetary Policy

Desired outcome: *Effective contribution to Canada's solid economic performance and to rising living standards for Canadians*

Strategy: *Keep inflation low, stable, and predictable, guided by a clearly defined inflation target*

Outcome goals: *Achieve a 2 per cent target for inflation and recommend a monetary policy framework that will best support economic performance in the future*

Experience has shown that the best way for a central bank to contribute to economic performance is by keeping inflation low, stable, and predictable. Since 1991, monetary policy actions towards this objective have been guided by a clearly defined inflation target.

Ongoing Work towards Goals and Desired Outcome

Achieving the 2 Per Cent Inflation Target

The conduct of monetary policy was extremely challenging in 2008. Three major global developments had a profound impact on the Canadian economy, making the outlook more uncertain than usual.

First and foremost, the turbulence in global financial markets intensified as the year progressed, culminating in the most severe financial crisis since the 1930s. Second, the global economy slowed markedly and by year-end had entered a recession, led by the contracting U.S. economy, a drying up of capital flows to emerging-market countries, and a marked decline in household and business confidence. Third, commodity prices—most importantly, energy prices—fluctuated sharply, surging to record highs in the summer and then dropping abruptly. This decline, as well as portfolio movements associated with the global financial crisis, led to a sharp drop in the Canadian dollar in the fourth quarter of the year to about 82 cents U.S., compared with 101 cents U.S. at the end of 2007.

In response to the global financial crisis, policy-makers in several major economies, including Canada, took extraordinary steps to provide liquidity to markets and restore credit flows (see page 21). With growing evidence of a pervasive economic downturn, they also lowered policy interest rates to levels that were close to, or below, previous postwar lows and committed to stimulative fiscal policies. In light of rapidly diminishing inflationary pressures, the Bank of Canada lowered its policy rate aggressively by a cumulative 275 basis points in 2008, from a level of 4.25 per cent at the end of 2007, to 1.5 per cent by the end of 2008.

Global economic growth slowed in the first half of the year, particularly in advanced countries, while continuing expansion in emerging-market economies contributed to rising demand for commodities. The resulting sharp run-up in commodity prices led not only to higher global inflation, but also to further improvements in Canada's terms of trade and increases in real national income.

In spite of the support provided by rising commodity prices, the average level of economic activity in Canada over the first two quarters of the year remained essentially unchanged, following modest growth in the second half of 2007. Export volumes fell, and growth in final domestic demand decelerated noticeably. Against a backdrop of subdued domestic inflation, protracted weakness in the U.S. economy, and tighter credit conditions, the Bank lowered the policy rate in January, March, and April, for a total decrease of 125 basis points.

When the Bank published its July *Monetary Policy Report Update*, commodity prices, particularly energy prices, were sharply higher, and the additional boost to income stemming from Canada's strong terms of trade was seen as offsetting the effects of slowing global economic activity, especially the slowdown in the United States. In this context, it was judged that the target for the overnight rate, at 3 per cent, remained appropriate. Total CPI inflation was rising above the 2 per cent target and, assuming that energy prices would follow the prices of energy futures, was projected to move temporarily above the upper end of the inflation-control range before returning to the 2 per cent target in the second half of 2009.

In September and early October, the financial crisis deepened. Credit spreads spiked, certain segments of the market ceased functioning, and various measures of confidence plummeted.

By October, there was growing evidence that the U.S. economy was contracting and that the global economy was headed into recession. In light of diminished inflationary pressures and an intensifying global financial crisis, the Bank lowered its policy rate by 50 basis points on 8 October, in concert with other major central banks, and by a further 25 basis points on 21 October, its regularly scheduled announcement date. In its

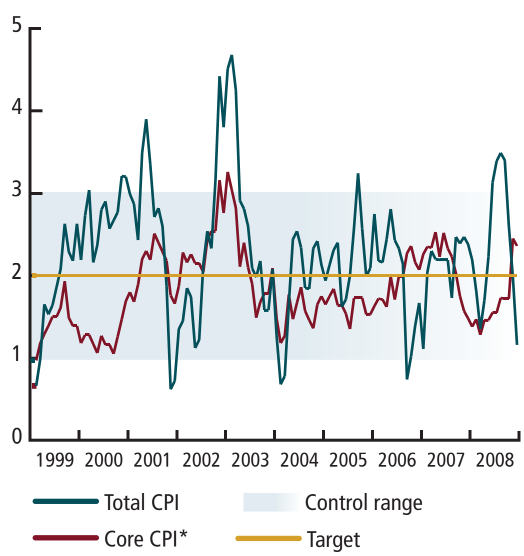
***Senior Deputy Governor Paul Jenkins and Governor Mark Carney** at a press conference following the release of the* Monetary Policy Report

October *Monetary Policy Report*, the Bank noted that economic growth was projected to be sluggish through the first quarter of 2009, as credit conditions had tightened markedly, external demand had decreased, and commodity prices had dropped sharply.

In December, the Bank announced a further 75-basis-point reduction in the overnight rate to 1.5 per cent, noting that the outlook for the world economy had deteriorated significantly, that the global recession would be broader and deeper than previously anticipated, and that global financial markets remained severely strained. Partly offsetting the drag from these developments on the domestic economy were a lower

Consumer Price Index

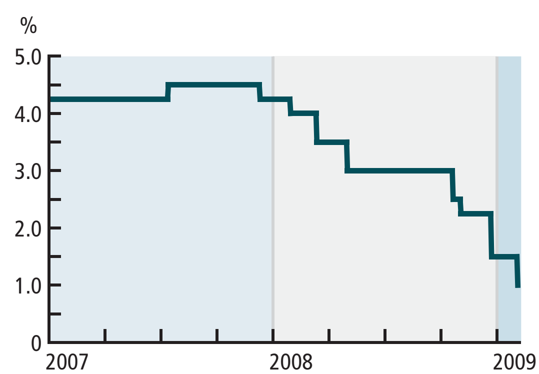
Year-over-year percentage change



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

Official Policy Rate

Daily



Canadian dollar and improvements in money markets and in overall credit conditions.

Total CPI inflation accelerated in the first eight months of 2008, reaching a peak of 3.5 per cent in August under the influence of rapidly rising commodity prices, particularly oil prices. Core inflation, in contrast, remained remarkably steady throughout this period at about 1.5 per cent. In November and December, core inflation jumped to 2.4 per cent, reflecting the elimination of significant discounts in automobile prices. Total CPI inflation fell in the fourth quarter, owing to steep declines in energy prices, ending the year at 1.2 per cent.

Priorities for 2008

- Research the costs and benefits of a lower inflation target and the costs and benefits of a price-level target
- Improve our understanding of the process and implications of globalization
- Carry out a more extensive investigation of real and financial linkages in the monetary policy transmission mechanism
- Analyze sectoral and regional adjustments to large relative-price shocks and other major disturbances
- Reassess potential output growth in the context of changing demographics and shifting productivity trends
- Explore the bounds of transparency and enhance the Bank's communications
- Redesign business processes and undertake other initiatives to support renewal of the analytic computing platform

Progress on Priorities

Research the costs and benefits of a lower inflation target and the costs and benefits of a price-level target

In 2008, the Bank made considerable progress in its multi-year research program designed to determine the potential costs and benefits of (i) targeting a lower rate of inflation and (ii) pursuing a price-level target instead of an inflation target. The Bank has created a special website to share its research on inflation and price-level targeting. It can be accessed at <http://www.inflationtargeting.ca/>.

The Bank's 2008 annual economic conference, "International Experience with the Conduct of Monetary Policy under Inflation Targeting," attracted high-profile international participants and examined many aspects of inflation targeting, including the role of a flexible exchange rate, the impact of external shocks, and the role of communication and transparency. The Bank also helped to organize other conferences and conference sessions on issues related to optimal inflation and price-level targeting, and Bank staff continued to collaborate with external experts on research into these issues.

Overall, the findings to date suggest that the optimal rate of inflation is lower than 2 per cent, but there is no consensus on the benefits of a lowered target or on the transitional costs of moving to a lower target. Models that are more fully developed may provide clearer guidance on these important issues. Recent work also confirmed earlier findings that, under a regime of price-level targeting, inflation expectations can act as a powerful stabilizer of the business cycle. However, the advantage of price-level targeting is uncertain when the economy is subjected to persistent relative-price shocks. Further research is required before firm policy conclusions can be drawn.

Improve our understanding of the process and implications of globalization

An effective understanding of how globalization affects the Canadian economy is vital to sound monetary policy. In 2008, Bank staff continued to examine how China, India, and other emerging-market economies affect global prices, concluding that such effects had been modest. Staff also analyzed how changes in commodity prices affect Canada's terms of trade, concluding that the sharp run-up in commodity prices since 2002 had provided considerable stimulus to final domestic demand and had contributed to improving living standards. Nevertheless, adjustments to this shock had likely contributed to slower growth in aggregate productivity.

Fellowship Program

The Bank of Canada's Fellowship Program is aimed at fostering excellence in research and analysis, as well as at developing partnerships with experts outside the Bank.

The Fellowship Award, established in 2002, provides financial support for individuals undertaking leading-edge research in macroeconomics, monetary economics, international finance, and the economics of financial markets and institutions. Each year, the Bank hosts a Learning Exchange during which Fellowship recipients share their recent research, meet with Bank staff to discuss areas of mutual interest, and confer on future directions for their research.

The Bank of Canada's Research Fellowship for 2008 was awarded to Professor Michael Devereux of the University of British Columbia and Professor Shouyong Shi of the University of Toronto. Both recipients had also received this award in 2003, the first year of the program. Governor Carney noted that "Professors Devereux and Shi are two outstanding economists whose work continues to provide valuable insights and make profound contributions to economic research."

The Governor's Award, launched in 2007, is given to researchers in the relatively early stage of their careers, who are working as assistant or associate professors in economics or business programs at Canadian universities, and who have demonstrated the potential to make exemplary research contributions in areas critical to the Bank's mandate.

Professor Henry Siu of the University of British Columbia, the first recipient of the Governor's Award, is known for his work in macroeconomics. In presenting the award, Governor Carney said that, at this early stage in his career, Professor Siu had "already demonstrated significant accomplishments and shows great promise to make further significant contributions to fields of study that are of interest to the Bank."

Further details about the Fellowship Program are available on the Bank's website at <http://www.bankofcanada.ca/en/fellowship/>.

***Fellowship Award, 2008** (left to right): Professor Shouyong Shi, University of Toronto; Governor Mark Carney; Jock Finlayson, Director and Chair of the Nominating Committee; and Professor Michael Devereux, University of British Columbia*

To help meet the goal of deepening its understanding of key relationships in the global economy, the Bank started work on developing a Global Projection Model in collaboration with the International Monetary Fund.

Further research was also undertaken on factors influencing the exchange rate. This work suggested that while the sensitivity of the Canadian dollar to movements in commodity prices has increased over time, more explicit ways of accounting for developments specific to the United States are required to better explain movements of the Canadian dollar, as well as those of other major currencies.

Carry out a more extensive investigation of real and financial linkages in the monetary policy transmission mechanism

Through research and analysis, the Bank aims for a better understanding of how changes in financial conditions affect key macroeconomic variables, such as output and inflation. As the global financial crisis intensified through 2008, the Bank significantly expanded the breadth and depth of its monitoring of the financial system, with an emphasis on money markets, bank funding costs, and borrowing costs and credit availability for households and non-financial businesses. Work continued on the development of financial accelerator models, which helped provide policy advice on the effects of the financial crisis on the macroeconomy. The Bank's regional offices closely monitored how changes in the availability and price of credit were affecting Canadian businesses.

Analyze sectoral and regional adjustments to large relative-price shocks and other major disturbances

In 2008, the Bank completed a comprehensive review of the sectoral impact of the increase in commodity prices since 2002. The studies demonstrated that the direct impact on aggregate output and employment had been relatively small: first because the commodity sector represents a relatively small share of the economy and, second, because output and employment within the energy sector are slow to react to increased investment, owing to lengthy project-completion times. Indirect

Adviser Agathe Côté speaking at an orientation session for new economists

effects played an important role, however, boosting domestic demand and positively affecting the construction sector, among others.

Reassess potential output growth in the context of changing demographics and shifting productivity trends

Potential output determines the rate at which the economy can grow in a sustainable, non-inflationary fashion. The aging of the baby-boom generation, declining birth rates, and stabilization of the number of women joining the labour force all point to a slowing in the growth of trend labour input over the coming decades. Without an offsetting increase in labour productivity, this implies lower potential output growth. Research conducted in 2008 suggests a low likelihood of a marked increase in trend productivity growth over the near term. Estimates of trend productivity growth underlying the Governing Council's projection for potential output were consequently lowered in the October *Monetary Policy Report*.

Other research sought to develop a better understanding of the factors affecting productivity in Canada. One study found that capital expenditures on information and communications technology, which tend to be lower in Canada than in the United States, have a small, but significant, positive effect on productivity. Another suggested that smaller firms tend to be less productive than larger firms; an important finding for Canada, where, on a relative basis, more people are employed in smaller firms than in the United States.

Improving the Bank's Research Capabilities

Research is critical to meeting the Bank's goals in each of its key functions. As part of a long-term effort to enhance its research capabilities, the Bank initiated an external review of its research in 2007. An external committee of eminent academic and practising research economists was asked to gauge the quality of the Bank's research and to make recommendations for improving the Bank's research environment. The committee reported its findings in 2008.

The committee focused on research that "expands the general state of knowledge" and judged that the research carried out at the Bank of Canada was "of relatively high quality." Not surprisingly, given that the Bank is only halfway through its multi-year initiative to upgrade its research, the committee also concluded that there remains significant room for improvement before the standards of other leading policy-making institutions are met.

The committee's recommendations fell into three general areas. The first related to the setting of priorities and allocation of work. The committee recommended giving research staff greater latitude in choosing research topics, and tailoring the portion of time spent on longer-term research to the interests and capabilities of researchers. The second area concerned organizational considerations. The committee recommended that the Bank's organizational structure be better aligned with its core functions to further support its research capabilities. The third area was the Bank's "career proposition." The committee's main recommendations were to align salaries for the Bank's PhD researchers with those of similar positions at first-tier Canadian universities, and to place greater emphasis on indicators of top-quality research, such as publication in top-ranked journals, as factors in promotion and performance pay.

In its response to the committee's report, the Bank noted the "significant progress" that had already been made in building its research capability, and that "the Bank's research reputation is growing." As mentioned in the Message from the Governor (page 4), the Bank also reorganized its departments and realigned responsibilities in 2008, a change that, among other benefits, will help to focus and strengthen research activities.

The Bank continues to address the challenges of compensation and career progression, and to ensure that researchers have the tools required to carry out high-quality research: the right information technology environment, data, and external partnerships.

The committee's report and the Bank's response to it are available at:
<http://www.bankofcanada.ca/en/pdf/ext_review.pdf>; and
<http://www.bankofcanada.ca/en/pdf/response_research_evaluation.pdf>.

Explore the bounds of transparency and enhance the Bank's communications

In 2008, research was conducted on the market's use of the forward-looking guidance provided in the Bank's policy rate announcements. It concluded that, while such guidance increased the predictability of policy interest rates from the standpoint of market participants, it also led market participants to take less account of relevant economic information in predicting such rates.

To increase the transparency of the monetary policy decision-making process, the Bank launched the publication of a quarterly, web-based *Senior Loan Officer Survey* (SLOS), which is released in conjunction with the *Business Outlook Survey*. The SLOS gathers information on changes to both the price and non-price terms of business lending at major Canadian financial institutions and surveys their views on how changing economic or financial conditions are affecting business lending.

Redesign business processes and undertake other initiatives to support renewal of the analytic computing platform

In 2007, the Bank initiated a major overhaul of its analytic computing infrastructure. Planning for this initiative was completed in 2008. Infrastructure to support the Bank's economic projection work was enhanced, and running times for projections were reduced by more than 80 per cent. A pilot for the "research zone" portion of the analytic computing platform was launched. When completed in 2009, this enhanced component will give Bank researchers access to specialized software and allow them to communicate and share data with researchers outside the Bank more easily.

Priorities for 2009

- *Strengthen current economic analysis and monitoring*
- *Continue research on the monetary policy framework, especially the challenges posed by policy rates approaching zero*
- *Continue research on the linkages between the real economy and the financial system, and incorporate it into forecasting models and monitoring*
- *Implement the recommendations of the External Research Evaluation Committee*

Financial System

Desired outcome: *Contribute to maintaining a stable and efficient financial system in Canada and globally*

Strategy: *Provide essential banking services and influence public sector agencies and private sector behaviour to improve the safety and efficiency of the financial system*

Outcome goals: *Contain systemic risk; produce influential research, analysis, and policy advice; and provide reliable central banking services*

The financial system consists of financial institutions, financial markets, and clearing and settlement systems. The Bank of Canada promotes the safety and efficiency of the financial system by providing central banking services, including liquidity facilities; overseeing key domestic clearing and settlement systems; conducting and publishing research on policy issues affecting the financial system; and by providing advice to various domestic and international policy-making bodies. In July 2008, amendments to the Bank of Canada Act gave the Bank greater flexibility in the provision of liquidity to the financial system.

Ongoing Work towards Goals and Desired Outcome

Promoting a Stable and Efficient Financial System

The crisis

The global financial turmoil that began in August 2007 developed into a crisis in the fourth quarter of 2008, when a series of failures and near-failures of large financial institutions in the United States and Europe led to an acute and broad-based loss of confidence. Wholesale funding markets came to a standstill in many countries, and most bank funding markets ceased to function at terms longer than overnight, or, in Canada's case, a week at most. Yield spreads on corporate bonds widened to all-time highs in October, equity markets experienced steep declines, and foreign exchange volatility increased sharply. As credit conditions tightened and deleveraging continued at many financial institutions, concerns intensified about the effects of financial sector weakness on the global economy.

Response to the crisis

In response to the crisis, governments and central banks—including the Bank of Canada—initiated a series of unprecedented actions aimed at stabilizing the global financial system. On 10 October, the finance ministers and central bank governors of the G-7 nations released a Plan of Action aimed at restoring the flow of credit. The plan committed member nations to take "all necessary steps" to unfreeze credit and money markets by ensuring that systemically important financial institutions would be supported with broad access to liquidity and funding and the ability to raise capital from public, as well as private, sources in amounts sufficient to re-establish confidence. The plan was later reinforced with a clear timetable of commitments at the G-20 summit in November.

The Bank of Canada responded aggressively by expanding its provision of liquidity through an increase in term purchase and resale agreements, by widening the range of eligible collateral, by extending the range of counter-parties, and by introducing new lending facilities (see page 21).

Bank of Canada Liquidity Responses to the Financial Crisis

Liquidity is vital to well-functioning financial markets. In 2008, as in the second half of 2007, the Bank was very active in defending the overnight interest rate. However, the erosion of liquidity in key markets in 2008, especially after mid-September, prompted many central banks to expand the range of their liquidity facilities. The Bank of Canada made two types of changes in 2008:

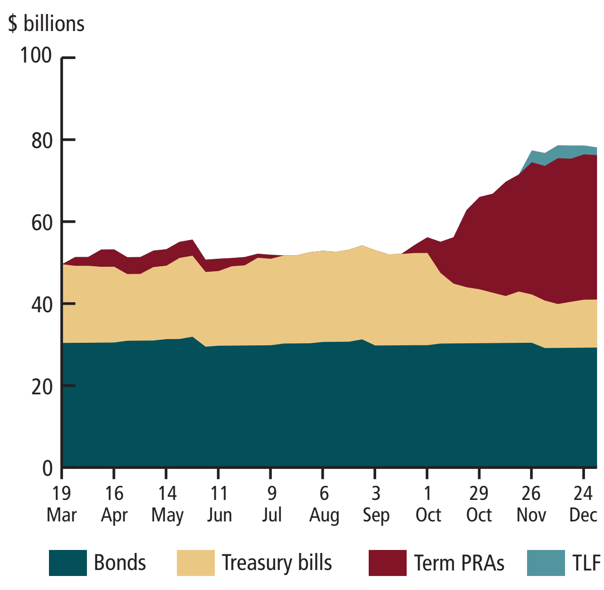
Expansion of existing, and introduction of new, liquidity facilities

- *Facilities for term purchase and resale agreements (PRAs) were expanded from $4 billion (par value) in the spring to over $35 billion by year-end; eligible counterparties were expanded to include participants in the Large Value Transfer System (LVTS); and the frequency of auctions was increased from biweekly to weekly.*
- *A money market term PRA was introduced that can be accessed by eligible money market participants on an indirect basis through primary dealers.*
- *A Term Loan Facility (TLF) was introduced for LVTS participants, with non-mortgage loan portfolios used as collateral.*

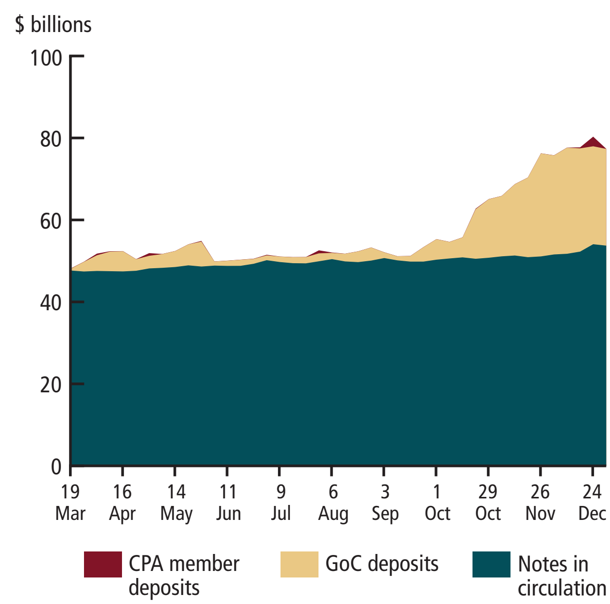
Changes to acceptable securities or collateral

- *The list of securities eligible for term PRAs was broadened, and asset-backed commercial paper from affiliated issuers was accepted on a temporary basis.*
- *General assignment of non-mortgage loan portfolios was accepted as LVTS collateral at the Standing Liquidity Facility on a temporary basis.*

Bank of Canada Assets, 2008



Bank of Canada Liabilities, 2008



The provision of term liquidity involved a substantial expansion of the Bank of Canada's balance sheet, but its effect on the monetary base was neutralized by an increase in Government of Canada (GoC) deposits.

The federal government also took steps to improve the access of banks and other financial institutions to funding, with a view to supporting their continued lending to consumers, homebuyers, and businesses. It implemented a program to purchase up to $75 billion of insured mortgages, which was later raised to $125 billion in the 2009 federal Budget, and introduced the Canadian Lenders Assurance Facility to provide a guarantee on certain wholesale debt issues of Canadian banks and other qualifying deposit-taking institutions.

In the weeks following these initiatives, strains in global short-term funding markets began to ease, as evidenced by a narrowing of spreads and a renewal of issuance. Nevertheless, credit spreads were expected to remain elevated for some time, partly because of the time it would take for confidence to be fully restored and for credit markets to again be fully functional.

The effect on the Canadian financial system

Throughout the crisis, the Canadian financial system proved relatively resilient, but it was not immune to spillover effects from abroad. Canadian wholesale funding markets were severely strained, which impeded the normal functioning of the financial system. Credit continued to expand, but at higher interest rate spreads relative to the policy rate.

Canada's regulatory framework contributed to financial stability in Canada during this period of turmoil. The ability of Canadian financial institutions to continue extending credit was helped by leverage ratios lower than those of many of their international peers, lower exposure to asset-backed products, better risk-management practices, and success in raising new capital, all of which have kept the Tier 1 capital ratios of all the major Canadian banks above 9 per cent. The Canadian mortgage market remained healthy, owing largely to conservative lending practices.

Building a more resilient global financial system

In addition to initiatives aimed at easing the stresses as they unfolded, central banks and regulatory authorities engaged in close consultation throughout 2008 to develop fundamental and forward-looking improvements to the regulatory framework, with the goal of increasing resiliency to financial shocks.

Toni Gravelle, Deputy Chief, Financial Stability Department, presents background on the global financial situation.

A notable achievement in this regard was an extensive report on the financial turbulence by the Financial Stability Forum (FSF), a group comprising national authorities, international standard-setting bodies, and international financial institutions. The report sets out concrete recommendations for strengthening prudential oversight of capital, liquidity and risk management, enhancing transparency and valuation, changing the role and uses of credit ratings, strengthening authorities' responsiveness to risks, and improving the way stresses in the financial system are dealt with. Canada has implemented the recommendations identified as priorities in 2008 and continues to work collaboratively to implement the full plan.

The Bank continued to work to increase the effectiveness of the International Monetary Fund (IMF) and, with international partners, to identify forces contributing to procyclicality in the financial system and to assess options for mitigating them.

Assessing the Financial Sector

In 2006, Canada invited the IMF to examine the health of the country's financial system under the Fund's Financial Sector Assessment Program (FSAP). The IMF conducted the assessment in 2007 and published its evaluation in February 2008. The overall conclusion was that Canada's financial system is mature, sophisticated, and well managed. The report states that financial stability is underpinned by sound macroeconomic policies and strong prudential regulation and supervision, while deposit insurance and arrangements for crisis management and failure resolution are well designed. The examination included a stress-testing exercise, which used as its scenario a disorderly unwinding of global imbalances. The exercise showed that Canada's major banks can withstand sizable shocks.

The *Financial System Review* (FSR), published semiannually in June and December, is an important means by which the Bank contributes to the stability and resilience of the Canadian financial system. The FSR reports on developments, identifies potential risks to the system's overall soundness, and highlights the Bank's efforts to mitigate those risks. It also summarizes recent work by Bank staff on issues relating to the financial system. In 2008, the FSR was redesigned to better communicate key risks and vulnerabilities arising from both international and domestic sources, as well as the collective judgment of the Bank's Governing Council on the major risks facing the financial system.

Containing Systemic Risk in Clearing and Settlement Systems

Under the Payment, Clearing and Settlement Act, the Bank is responsible for the oversight of clearing and settlement systems designated as being systemically important. Although ongoing financial turmoil in 2008 posed challenges for these systems, they functioned well throughout this period of heightened uncertainty and volatility.

In November, the Bank of Canada and other central banks signed an international protocol formalizing the co-operative oversight of CLS Bank, an international bank that provides for simultaneous settlement of foreign exchange transactions. The new protocol establishes a mandate for the Oversight Committee, which includes the Bank of Canada, and which will be the primary forum for carrying out co-operative oversight, with the U.S. Federal Reserve as lead overseer.

Over the course of the year, the Bank assessed a number of significant changes for each of the designated systems. The Bank continues to work closely with the owners and operators of the systems: the Canadian Depository for Securities, which operates CDSX; the Canadian Payments Association, which operates the LVTS, the system that handles large-value and time-sensitive Canadian-dollar payments; and CLS Bank.

The Bank regularly tests its own systems and periodically conducts operations from its backup facilities. In 2008, the Bank's own system for banking services was available 100 per cent of the time, a slight improvement from 2007.

Delegates from 27 countries attended CEMLA meetings hosted by the Bank in May. CEMLA is a regional association of Latin American and Caribbean central banks.

Priorities for 2008

- Continue to develop a framework for the assessment of financial system stability
- Review the principles and practices of the Bank's liquidity-provision facilities
- Conduct further work on financial system efficiency, including analysis of fixed-income markets and the cost of capital
- Assess the implications of concentration in financial services for clearing and settlement systems
- Implement the new business application for banking services

Progress on Priorities

Financial System Stability

Continue to develop a framework for the assessment of financial system stability

Significant progress was made in 2008 on developing a framework that will help to identify and evaluate sources of systemic risk to the Canadian and international financial systems. Staff investigated several elements of such a framework, including possible means of assessing risks related to contagion in the Canadian and international banking sectors; household indebtedness; the interdependencies of clearing and settlement systems; the settlement of derivatives; and liquidity management at Canadian banks. Work continued on macro stress testing to incorporate the impact of market risk. In addition, the Bank further developed a framework to monitor and analyze risks from international sources.

Review the principles and practices of the Bank's liquidity-provision facilities

Central banks are the ultimate sources of liquidity to the financial system. Disruptions in financial markets have led central banks to re-examine their roles as liquidity providers, particularly under conditions of financial market stress. In the June *Financial System Review*, an article addressed the questions of why, when, and how a central bank might intervene in financial markets. The article set out principles for designing a policy framework and identified appropriate central bank instruments to respond to extraordinary financial market turmoil, consistent with central bank policy goals and functions. These principles guided the expansion of liquidity operations in response to the intensification of the financial crisis in the autumn.

Financial System Efficiency

Conduct further work on financial system efficiency, including analysis of fixed-income markets and the cost of capital

In 2008, research conducted at the Bank examined a number of topics related to efficiency, including:

- price formation and liquidity in fixed-income markets
- the impact of disclosure requirements on the cost of capital
- the contribution of covered bonds to efficiency by providing further diversification of funding sources for financial institutions
- the role of foreign exchange dealers as providers of intraday and overnight liquidity
- the spread of electronic banking
- the impact of a tiered settlement network on efficiency

Assess the implications of concentration in financial services for clearing and settlement systems

Consolidation in the financial sector continues to be a global trend. In 2008, the Bank studied the possible effects of such consolidation on domestic clearing and settlement systems. A simulation approach was used to study several hypothetical mergers between participants in Canada's Large Value Transfer System. The results suggest that a merger between two participants could affect the risks and costs faced by all participants in the network, depending on the nature of the interactions between the merging participants, and could also have implications for the operation of other domestic and international clearing and settlement arrangements.

Building IT Infrastructure

Implement the new business application for banking services

As sole provider of unique services that support Canada's critical clearing and settlement systems, the Bank has undertaken a multi-year initiative to improve the reliability and efficiency of related operations. A key component of the initiative, the High-Availability Banking System (HABS), was successfully launched in October 2008. This system supports the critical operations for domestic and international payment, clearing, and settlement systems, as well as the provision of short-term liquidity and securities services. Work on HABS involved developing hardware and software, testing, and training of internal and external users.

Priorities for 2009

- *Promote macroprudential surveillance and regulation, and contribute to regulatory initiatives domestically and internationally*
- *Continue to develop a framework for the assessment of financial system stability, and strengthen the analysis and communication of risks to the Canadian financial system*
- *Reassess the principles and practices underlying the Bank's liquidity-provision facilities*
- *Analyze the microfoundations of financial markets, including the role played by complex instruments and infrastructure*
- *Identify and assess risks from clearing and settlement systems and other infrastructure*

Currency

Desired outcome: *Canadians use bank notes with confidence*

Strategy: *Reduce counterfeiting below a clearly defined threshold*

Outcome goals: *Reduce counterfeiting to below 100 counterfeits detected annually for each million genuine notes in circulation by 2009, and prepare to start issuing a new series of bank notes in 2011*

The Bank of Canada is responsible for supplying Canadians with bank notes they can use with confidence. In 2008, the Bank issued 300 million new bank notes and removed 250 million worn notes from circulation. At year-end, there were approximately 1.8 billion bank notes in circulation with a total value of nearly $54 billion.

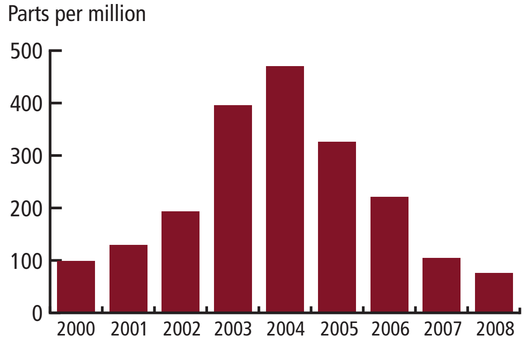
Ongoing Work towards Goals and Desired Outcome

The Bank's strategy to maintain confidence in Canadian bank notes consists of four elements: developing bank notes that are difficult to counterfeit; increasing the routine verification of bank notes by retailers; promoting the deterrence of counterfeiting by law enforcement and prosecutors; and withdrawing worn notes, counterfeits, and more vulnerable older-series notes from circulation.

In 2008, the number of counterfeit notes detected in circulation declined for a fourth consecutive year to 76 counterfeits for each million genuine notes in circulation. This is below the Bank's target of fewer than 100 counterfeits per million to be achieved by 2009. The value of counterfeits passed increased, however, to $6 million, from $3.3 million in 2007, owing to a $100 counterfeit that was passed in large numbers in the Greater Toronto and Montréal areas.

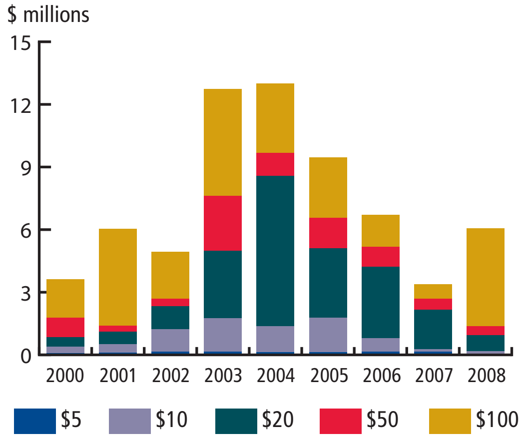
The $100 note was the most counterfeited denomination in 2008, a change from the recent past, when the most counterfeited denomination was the $20 note.

Number of Counterfeit Bank Notes Detected per Million Notes in Circulation*



* Medium-term plan target for 2009: less than 100 ppm

Value of Counterfeit Bank Notes Detected in Circulation



Over one-third of the counterfeits detected in 2008 were of notes from older, less-secure series, even though older-series notes represent a very small proportion of the notes in active circulation.

In response to the $100 counterfeits, the Bank alerted the public by issuing press releases and by communicating with retailers, both directly and through their business associations. The Bank provided additional training in bank note authentication and worked closely with financial institutions to identify counterfeits in circulation. Police credited the resulting awareness among retailers for the arrests of many individuals attempting to pass these counterfeit notes. By year-end, the number of counterfeit $100 notes detected had declined significantly.

Priorities for 2008

- Continue to develop a significantly more secure next generation of bank notes
- Extend targeted communications aimed at increasing retailer verification of bank notes
- Increase the engagement of law-enforcement agencies and prosecutors in counterfeit deterrence
- Complete the refurbishment of note-processing equipment, and continue to strengthen the Bank Note Distribution System
- Lower the target threshold for counterfeiting, with reference to the experience of leading central banks

Progress on Priorities

Continue to develop a significantly more secure next generation of bank notes

Steady progress was made in 2008 towards issuing a new series of bank notes. The evaluation of materials and security features continued, and options for the visual design of the new notes were developed.

The Bank works closely with other central banks, the security printing industry, and equipment manufacturers to gain a better understanding of the threat posed by emerging reprographic technologies available to counterfeiters and to develop new security features. For example, the Bank is a member of the Central Bank Counterfeit Deterrence Group, an association of 30 central banks that collaborate to identify and analyze counterfeiting threats and to develop strategic responses. In 2008, the Bank collaborated with several private sector firms in the assessment of new technologies for bank note security and the development of new features. In partnership with another central bank and academic researchers, the Bank also conducted research on the performance of various security features in simulated authentication processes.

Extend targeted communications aimed at increasing retailer verification of bank notes

Bank note security depends on public awareness of the security features found on bank notes, as well as on retailers routinely using these features to verify that a note is genuine. To promote bank note verification, the Bank produces a wide variety of print, video, and digital educational material, some of which is available in several languages in addition to English and French. Detailed information can be found at <http://www.bankofcanada.ca/en/banknotes/counterfeit/index.html>.

Staff in the Bank's regional offices deliver customized training sessions to retailers and other cash handlers, concentrating on cash-intensive businesses.

In partnership with the RCMP and other police agencies, payment card partners, Canada Post, and several retail associations, the Bank launched a DVD titled "Fighting Fraud on the Front Lines." The DVD, which covers currency counterfeiting, as well as the fraudulent use of credit and debit cards, forged cheques, and identity theft, has proven popular, with more than 80,000 copies distributed in 2008. It was also recognized by the International Association of Currency Affairs as Best Currency Public Education Program. The program can be viewed on the Bank's website at <http://www.bankofcanada.ca/en/banknotes/fraud/fraud.html>.

Increase the engagement of law-enforcement agencies and prosecutors in counterfeit deterrence

The Bank works closely with law-enforcement agencies, particularly the RCMP, as well as Crown prosecutors, to raise awareness of the direct and indirect costs of counterfeiting, the importance of preventing it, and the need to prosecute offenders. The Bank publishes a quarterly newsletter, *Anti-Counterfeiting Connections*, aimed at law-enforcement officers and prosecutors, as well as providing anti-counterfeiting instruction and material to the criminal justice programs at community colleges and to police academies across the country.

Deputy Governor Pierre Duguay presented the 2008 Law Enforcement Award of Excellence for Counterfeit Deterrence to the RCMP's Integrated Counterfeit Enforcement Team in Toronto. Their investigation led to the seizure of over $4 million in counterfeit* Canadian Journey *$20 notes—the largest seizure in Canadian history. No notes were believed to have been circulated. *(Left to right): Pierre Duguay, Corporal Tim Laurence, Corporal Susan MacLean, and Staff Sergeant Ken MacDonald.*

In 2008, the Bank established a database of prosecutions to monitor sentencing trends. In the cases analyzed, the information in the Bank's victim-impact statement was used by police or Crown prosecutors in over one-third of prosecutions.

Complete the refurbishment of note-processing equipment, and continue to strengthen the Bank Note Distribution System

The Bank's two note-processing centres sort bank notes received from financial institutions for quality and authenticity. Good-quality notes are returned to circulation, worn notes and less-secure notes from older series are destroyed, and counterfeits are sent to the RCMP. In 2008, the Bank processed 665 million bank notes and removed about 250 million worn notes from circulation. To improve efficiency and extend the useful life of the equipment, the Bank has been refurbishing its note-processing systems, which were installed when the centres were built in the 1990s. Completion of the project, scheduled for 2008, will take place in 2009, owing to delays in software development.

From Beads to Bytes: Canada's National Currency Collection

The fourth volume in the Bank of Canada's "souvenir" book series, From Beads to Bytes: Canada's National Currency Collection*, explores money, its evolution, and its role in society, highlighting items from the National Currency Collection, which is housed in the Currency Museum at the Bank's head office in Ottawa.*

The book features many of the strange and unusual objects that have been used as money throughout history and examines the factors that have influenced its development. It also introduces the reader to the hobby of numismatics.

*This book, as well as the first three in the series—*The Bank of Canada: An Illustrated History, The Art and Design of Canadian Bank Notes*, and* More than Money: Architecture and Art at the Bank of Canada*—are available at the Currency Museum. They can also be purchased by phoning 613 782-8248 or 1 877 782-8248 (toll-free in North America); by emailing publications@bankofcanada.ca; or by writing to Publications Distribution, Bank of Canada, West Tower, 9th Floor, 234 Wellington Street, Ottawa, Ontario K1A 0G9.*

Through the Bank Note Distribution System (BNDS), which is operated by the Bank and participating financial institutions, the Bank supplies new notes to financial institutions, which recirculate fit notes and return worn notes to the Bank. The system was implemented in 1997–98. Following a review of its performance, basic elements for strengthening the system were identified by the Bank and financial institutions in 2008. Work will continue on refinements to the system to ensure that it continues to meet its objectives efficiently.

Lower the target threshold for counterfeiting, with reference to the experience of leading central banks

In 2008, the Bank examined opportunities for lowering its target threshold for counterfeiting in the next medium-term plan. Based on the experience in Canada and in other countries, achieving consistently low levels of counterfeiting is important to maintaining confidence in bank notes.

Because changes in payment preferences can affect both the demand for bank notes and the overall efficiency of the retail payments system, the Bank monitors and analyzes the use and acceptance, by consumers and merchants, of payment methods such as cash, debit cards, and credit cards. A discussion paper and an article in the winter 2008–09 issue of the *Bank of Canada Review* summarized the Bank's research on this subject. A new research project is planned for 2009, in consultation with several other central banks, that will provide data to model the characteristics of, and the motivations for, the choice of payment method in individual transactions.

Priorities for 2009

- *Continue the multi-year program to develop a significantly more secure next generation of bank notes*
- *Extend the program to increase bank note verification at point of sale*
- *Maintain the reach and effectiveness of the work with law enforcement and increase the awareness among prosecutors of the consequences of counterfeiting*
- *Complete the refurbishment of note-processing equipment, and continue to strengthen the Bank Note Distribution System*
- *Summarize research on the use of, and demand for, bank notes and alternative payment methods, and identify opportunities for further study*

Funds Management

Desired outcome: *Stable and effective management of the outstanding stock of federal debt, and of Government of Canada and Bank of Canada financial assets, including operational and financial risks*

Strategy: *Maintain effective partnerships; leverage new analytical tools; review services, processes, and systems; enhance risk-management framework; and ensure clear and effective governance arrangements*

Outcome goal: *Provide cost-effective services within a strong risk-management framework, including sound policy advice and effective implementation*

The Bank of Canada is the federal government's fiscal agent. It advises on and implements the government's domestic and foreign debt programs and manages the flows of government funds and the investment of its financial assets. The Bank provides related banking services and support services for the government's retail debt program. An integral part of this work is managing financial and operational risks through a strong risk-management framework. In addition, the Bank manages its own balance sheet and manages and administers the assets held by its pension fund. It also undertakes banking activities on behalf of other central banks and international financial organizations.

Ongoing Work towards Goal and Desired Outcome

Significant dislocations and volatility in financial markets in 2008 presented important challenges for funds-management activities. There was a sizable increase in the volume of transactions during the year and in the complexity of operations. Despite these challenges, operations related to funds management were carried out successfully, and the year's goals were accomplished.

Fiscal Agent Responsibilities

As part of its fiscal agent responsibilities, the Bank provides banking services to the federal government. These include making and receiving payments, settling and paying entitlements on domestic debt, and providing information to facilitate cash-management and reconciliation activities. The expansion of operations and the high volume of activity resulting from the market turbulence in 2008 required timely and effective responses in the area of banking services. Overall, operations proceeded smoothly throughout the year.

Progress was made towards streamlining Receiver General settlement activities by identifying ways to reduce manual intervention and duplication. These changes were originally to be implemented through the Canadian Payments Association's "Truncation and Electronic Cheque Presentment" project. However, because this project was discontinued in 2008, work has begun to explore alternative ways of implementing these changes.

The government's cash balances are managed to meet its policy objectives in a cost-effective manner. In recent years, the main goal was to hold the lowest level of cash balances possible, while ensuring that sufficient funds were available to meet the government's daily requirements. Because of events in financial markets in 2008, government balances were significantly increased in the last quarter of the year to support those Bank of Canada operations that provide liquidity to financial markets and to meet the government's own increased funding needs. As a result, average cash balances in 2008 were $12.0 billion, compared with $8.2 billion in 2007.

Finally, the Bank of Canada has agreed to act as the administrative agent for the Canadian Lenders Assurance Facility and to work closely with the Department of Finance in establishing the framework under which the program will operate.

Other Funds-Management Responsibilities

The Bank undertakes transactions with chartered banks and federally chartered trust and loan companies arising from the requirement that these institutions transfer to the Bank all unclaimed balances in accounts domiciled in Canada that are denominated in Canadian currency and that have been inactive for 10 years. The owners of these accounts can have their money returned if they can provide proof of ownership. In 2008, financial institutions transferred $43.2 million in unclaimed balances to the Bank. There were approximately 42,600 general inquiries, and the Bank paid out or returned a total of $12.1 million to satisfy about 8,000 claims.

The Bank provides services to foreign central banks and to international financial organizations, including the provision of Canadian-dollar-denominated operating accounts, the provision of a securities account for the settlement and custody of securities, and the safekeeping of gold. Volumes in 2008 increased from the previous year.

Presenter James Chapman at the workshop, "Payments Economics: Theory and Policy," held at the Bank in November 2008

Minor changes were made in 2008 to the management of the Bank's pension fund. As part of a shift, begun in 2007, to have external managers oversee the active-style portion of equities held in the fund, managers for the global equity and the nominal bond portions of the fund were engaged. The Bank initiated a study of how best to manage assets and liabilities over long periods of time.

Priorities for 2008

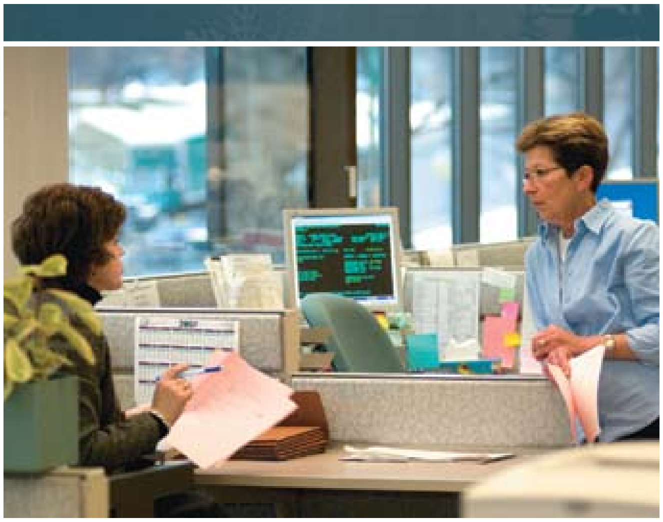
- Implement the government's debt strategy, including its objective of promoting the liquidity of Government of Canada securities in an effective manner
- Manage the foreign exchange reserves, including the liabilities that finance them
- Continue to manage the retail debt program in a cost-effective way

Progress on Priorities

Implement the government's debt strategy, including its objective of promoting the liquidity of Government of Canada securities in an effective manner

The main objectives of the federal debt strategy are to efficiently raise funding, to refinance maturing debt, and to cover projected financial requirements. Through its debt strategy, the federal government strives to maintain a well-functioning Government of Canada securities market, which helps to keep debt costs low and contributes to efficient capital markets by providing key pricing and hedging tools.

In response to the turbulence in financial markets, debt issuance was increased significantly, owing to policy measures taken by the Bank of Canada and the federal government to support the availability of credit in Canada. Funding of the Insured Mortgage Purchase Program



(Left to right): Mary McSheffrey and Sheila Kealey, Funds Management and Banking Department

(IMPP) resulted in three supplementary auctions of 5-year bonds in the fourth quarter of 2008 that totalled $12.0 billion. As well, larger treasury bill auctions were held. The stock of treasury bills outstanding stood at $176.8 billion at the end of 2008. To effectively manage changes to the domestic borrowing program and to support a well-functioning market, consultations were held with market participants.

In the second quarter of 2008, the domestic borrowings of three Crown corporations—the Business Development Bank of Canada, Farm Credit Canada, and the non-Canada-Mortgage-Bond issuance of the Canada Mortgage and Housing Corporation—were consolidated into the government's domestic debt program. In 2008, Crown borrowing under this new program was $19.7 billion, of which $8.2 billion was short term and $11.5 billion was long term. Overall, this increased amount of borrowing from consolidation supported the functioning of the Government of Canada securities market, and was cost-effective for the government.

Average turnaround times for regular auctions and for buyback and switch operations—which the Bank undertakes on behalf of the government—remained within the targets of less than 3 and 5 minutes, respectively. The average turnaround time for regular auctions was 1.57 minutes and for buyback and switch operations it was 2.47 minutes.

Manage the foreign exchange reserves, including the liabilities that finance them

Canada's official international reserves, held mainly in the Exchange Fund Account (EFA), provide foreign currency liquidity and, if required, funds to help promote orderly conditions for the Canadian dollar in foreign exchange markets. At year-end, official international reserves totalled US$43.872 billion, an increase of US$2.791 billion over 2007. As in previous years, the assets of the EFA were funded principally through an ongoing program of cross-currency swaps of domestic obligations.

The depreciation of the euro against the U.S. dollar and a sharp deterioration in market liquidity of swaps in the fourth quarter posed challenges for funding reserves. The large level of maturing foreign currency bond issues in 2008 also added to the need to proactively manage the funding of the EFA.

The Bank carefully monitors risks related to credit, interest rates, and foreign exchange exposure in the Exchange Fund Account. Given the increased number of changes to credit ratings of actual and potential private sector counterparties, greater attention than usual was paid to credit assessment. In addition, the Bank updated and improved credit stress-test scenarios for the EFA. With regard to market risk, the Bank implemented a value-at-risk framework in 2008 for monitoring and reporting on the sensitivity of the EFA portfolio to movements in interest rates and exchange rates.

Despite unusual and persistent market pressures arising from dislocations in global credit markets, the EFA's conservative investment policy resulted in a strong performance in 2008 in terms of both return and risk exposure, and the EFA earned a positive underlying return net of liabilities.

Continue to manage the retail debt program in a cost-effective way

The federal government issues two types of retail debt instruments: Canada Savings Bonds, which can be redeemed at any time, and Canada Premium Bonds, which typically carry a higher rate of interest but can be redeemed only once a year. Since the winding up of the Canada Investment and Savings agency in 2007, the Bank has been responsible for the marketing and sales of retail debt. In addition to its responsibility for the operational aspects of the program, the Bank provides the government with policy advice on retail debt.

The retail debt campaign was conducted smoothly in 2008, and it responded effectively to an increase in demand for its products, which was attributable to investor risk aversion in the midst of financial market turmoil.

The Bank has adopted a "new business framework" to manage back-office operations for retail debt, with the goal of achieving significant savings over time. In addition, approximately $1 million of savings was realized in 2008 from streamlining printing processes by implementing a new contracting strategy. More significant savings are anticipated in 2009 and in years thereafter.

Priorities for 2009

- *Provide focused, timely policy advice on the domestic debt program and foreign reserves management in view of evolving borrowing requirements and market conditions*
- *Implement the medium-term framework for managing operational risk arising from expanded collateral on the Bank's balance sheet*
- *Achieve key milestones and objectives for enhancing the operational cost-effectiveness of the retail debt program*
- *Build business resilience and support initiatives that address the financial crisis*
- *Advance a research program to better understand trade-offs between risk and efficiency for payment and settlement systems*

Corporate Administration

Desired outcome: *Efficient and effective corporate administration services, in support of achieving Bank objectives*

Strategy: *Further develop the Bank's policy and accountability framework to enhance effectiveness and efficiency in the areas of human resource and financial management, infrastructure, and internal communications*

Outcome goal: *Provide cost-effective services and sound policy advice on the management of Bank resources*

To achieve the objectives of its core functions, the Bank of Canada relies on a variety of internal services in such diverse areas as human resources, information technology, finance, legal, communications, knowledge and information management, facilities, and security.

Ongoing Work towards Goal and Desired Outcome

The financial turbulence that prevailed throughout the year had a significant impact on the demand for many corporate support services, especially information, financial, and communication services. In addition, the reorganization of responsibilities (see Message from the Governor on page 4) resulted in a significant draw on resources from various internal services in 2008 and will require continued work in 2009.

Despite these challenges, steady progress was made on priority initiatives. Key new demands were addressed, while the delivery of core services was maintained.

Priorities for 2008

- Complete implementation of the core elements of the management/leadership development program
- Further align the Bank's recruitment and development strategies with changing business needs, labour market conditions, and demographics
- Enhance information-management policies and standards
- Enhance facilities and security infrastructure
- Simplify and standardize IT infrastructure to reduce run costs
- Further implement Analytic Environment and High-Availability programs

Progress on Priorities

Complete implementation of the core elements of the management/leadership development program

Effective management and leadership skills are critical to the Bank's success, and a major initiative to strengthen these skills was launched in 2007. As well as classroom training, the program includes on-the-job training, external learning opportunities, and mentoring. In 2008, the remaining elements of the core program were implemented, including several new modules. About two-thirds of Bank managers have participated in courses offered as part of the program over the past two years, and evaluations are generally very positive. The program will remain a priority, and will continue to be refined and adapted as new needs are identified or with changes in the external environment.

Further align the Bank's recruitment and development strategies with changing business needs, labour market conditions, and demographics

A major challenge in coming years will be managing the transition from a workforce dominated by the baby-boom generation to one drawn from a smaller and younger cohort of workers. With this in mind, the Bank is refining its approach to attracting, engaging, and retaining talented staff, including updating its recruitment tools and processes. In 2008, increasing use was made of international secondments and exchanges, as well as internal development opportunities, as a means of accessing and developing skills. In addition, the hiring of students on a temporary basis continues to be a useful way to gain from the energy and ideas of younger people while marketing the Bank as an attractive employment option.

Enhance information-management policies and standards

Sound information management is vital to the success of the Bank. The challenge is made more acute by the looming demographic changes in Canada's workforce. During 2008, a new information-management policy was developed, and automated tools that support information management were expanded and refined. Enhanced processes and standards were developed for use in the new information technology environment, particularly for tools that will support economic and financial analysis in the Bank. The rollout of these new tools in 2009 and 2010 will mark a significant step forward in effective, integrated information management at the Bank.

Enhance facilities and security infrastructure

Ongoing monitoring and investment are essential for security and to ensure the efficient and safe operation of the Bank's facilities. In 2008, the work program included the replacement of aging infrastructure, upgrading of some monitoring tools, as well as waterproofing of the platform on the northwest side of the head office complex in Ottawa. A major planning effort is under way for the renewal and modernization of the head office complex, which is now about 30 years old. In 2008, the Bank also re-examined the location of its data centres, business-recovery sites, and critical operations, with a view to enhancing business continuity over the medium to long term.

Simplify and standardize IT infrastructure to reduce run costs

The Bank's medium-term plan calls for rationalizing IT infrastructure, improving processes, and creating a capability that supports excellence throughout the Bank. In 2008, the Bank continued work on the IT transformation program that was launched in 2007. The broad objectives of the program are to construct a more effective IT system, while reducing "run costs" and investing more in innovation. Organizational restructuring is an important part of this transformation.

Staffing and Recruitment Consultant, Francine Besner, talks with candidates during the Bank's university recruitment campaign.

In 2008, staff were reorganized to better align IT resources. Projects are also being launched to introduce more standardized, less complex infrastructure, with a view to greater efficiency, including reduced run costs.

Further implement High-Availability and Analytic Environment programs

In addition to continuing the delivery of reliable computing services in several locations, the Bank is making good progress on enhancing its computing environment over the 2007–09 planning period. Two initiatives are particularly noteworthy.

As part of a multi-year initiative designed to ensure that the Bank's critical business applications continue to operate in a highly reliable manner, the High-Availability Banking System (HABS) was launched successfully in October 2008 (see page 25).

The Analytic Environment Program is a significant multi-year initiative to improve the computing environment and the business processes that support the Bank's economic and financial analysis. The program involves significant upgrades to the computing platform and tools used by the Bank's economists and analysts, as well as more effective business processes and work practices. Steady progress was made across the board in 2008. In particular, new technology for running economic models helped to significantly improve run times. In addition, the pilot implementation of a more flexible environment for collaborative economic research proved invaluable in planning for the creation of a full "research zone" in 2009.

Priorities for 2009

- *Review the Bank's strategies for total compensation and for recruitment and retention*
- *Simplify and standardize IT infrastructure*
- *Develop and implement innovative solutions to support priority business needs*
- *Complete strategies for long-term renewal of facilities and for enhanced business continuity*
- *Address evolving financial-reporting requirements*
- *Enhance communications to support Bank functions*

Management Commentary

Summary of Financial Results

The Bank of Canada's finances are shaped by its mandate, which is to promote Canada's economic well-being. General information about how the Bank's balance sheet supports its functions can be found on our website at <http://www.bankofcanada.ca/en/backgrounders/bg-bank-balance-sheet.html>. The information presented there explains how the Bank uses its assets and liabilities in carrying out these functions and provides background on the Bank's capital.

This section of the *Annual Report* presents management's commentary on the financial results for the year, both in the context of annual results and of our three-year strategic planning cycle.

Financial Highlights for the Year

The Bank's balance sheet

The Bank's assets and liabilities, along with changes to these balances as displayed in the *Statement of Cash Flows*, support one or more of the Bank's functions.

The largest single item on the balance sheet continues to be the liability, *Bank notes in circulation,* created through the issuance of Canadian bank notes. As at 31 December 2008, *Bank notes in circulation* were valued at $53,731 million, an increase of 6 per cent over 2007. This growth in demand for notes by the Canadian public was slightly higher than usual, in part reflecting a substitution out of other assets at a time of increased economic uncertainty.

Other changes to the Bank's balance sheet in 2008 result largely from activities undertaken as part of the Bank's financial system function. The size of the balance sheet rose over the past year, owing primarily to the provision of term liquidity to support the efficient functioning of the Canadian financial system.

The size of the balance sheet remained relatively constant through the first three quarters of 2008, despite some activity to provide liquidity to the markets. In mid-October, consistent with the Bank's commitment under the G-7 Plan of Action, the Bank announced several measures to provide exceptional liquidity to the financial system. Those actions included new term money market and term lending facilities, as well as the acceptance of a wider range of collateral from a wider range of counterparties (see box on page 21). Between October and December, the Bank provided liquidity through securities purchased under resale agreements more frequently.

Securities purchased under resale agreements were $35,327 million at 31 December 2008, an increase of $31,364 million over 2007. In both years, these amounts represented term purchase and resale agreements. The significant year-over-year increase relates entirely to the term liquidity provided to the financial system. At 31 December 2008, *Advances to members of the Canadian Payments Association* were $1,902 million. This amount mainly represents term advances under the Term Loan Facility. To finance the term purchase and resale agreements and the Term Loan Facility, the Bank reduced its treasury bill portfolio, either through sales or lower acquisitions, and it carried higher Government of Canada deposits.

Statement of Net Income

Revenue from investments

For a central bank, revenues are not driven by profit-maximization objectives, but rather by the activities that the organization undertakes in support of its public policy responsibilities. The Bank's main source of revenue is interest earned on holdings of federal government securities. In 2008, the Bank's revenue decreased by $64 million, or 3 per cent from 2007. This change reflected the general decline in interest rates, as well as changes in the composition of the Bank's assets and liabilities as a result of new measures taken in 2008 to provide liquidity to the financial system.

Revenue from Government of Canada treasury bills and bonds in 2008 was $2,107 million, a decrease of 11 per cent or $249 million over 2007. This was primarily the result of lower short-term investment yields, coupled with slightly lower average portfolios of treasury bills and bonds. This decrease was largely offset by gains on treasury bills sold during the year and interest earned on higher volumes of term purchase and resale agreements. Higher balances of Government of Canada deposits carried during the latter part of the year to fund these activities resulted in an additional $46 million of interest being paid on Government of Canada deposits.

After expenses, the net income transferred to the Receiver General for Canada in 2008 was $1,852 million, approximately $172 million less than the amount transferred in 2007.

Operating expenses

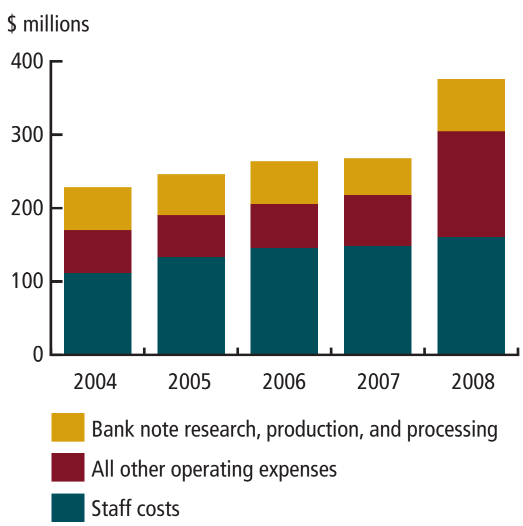
Operating expenses support the Bank's activities in its four functions: monetary policy, financial system, currency, and funds management. Operating expenses for the Bank in 2008 were $376 million, an increase of $108 million over 2007 (see note 14 in the Financial Statements).

The single largest component of the year-over-year increase relates to $59 million in costs for retail debt services. These costs are no longer being recovered from the Department of Finance, which previously reimbursed the Bank for all expenses related to retail debt. These expenses are part of the Bank's funds-management function and are included in *All other operating expenses* in the chart below. The remaining increase in all other operating expenses relates to technology initiatives (such as the deployment of the new High-Availability Banking System and continued development of the Analytic Environment Program) and to increased analysis related to the financial market turmoil. These increases supported the Bank in undertaking its funds-management and financial system functions.

Expenses for *Bank note research, production, and processing,* part of the currency function, increased by $22 million because of a greater volume of notes printed in 2008, following production delays in 2007.

Staff costs, which comprise salaries, benefits, and other staff-related expenses, increased by $12 million. This reflected additional resource requirements for the deployment of the High-Availability Banking System; higher costs for employee future benefits, resulting from updated demographic assumptions; and compensation increases to keep pace with trends in the labour market.

Operating Expenses



Note: Operating expenses for 2004 to 2007 are presented net of retail debt services, 100 per cent of which were recovered from the Government of Canada.

Future Accounting Changes

In March 2008, the Canadian Accounting Standards Board (AcSB) confirmed transition dates for the conversion to International Financial Reporting Standards (IFRS). The Bank's transition date for the conversion to IFRS is 1 January 2011 and will require the restatement, for comparative purposes, of amounts reported for the year ended 31 December 2010.

IFRS uses a conceptual framework similar to Canadian GAAP, but there are differences in recognition, measurement, and disclosure requirements. In 2008, the Bank completed a diagnostic exercise to highlight areas where IFRS is expected to have the highest impact, and to assist in prioritizing analysis. A project team was set up, and a formal approach for conversion to IFRS was established. In the second half of 2008, the team began a detailed analysis of IFRS. The Bank will continue to invest in training and resources throughout the transition period to facilitate a timely conversion.

The impact of the transition on financial reporting cannot be reasonably estimated at this time.

The Bank's Medium-Term Plan for 2007–09

The year 2008 was the second of the Bank's current medium-term plan (MTP): Moving Forward—Building the Future Together. *The plan focuses on three strategic priorities: renewing the Bank's infrastructure, creating a superior work environment, and staying at the forefront of good governance.*

The MTP financial plan excludes expenses associated with both non-current deferred employee benefits and the procurement of bank notes, because of their volatility. Deferred employee benefits are susceptible to changes in year-end discount rates used to value financial obligations. Bank note costs are subject to swings in the volume of notes required from year to year. Retail debt costs were reflected on a net recovery basis, since these costs were being recovered from the Department of Finance when the plan was developed.

Beginning 1 January 2008, retail debt expenses were no longer recovered from the Department of Finance. This change has rendered the Bank's actual expenses for 2008 and beyond significantly higher than in previous years. The chart below highlights the impact of this change on MTP estimates and provides a financial profile for the 3-year plan.

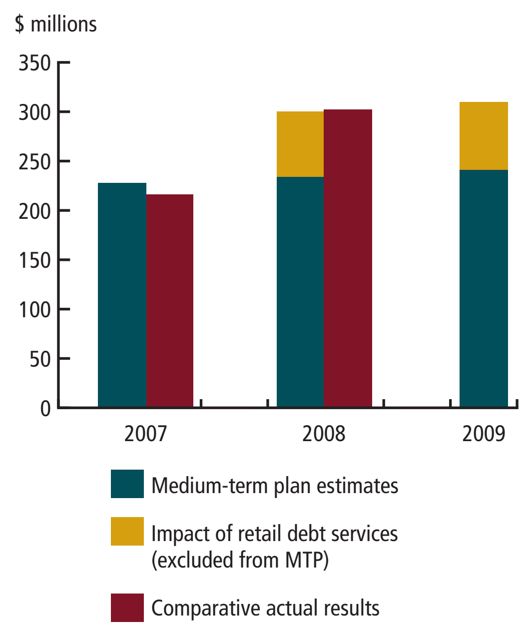
In 2007, financial results as they relate to the MTP fell within the established estimates, despite additional costs incurred as a result of continued efforts to establish a robust high-availability environment for critical banking systems. This upgraded environment improves the reliability and efficiency of banking system operations.

As reflected in the MTP financial profile, results for 2008 (adjusted for retail debt) were close to MTP estimates. The year marked the successful conclusion of the high-availability initiative. While the Bank was able to implement the project within MTP estimates, it is expected that ongoing operating costs will be higher than originally anticipated.

Significant progress was also made on two other initiatives: the Analytic Environment (AE) Program, which entails renewal of the infrastructure and business processes for data management, research, and analysis; and the information technology (IT) transformation initiative, which strengthens technology infrastructure and services.

In 2009, efforts will again focus on priorities within functional areas, including the provision of liquidity support to the Canadian financial system in light of the evolution of the financial markets. In addition, investments in significant MTP projects will continue. The AE Program and IT transformation initiatives will build on work performed in 2008 to achieve many of their planned outcomes. Within the currency function, resources will continue to be allocated to developing the next generation of bank notes, which the Bank plans to start issuing in 2011.

Medium-Term Plan Financial Profile



Risk Management

Overview

Risk management supports better decision making by providing greater insight into the nature of risks and their possible impact, as well as the development of cost-effective strategies to avoid or mitigate risk.

The Bank has a well-established, integrated risk-management framework for identifying, managing, and monitoring financial risk, operational risk (which includes key business and project risks), and reputational risk. Through an annual self-assessment process, senior managers identify and assess the key risks that could impede the fulfillment of the Bank's responsibilities and the achievement of its objectives. Risk-management strategies are reviewed and modified as required.

Risk-Governance Structure

The risk-management framework is supported by a strong governance structure. The responsibilities of the key stakeholders in risk management are as follows:

Board of Directors

The Board of Directors oversees the risk-management process. This involves an annual review of the Bank's risk "scorecard" and functional risk briefings throughout the year. The Audit and Finance Committee also assists the Board in fulfilling its responsibilities with respect to the management of financial-reporting risk associated with the Bank's balance sheet and the adequacy of internal controls.

Senior Management

Areas of corporate risk and approaches to managing these risks are reviewed annually and discussed with the Governing Council and the Corporate Management Committee. The Deputy Governors and the Department Chiefs are responsible to the Governor and Senior Deputy Governor for the management of corporate risk in their respective areas of responsibility. As part of their ongoing monitoring, the Governing Council and the Corporate Management Committee review any significant changes in the levels of risk and any new areas of risk identified during the year; these changes are reported to the Board on a timely basis.

Financial Risk Office

The Bank has a Financial Risk Office, independent of operations, that is responsible for monitoring and reporting on the financial risks relating to assets and liabilities on the Bank of Canada's balance sheet. In addition, the office reports to the Department of Finance and to the Bank on risks and investment performance arising from the management of the government's debt and foreign reserves.

Financial Services and Internal Audit

Financial Services is responsible for financial planning, accounting, and financial reporting. Appropriate systems of internal control exist to safeguard assets and produce accurate financial reports. Internal Audit, which reports functionally to the Audit and Finance Committee, independently conducts periodic reviews of the Bank's operations, including the risk-management process, to assess the appropriateness and effectiveness of the systems of internal control implemented by management to manage risk. This process provides reasonable assurance that objectives will be achieved.

Risk-Management Working Group

The Risk-Management Working Group, composed of senior representatives from across the Bank, is responsible for facilitating the Bank's annual self-assessment process. The group meets quarterly to share risk-management initiatives within their respective departments, as well as knowledge acquired through external conferences and contacts with other organizations.

Financial Risk

Financial risk is the risk associated with the Bank's management of its financial assets and liabilities. During 2008, the operations undertaken to increase liquidity affected both credit and interest rate risk.

Credit Risk—Credit risk is the risk that a counterparty to a financial contract will fail to discharge its obligations in accordance with agreed-upon terms.

The Bank's exposure to credit risk is very limited because of the high-quality investments that it holds and by virtue of the fact that Section 18 of the Bank of Canada Act prohibits the Bank from lending funds on an uncollateralized basis.

Over the past year, consistent with the Bank's commitment to provide liquidity to the Canadian financial system, the Bank expanded the collateral that it was willing to accept to include National Housing Act Mortgage-Backed Securities, U.S. Treasuries, certain asset-backed commercial paper, and the non-mortgage loan portfolios of eligible counterparties. To maintain a low level of credit exposure, the Bank sets strict eligibility criteria for all collateral and has established concentration limits on private sector securities pledged as collateral. To further reduce credit risk, the Bank requires excess collateral relative to the loan provided, tracks the fair value of this collateral on a daily basis, and imposes margin calls when the fair value of the collateral falls below established minimum levels.

Counterparties are assigned maximum individual and aggregate allocation limits based on credit ratings for both the Canadian-dollar Term Loan Facility and term purchase and resale agreements.

Interest Rate Risk—Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Over the year, interest rate risk declined marginally because of the Bank's sale of a portion of its treasury bill portfolio to fund some of the market operations undertaken. Treasury bills are the only financial asset the Bank carries at fair value.

More information on financial risk is available in note 6 to the Financial Statements.

Operational Risk

Operational risk is defined as the risk of negative impact to the Bank's assets, resources, or operational requirements resulting from people, processes, systems, and external sources (including those from external partners/suppliers). Operational risk is one of the broad categories of risk assessed and monitored by Bank management. Monitoring risk incidents during the year enables the Bank to identify potential exposures and trends over time, which is important for planning and resource allocation. In addition to monitoring risk incidents, the Bank has contingency plans in place that ensure the continuity of operations in the event of a disruption to regular business.

FINANCIAL STATEMENTS

As at 31 December 2008

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 are 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 for the integrity and reliability of these financial statements and for the accounting system from which they are derived, management has developed and maintains a system of internal controls 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.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal controls and exercises this responsibility through the Audit and Finance Committee of the Board. The Audit and Finance Committee is composed of members who are neither officers nor employees of the Bank and who are financially literate. The Audit and Finance Committee is therefore qualified to review the Bank's annual financial statements and to recommend their approval by the Board of Directors. The Audit and Finance Committee meets with management, the Chief Internal Auditor, and the Bank's external auditors who are appointed by Order-in-Council. The Audit and Finance Committee has established processes to evaluate the independence of the Bank's external auditors and reviews all services provided by them. The Audit and Finance Committee has a duty to review the adoption of, and changes in, accounting principles and procedures that have a 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, Ernst & Young LLP and PricewaterhouseCoopers LLP, and their report is presented herein. The external auditors have full and unrestricted access to the Audit and Finance Committee to discuss their audit and related findings.

M. Carney, Governor

S. Vokey, CA, Chief Accountant

Ottawa, Canada
23 January 2009

AUDITORS' REPORT

To the Minister of Finance, registered shareholder of the Bank of Canada (the "Bank")

We have audited the balance sheet of the Bank as at 31 December 2008 and the statements of net income, comprehensive income, changes in capital, and cash flows 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 2008 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

Ernst + Young LLP

ERNST & YOUNG LLP
Chartered Accountants
Licensed Public Accountants

PricewaterhouseCoopers LLP

PRICEWATERHOUSECOOPERS LLP
Chartered Accountants
Licensed Public Accountants

Ottawa, Canada
23 January 2009

BALANCE SHEET

As at 31 December
(Millions of dollars)

	2008	2007
ASSETS		
Cash and foreign deposits (note 3)	119.5	3.3
Loans and receivables		
Securities purchased under resale agreements (note 4a)	35,326.9	3,963.4
Advances to members of the Canadian Payments Association (note 4b)	1,902.3	1.5
Other receivables	4.5	37.3
	37,233.7	4,002.2
Investments (note 5)		
Treasury bills of Canada	11,717.1	20,280.9
Government of Canada bonds	29,267.7	29,359.8
Other investments	38.0	38.0
	41,022.8	49,678.7
Property and equipment (note 7)	137.0	133.7
Other assets (note 8)	70.5	78.9
	78,583.5	53,896.8
LIABILITIES AND CAPITAL		
Bank notes in circulation (note 9)	53,731.3	50,565.2
Deposits (note 10)		
Government of Canada	23,604.0	1,970.4
Members of the Canadian Payments Association	25.9	501.5
Other deposits	783.3	509.2
	24,413.2	2,981.1
Other liabilities (note 11)	226.1	195.8
	78,370.6	53,742.1
Capital (note 13)	212.9	154.7
	78,583.5	53,896.8

Commitments, contingencies, and guarantees (note 15)

M. Carney, Governor

S. Vokey, CA, Chief Accountant

On behalf of the Board

M. L. O'Brien, FCA,
Chair, Audit and Finance Committee

W. A. Black,
Lead Director

See accompanying notes to the financial statements.

STATEMENT OF NET INCOME

Year ended 31 December
(Millions of dollars)

	2008	2007
REVENUE		
Revenue from investments	2,107.1	2,356.1
Realized gains on sales of treasury bills of Canada	31.5	-
Interest earned on securities purchased under resale agreements	212.9	22.3
Other revenue	12.7	4.1
Interest expense on deposits	(136.1)	(90.4)
	2,228.1	2,292.1
EXPENSE by function (notes 1 and 14)		
Monetary policy	67.8	67.9
Financial system	54.5	38.8
Currency	142.2	120.7
Funds management	111.4	40.3
	375.9	267.7
NET INCOME	1,852.2	2,024.4

STATEMENT OF COMPREHENSIVE INCOME

Year ended 31 December
(Millions of dollars)

	2008	2007
NET INCOME	1,852.2	2,024.4
OTHER COMPREHENSIVE INCOME		
Change in net unrealized gains on available-for-sale assets	89.7	22.7
Reclassification of gains on available-for-sale assets realized during year	(31.5)	-
	58.2	22.7
COMPREHENSIVE INCOME	1,910.4	2,047.1

See accompanying notes to the financial statements.

STATEMENT OF CHANGES IN CAPITAL

Year ended 31 December
(Millions of dollars)

	2008	2007
SHARE CAPITAL	5.0	5.0
STATUTORY RESERVE	25.0	25.0
SPECIAL RESERVE		
Balance, beginning of year	100.0	-
Allocation from net income	-	100.0
Balance, end of year	100.0	100.0
RETAINED EARNINGS		
Balance, beginning of year	-	-
Transition adjustment - Financial instruments (note 2f)	-	26.6
Net income	1,852.2	2,024.4
Allocation to special reserve	-	(100.0)
Transfer to Receiver General for Canada	(1,852.2)	(1,951.0)
Balance, end of year	-	-
ACCUMULATED OTHER COMPREHENSIVE INCOME		
Balance, beginning of year	24.7	-
Transition adjustment - Financial instruments (note 2f)	-	2.0
Other comprehensive income	58.2	22.7
Balance, end of year	82.9	24.7
CAPITAL (note 13)	212.9	154.7

See accompanying notes to the financial statements.

STATEMENT OF CASH FLOWS

Year ended 31 December
(Millions of dollars)

	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Interest received	2,379.5	2,351.2
Dividends received	4.2	3.9
Other income received	43.9	48.8
Interest paid	(136.8)	(91.9)
Payments to suppliers and employees	(349.8)	(280.0)
Net (increase) decrease in *Advances to members of the Canadian Payments Association*	(1,899.2)	10.6
Net increase in *Deposits*	21,432.6	297.6
Proceeds from maturity of securities purchased under resale agreements	192,416.4	41,221.2
Acquisition of securities purchased under resale agreements	(223,704.4)	(42,327.8)
Repayments of securities sold under repurchase agreements	(5,989.3)	(10,121.3)
Proceeds from securities sold under repurchase agreements	5,989.3	10,121.3
Net cash provided by (used in) operating activities	(9,813.6)	1,233.6
CASH FLOWS FROM INVESTING ACTIVITIES		
Net (increase) decrease in *Treasury bills of Canada*	8,517.1	(2,087.4)
Purchases of Government of Canada bonds	(3,888.4)	(2,939.4)
Proceeds from maturity of Government of Canada bonds	3,988.7	3,943.0
Purchase of property and equipment	(18.5)	(15.8)
Net cash provided by (used in) investing activities	8,598.9	(1,099.6)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in *Bank notes in circulation*	3,166.1	1,803.0
Amount paid to Receiver General for Canada	(1,836.0)	(1,936.1)
Net cash provided by (used in) financing activities	1,330.1	(133.1)
EFFECT OF EXCHANGE RATE CHANGES ON FOREIGN CURRENCY	0.8	(0.7)
INCREASE IN CASH AND FOREIGN DEPOSITS	116.2	0.2
CASH AND FOREIGN DEPOSITS, BEGINNING OF YEAR	3.3	3.1
CASH AND FOREIGN DEPOSITS, END OF YEAR	119.5	3.3

See accompanying notes to the financial statements.

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2008

(Amounts in the notes to the financial statements are in millions of Canadian 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, financial system stability, a safe and secure currency, 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 net income* are reported on the basis of these four 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.

Financial system

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

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.

Funds management

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

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. The significant accounting policies of the Bank are summarized as follows:

a) Change in accounting policies

Effective 1 January 2008 and in accordance with standards issued by the Canadian Institute of Chartered Accountants (CICA), the Bank adopted the following new accounting standards:

Financial instruments – disclosure and presentation

CICA Handbook, Sections 3862, Financial Instruments – Disclosure and 3863, Financial Instruments – Presentation replace Section 3861, Financial Instruments – Disclosure and Presentation. These new sections place increased emphasis on disclosures about the nature and extent of the risks arising from financial instruments and how the entity manages those risks (note 6).

Capital disclosures

CICA Handbook, Section 1535, Capital Disclosures, specifies the disclosure of: (i) an entity's objectives, policies, and processes for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has complied with any capital requirements; and (iv) if it has not complied, the consequences of such non-compliance (note 13).

Other significant changes to accounting standards

In October 2008, the CICA issued amendments to CICA Handbook Section 3855 – Financial Instruments – Recognition and Measurement. The amendments permit, under specific circumstances, financial assets to be reclassified from held-for-trading to the available-for-sale classification or from available-for-sale to the loans and receivables classification. The amendments were effective 1 August 2008.

The Bank has not made any reclassifications permitted under these amendments.

b) Use of estimates

The preparation of financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions based on information available at the financial statement date. Actual results could differ from these estimates. These estimates are primarily in the area of pension and other employee future benefits.

c) Revenue recognition

Interest revenue earned on treasury bills and bonds is recorded using the effective interest method. Dividend revenue on the Bank for International Settlements (BIS) shares is recorded as dividends are declared.

Realized gains on the sale of treasury bills of Canada are recorded at the time of sale as a reclassification from *Other Comprehensive Income* and are calculated as the excess of proceeds over the amortized cost.

Interest earned on securities purchased under resale agreements is recorded using the effective interest method.

Other revenue is comprised mostly of interest earned on advances to members of the Canadian Payments Association and is recorded using the effective interest method.

d) 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.

e) Translation of foreign currencies

Investment income is translated at the rate in effect at the date of the transaction.

Assets and liabilities denominated in foreign currencies are translated to Canadian dollars at the rates of exchange prevailing at the balance sheet dates. The resulting gains and losses are included in *Other revenue*.

f) Financial instruments

Financial instruments are measured at fair value on initial recognition. Subsequent to initial recognition, they are accounted for based on their classification. Transaction costs are expensed as incurred for all classes of financial instruments. The Bank accounts for all financial instruments using settlement date accounting.

Subsequent to initial recognition, financial assets classified as available-for-sale (AFS) are measured at fair value using quoted market prices or at cost if the instruments are not traded in an active market. Unrealized changes in values of AFS financial assets held at fair value are recognized in *Other Comprehensive Income*. The Bank's financial assets designated as AFS consist of the Treasury bills of Canada and Other investments portfolios.

Subsequent to initial recognition, financial assets classified as held-to-maturity (HTM) are measured at amortized cost using the effective interest method. The Government of Canada bonds portfolio is classified as HTM.

All other financial assets, excluding cash and foreign deposits, are classified as loans and receivables. Subsequent to initial recognition, these are measured at amortized cost using the effective interest method of amortization.

The Bank has not classified any of its financial assets as held-for-trading.

All financial assets, other than treasury bills of Canada, are measured at the lower of cost or net recoverable amount.

Subsequent to initial recognition, financial liabilities are measured at amortized cost using the effective interest method, with the exception of bank notes in circulation, which are measured at face value.

The Bank has not classified any of its financial liabilities as held-for-trading.

The transition adjustment to retained earnings in the *Statement of changes in capital* reflects the impact of the adoption of CICA Handbook Section 3855 – Financial Instruments – Recognition and Measurement on 1 January 2007. The transition adjustment relates to the adoption of the effective interest method for the bond portfolio, and the remeasurement of assets classified as available-for-sale. The adoption of the effective interest method for the bond portfolio resulted in an increase of $26.6 million to their amortized cost at 1 January 2007. Adjustments arising from the remeasurement of financial assets classified as available-for-sale resulted in an increase to *Accumulated Other Comprehensive Income* of $2.0 million at 1 January 2007.

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 by securities and are generally one business day 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 *Other revenue* at the maturity date of the transaction.

h) Property and equipment

Property and equipment consists of land, buildings, computer hardware/software, other equipment, and projects in progress. Property and equipment is recorded at cost less accumulated amortization except for land, which is recorded at cost and projects in progress, which are recorded at cost but not amortized until the asset is put into service. Amortization 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

When completed, projects in progress are classified according to the above categories.

i) Securities purchased under resale agreements

Securities purchased under resale agreements are reverse repo-type transactions in which the Bank purchases securities from designated counterparties with an agreement to sell them back at a predetermined price on an agreed transaction date. For accounting purposes, 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) Securities sold under repurchase agreements

Securities sold under repurchase agreements are repo-type transactions in which the Bank sells Government of Canada securities to designated counterparties with an agreement to buy them back at a predetermined price on an agreed transaction date. For accounting purposes, 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.

k) Cash and foreign deposits

Cash and foreign deposits comprises cash on hand as well as highly liquid demand deposits in foreign currencies with other central banks or international institutions.

l) Future accounting changes

Intangible Assets

In October 2008, the CICA issued Handbook Section 3064, Goodwill and Intangible Assets, replacing Section 3062 of the same name and Section 3450, Research and Development Costs. This new standard provides guidance for the identification, recognition, and measurement of externally acquired or internally developed intangible assets and requires separate disclosure thereon. The standard is effective for the Bank as of 1 January 2009. The Bank does not expect the new standard to have a significant impact on its financial statements.

International Financial Reporting Standards (IFRS)

In March 2008, the Canadian Accounting Standards Board confirmed its decision to require all publicly accountable enterprises to report under IFRS for years beginning on or after 1 January 2011. As a publicly accountable enterprise, the Bank will be required to report under IFRS commencing with the year ended 31 December 2011 and will be required to restate its 2010 comparative figures to be compliant with IFRS.

The Bank is currently undertaking a comprehensive evaluation of the impact of these new standards on the recognition, measurement, presentation, and disclosure of financial statement items.

3. Cash and foreign deposits

Included in *Cash and foreign deposits* is Can$108.3 million (Can$2.1 million in 2007) of U.S. dollars.

4. Loans and receivables

Loans and receivables are comprised primarily of securities purchased under resale agreements and advances to members of the Canadian Payments Association. In 2008, the Bank provided exceptional term liquidity to the Canadian financial system through both of these instruments. These transactions are fully collateralized in accordance with publicly disclosed collateral eligibility and margin requirements. Financial risks related to these instruments are discussed in note 6.

a) Securities purchased under resale agreements

Balances outstanding at 31 December are comprised of agreements with original terms to maturity ranging from 28 to 91 days. (Balances outstanding at 31 December 2007 are comprised of agreements with original terms to maturity of 28 days.) Securities purchased under resale agreements for terms of longer than one business day are acquired through an auction process. Details of these auctions are announced by the Bank in advance. Bids are submitted on a yield basis, and funds are allocated in descending order of bid yields.

b) Advances to members of the Canadian Payments Association

Advances to members of the Canadian Payments Association are comprised of liquidity loans made under the Bank's standing liquidity facility as well as term advances made under the Bank's commitment to provide term liquidity to the Canadian financial system.

Term advances, which comprise $1,901.6 million ($nil in 2007) of the outstanding balance, have terms to maturity of 28 days. Term advances are extended through an auction process with a minimum bid yield of the Bank Rate.

The remaining balance of $0.7 million ($1.5 million in 2007) are advances maturing the next business day. Interest on overnight advances is calculated at the Bank Rate.

5. Investments

There were no securities loaned under the Securities Lending Program at 31 December 2008 ($nil in 2007).

Comprising *Other investments*, the Bank holds 9,441 shares in the BIS in order to participate in the BIS and in international initiatives generally. Ownership of the BIS shares is limited to central banks, and new shares can only be acquired following an invitation to subscribe extended by the BIS Board of Directors. The shares are non-transferable unless prior written consent is obtained from the BIS.

Financial risks relating to these financial instruments are discussed in note 6.

6. Financial instruments and risk

The Bank's financial instruments consist of cash and foreign deposits, securities purchased under resale agreements, advances to members of the Canadian Payments Association, other receivables, investments, bank notes in circulation, deposits, and other liabilities (net of post-employment and post-retirement obligations).

Fair values of financial instruments

Fair values of securities purchased under resale agreements are determined using market yields-to-maturity for similar instruments available at the balance sheet date.

Fair values of treasury bills of Canada and Government of Canada bonds are based on quoted market prices.

The calculation of fair value for BIS shares (*Other investments*) is based on recent share issues and is estimated as being 70 per cent of the Bank's interest in the BIS shareholders' equity. BIS shares are classified as AFS but are carried at cost since they do not have a quoted market value in an active market.

The amortized cost of cash and foreign deposits, advances to members of the Canadian Payments Association, other receivables, deposits, and other financial liabilities (which is composed of other liabilities, excluding the portion representing accrued post-retirement and post-employment benefits liabilities as described in note 12) approximates fair value, given their short-term nature. The face value of bank notes in circulation is equal to their fair value.

The fair values of financial assets and liabilities are presented in the following table:

	2008		2007	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial assets				
Cash and foreign deposits	119.5	119.5	3.3	3.3
Securities purchased under resale agreements	35,326.9	35,334.9	3,963.4	3,963.4
Advances to members of the Canadian Payments Association	1,902.3	1,902.3	1.5	1.5
Other receivables	4.5	4.5	37.3	37.3
Treasury bills of Canada	11,717.1	11,717.1	20,280.9	20,280.9
Government of Canada bonds	29,267.7	33,197.2	29,359.8	31,551.0
Other investments	38.0	295.8	38.0	240.6
	78,376.0	82,571.3	53,684.2	56,078.0
Financial liabilities				
Bank notes in circulation	53,731.3	53,731.3	50,565.2	50,565.2
Deposits	24,413.2	24,413.2	2,981.1	2,981.1
Other financial liabilities	100.8	100.8	85.3	85.3
	78,245.3	78,245.3	53,631.6	53,631.6

Financial Risk

The Bank is exposed to credit risk, market risk, and liquidity risk as a result of holding financial instruments. The following is a description of those risks and how the Bank manages its exposure to them.

a) Credit risk

Credit risk is the risk that a counterparty to a financial contract will fail to discharge its obligations in accordance with agreed-upon terms.

The Bank is exposed to credit risk through its investment portfolio, advances to members of the Canadian Payments Association, and through market transactions conducted in the form of securities purchased under resale agreements and loans of securities. The maximum exposure to credit risk is estimated to be the carrying value of the items listed above. There are no past due or impaired amounts.

Advances to members of the Canadian Payments Association and securities purchased under resale agreements are fully collateralized loans. Collateral is taken in accordance with the Bank's publicly disclosed eligibility criteria and margin requirements accessible on its website. In the unlikely event of a counterparty default, collateral can be liquidated to offset credit exposure. The credit quality of collateral is managed through a set of restrictions based on asset type, term to maturity, and the credit ratings of the securities pledged.

Term advances to members of the Canadian Payments Association are fully collateralized with non-mortgage loan portfolios.

Concentration of credit risk

The Bank's investment portfolio, representing 52 per cent of the carrying value of its total assets, is essentially free of credit risk because the securities held are primarily direct obligations of the Government of Canada. The Bank's advances to members of the Canadian Payments Association and securities purchased under resale agreements, representing 45 per cent of the carrying value of its total assets, are collateralized obligations of various Canadian-based financial institutions.

The fair value of collateral pledged against securities purchased under resale agreements at the balance sheet date is \$37,753.5 million, representing 107 per cent of the amortized cost of \$35,326.9 million.

Collateral is concentrated in the following major categories:

	$	%
Securities issued or guaranteed by the Government of Canada	20,727.6	54.9
Securities issued or guaranteed by a provincial government	8,031.8	21.3
Securities issued by a municipality	153.6	0.4
Corporate securities	5,604.5	14.8
Asset-backed commercial paper	3,236.0	8.6
Total fair value of collateral pledged	37,753.5	100.0

b) Market risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: interest rate risk, currency risk, and other price risk.

Interest rate risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

The Bank's investment in treasury bills and bonds acts as a counterpart to the non-interest-bearing bank notes in circulation liability, and supports the Bank's operational independence to conduct monetary policy. These assets are acquired in proportions to broadly resemble the structure of the Government of Canada's domestic debt outstanding to reduce interest rate risk from the perspective of the Government of Canada.

The Bank's exposure to fair-value interest rate risk arises principally through its investment in treasury bills. Fair-value interest rate risk also arises with Government of Canada deposits and other deposits. All of the aforementioned instruments are short-term in duration. The fair value of the treasury bills of Canada portfolio held by the Bank is exposed to fluctuations owing to changes in market interest rates since these securities are classified as AFS and measured at fair value. Unrealized gains and losses on the treasury bills of Canada portfolio are recognized in *Accumulated Other Comprehensive Income* in the *Capital* section of the balance sheet until they mature or are sold. All other financial assets or liabilities are carried at amortized cost or at face value.

The figures below show the effect at 31 December 2008 of an (increase)/decrease of 25 basis points in interest rates on the fair value of the treasury bill portfolio and other comprehensive income:

	(Increase)/Decrease
Treasury bills of Canada	**$ (16.9)/16.2**

The Bank's exposure to interest rate risk in the form of fluctuations in future cash flows of existing financial instruments is limited to Government of Canada deposits and cash and foreign deposits, since these instruments are subject to variable interest rates. The remainder of the Bank's financial assets and liabilities have either fixed interest rates or are non-interest-bearing.

For all financial instruments, except bank notes in circulation, future cash flows of the Bank are dependent on the prevailing market rate of interest at the time of renewal.

The following table illustrates interest rate risk relative to future cash flows by considering the expected maturity or repricing dates of existing financial assets and liabilities.

As at 31 December 2008

	Weighted-average interest rate %	Total	Non-interest-sensitive	1 business day to 1 month	1 to 3 months	3 to 12 months	1 to 5 years	Over 5 years
FINANCIAL ASSETS								
Cash and foreign deposits	0.00	119.5	-	119.5	-	-	-	-
Loans and receivables								
Advances to members of the CPA	1.75	1,902.3	-	1,902.3	-	-	-	-
Securities purchased under resale agreements	1.97	28,863.2	-	28,863.2	-	-	-	-
	2.30	6,463.7	-	-	6,463.7	-	-	-
		35,326.9						
Other receivables		4.5	4.5	-	-	-	-	-
Investments								
Treasury bills of Canada	2.94	50.0	-	50.0	-	-	-	-
	2.64	99.9	-	-	99.9	-	-	-
	2.23	11,567.2	-	-	-	11,567.2	-	-
	2.24	11,717.1						
Government of Canada bonds[1]	11.56	17.2	-	-	17.2	-	-	-
	4.76	3,811.2	-	-	-	3,811.2	-	-
	4.90	12,834.7	-	-	-	-	12,834.7	-
	5.08	12,604.6	-	-	-	-	-	12,604.6
	4.96	29,267.7						
Shares in the BIS		38.0	38.0	-	-	-	-	-
		78,376.0	42.5	30,935.0	6,580.8	15,378.4	12,834.7	12,604.6
FINANCIAL LIABILITIES								
Bank notes in circulation		53,731.3	53,731.3	-	-	-	-	-
Deposits								
Government of Canada	0.95	23,604.0	-	23,604.0	-	-	-	-
Members of the CPA	1.25	25.9	-	25.9	-	-	-	-
Other deposits								
Unclaimed balances		351.4	351.4	-	-	-	-	-
Other	1.30	431.9	-	431.9	-	-	-	-
Other financial liabilities		100.8	100.8	-	-	-	-	-
		78,245.3	54,183.5	24,061.8	-	-	-	-
Interest rate sensitivity gap		130.7	(54,141.0)	6,873.2	6,580.8	15,378.4	12,834.7	12,604.6

1. *Carrying amounts of Government of Canada bonds include accrued interest.*

The Bank's revenue will vary over time in response to future movements in interest rates; these variations would not affect the ability of the Bank to fulfill its obligations since its revenues greatly exceed its expenses.

Currency risk

Currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

At the balance sheet date, the Bank holds Can$108.3 million in U.S. dollars. This balance is offset by an equivalent U.S.-dollar-denominated deposit liability. Given the small size of the net foreign currency exposure compared with the total assets of the Bank, currency risk is not considered material.

Other price risk

Other price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from changes in interest and exchange rates), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market. The Bank is not exposed to significant other price risk.

c) Liquidity risk

Liquidity risk is the risk that an entity will encounter difficulty in meeting its obligations associated with financial liabilities. As shown in the following table, the Bank's largest liability is *Bank notes in circulation*. As a counterpart to this non-interest-bearing liability with no fixed maturity, the Bank holds a portfolio of highly liquid, interest-bearing securities. In the event of an unexpected redemption of bank notes, the Bank has the ability to settle the obligation by selling its assets.

As the central bank, the Bank is the ultimate source of liquid funds to the Canadian financial system, and has the power and operational ability to create Canadian-dollar liquidity in unlimited amounts at any time. This power is exercised within the Bank's commitment to keep inflation low, stable, and predictable.

The following table presents a maturity analysis for the Bank's financial assets and liabilities. The balances in this table do not correspond to the balances in the *Balance Sheet*, since the table presents all cash flows on an undiscounted basis.

As at 31 December 2008

	Total	No fixed maturity	1 business day	1 business day to 1 month	1 to 3 months	3 to 12 months	1 to 5 years	Over 5 years
FINANCIAL ASSETS								
Cash and foreign deposits	119.5	119.5	-	-	-	-	-	-
Loans and receivables								
Advances to members of the CPA	1,902.3	-	0.7	1,901.6	-	-	-	-
Securities purchased under resale agreements	35,367.3	-	-	28,884.9	6,482.4	-	-	-
Other receivables	4.5	-	-	4.5	-	-	-	-
Investments								
Treasury bills of Canada	11,775.0	-	-	50.0	100.0	11,625.0	-	-
Government of Canada bonds[1]	41,556.0	-	-	-	182.2	5,014.1	16,493.4	19,866.3
Shares in the BIS	38.0	38.0	-	-	-	-	-	-
	90,762.6	157.5	0.7	30,841.0	6,764.6	16,639.1	16,493.4	19,866.3
FINANCIAL LIABILITIES								
Bank notes in circulation	53,731.3	53,731.3	-	-	-	-	-	-
Deposits								
Government of Canada	23,604.0	23,604.0	-	-	-	-	-	-
Members of the CPA	25.9	-	25.9	-	-	-	-	-
Other deposits								
Unclaimed balances	351.3	351.3	-	-	-	-	-	-
Other	431.9	431.9	-	-	-	-	-	-
Other liabilities	100.8	-	-	100.8	-	-	-	-
	78,245.2	78,118.5	25.9	100.8	-	-	-	-
Net maturity difference	12,517.4	(77,961.0)	(25.2)	30,740.2	6,764.6	16,639.1	16,493.4	19,866.3

1. *Interest payments on Government of Canada bonds are classified according to their coupon date.*

In the table above, liabilities with no fixed maturity include *Bank notes in circulation* and *Government of Canada Deposits*. Historical experience has shown that bank notes in circulation provide a stable source of long-term funding for the Bank. *Government of Canada Deposits* are comprised of deposits held in the Bank's capacity as the Government of Canada's fiscal agent, as well as funds advanced to the Bank to support the provision of exceptional liquidity to the Canadian financial system.

7. Property and equipment

	2008			2007		
	Cost	Accumulated amortization	Net book value	Cost	Accumulated amortization	Net book value
Land and buildings	183.5	103.2	80.3	183.5	98.6	84.9
Computer hardware/ software	69.9	47.8	22.1	58.3	50.2	8.1
Other equipment	123.9	97.5	26.4	118.9	98.9	20.0
	377.3	248.5	128.8	360.7	247.7	113.0
Projects in progress	8.2	-	8.2	20.7	-	20.7
	385.5	248.5	137.0	381.4	247.7	133.7

Projects in progress in 2008 consist primarily of investments in the Analytic Environment Program ($5.3 million; $nil in 2007) and upgrades to bank-note-processing equipment ($1.9 million; $1.8 million in 2007). The High-Availability project in progress at 31 December 2007 was completed during the year.

During the year, the Bank's work in preparation for the Canadian Payments Association's Truncation and Electronic Cheque Presentment initiative, which was in progress at 31 December 2007, was terminated prior to completion. The Bank's decision to terminate this work reflects the Canadian Payments Association's conclusion that anticipated enhancements to efficiency could not be fully realized. Accumulated project costs to the date of termination, totalling $2.4 million, were written off and included in *Funds management* on the statement of net income.

The net carrying amount of property and equipment is reviewed when events or changes in circumstances indicate that future benefits may no longer be reasonably assured, and is adjusted if required. No such adjustments, except as noted above, were recorded during the years ended 31 December 2008 and 31 December 2007.

8. Other assets

Other assets include the pension accrued benefit asset of $53.3 million ($59.1 million in 2007) and other items related to the administrative functions of the Bank.

9. 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. A breakdown by denomination is presented below.

	2008	2007
$5	1,017.9	940.9
$10	1,091.8	1,079.1
$20	16,126.3	15,659.3
$50	7,563.2	7,133.2
$100	26,354.1	24,095.0
Other bank notes	1,578.0	1,657.7
	53,731.3	50,565.2

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

10. Deposits

The liabilities within this category primarily consist of Can$97.3 million ($nil in 2007) in U.S.-dollar demand deposits and $24,315.9 million in Canadian-dollar demand deposits ($2,981.1 million in 2007). 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 net income*.

11. Other liabilities

This category primarily includes accrued post-retirement and post-employment benefits liabilities of $125.2 million ($110.5 million in 2007), an accrued transfer payment to the Receiver General for Canada of $52.2 million ($36.0 million in 2007), accounts payable and accrued liabilities of $48.4 million ($34.5 million in 2007), and payroll liabilities of $0.3 million ($11.0 million in 2007).

12. 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. The 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 2008, and the next required valuation will be as of 1 January 2011.

The total cash payment for employee future benefits for 2008 was $13.8 million ($10.7 million in 2007), consisting of $7.2 million ($4.4 million in 2007) in cash contributed by the Bank to its funded pension plans and $6.6 million ($6.3 million in 2007) 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[1]		Other benefit plans	
	2008	2007	2008	2007
Plan assets				
Fair value of plan assets at beginning of year	997.5	984.9	-	-
Bank's contribution	7.2	4.4	-	-
Employees' contributions	7.7	8.0	-	-
Benefit payments and transfers	(34.6)	(31.7)	-	-
Actual return on plan assets	(185.4)	31.9	-	-
Fair value of plan assets at year-end[2]	792.4	997.5	-	-
Benefit obligation				
Benefit obligation at beginning of year	965.5	923.8	167.6	160.1
Current service cost	29.9	25.6	7.3	6.4
Employee contributions	7.7	8.0	-	-
Interest cost	44.8	39.8	7.5	6.9
Benefit payments and transfers	(34.6)	(31.7)	(6.6)	(6.3)
Actuarial loss	119.6	-	6.5	0.5
Benefit obligation at year-end	1,132.9	965.5	182.3	167.6
Plan status				
Excess (deficiency) of fair value of plan assets over benefit obligation at year-end	(340.5)	32.0	(182.3)	(167.6)
Unamortized net transitional obligation (asset)	(38.8)	(51.7)	13.8	16.3
Unamortized cost of amendments	12.7	15.0	-	1.0
Unamortized net actuarial loss	419.9	63.8	43.3	39.8
Accrued benefit asset (liability)	53.3	59.1	(125.2)	(110.5)

1. *For the Supplementary Pension Arrangement, in which the accrued benefit obligation exceeds plan assets, the accrued benefit obligation and fair value of plan assets totalled $71.0 million ($54.1 million in 2007) and $40.3 million ($37.5 million in 2007), respectively.*
2. *The assets of the pension benefit plans were composed as follows: 52 per cent equities; 28 per cent bonds; 6 per cent real return Government of Canada bonds; 4 per cent other real return investments; 6 per cent real estate assets; and 4 per cent short-term securities and cash (55 per cent, 28 per cent, 6 per cent, 2 per cent, 5 per cent, and 4 per cent, respectively, in 2007).*

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

Benefit plan expense

	Pension benefit plans		Other benefit plans	
	2008	**2007**	**2008**	**2007**
Current service cost, net of employees' contributions	29.9	25.6	7.3	6.4
Interest cost	44.8	39.8	7.5	6.9
Actual (return) loss on plan assets	185.4	(31.9)	-	-
Actuarial loss	119.6	-	6.5	0.5
Benefit plan expense (income), before adjustments to recognize the long-term nature of employee future benefit costs	379.7	33.5	21.3	13.8
Adjustments				
Difference between expected return and actual return on plan assets for the year	(244.9)	(14.4)	-	-
Difference between amortization of past service costs for the year and actual cost of plan amendments for the year	2.3	2.3	1.0	1.0
Difference between amortization of actuarial loss for the year and actuarial loss on accrued benefit obligation for the year	(111.2)	7.4	(3.5)	1.5
Amortization of transitional obligation (asset)	(12.9)	(12.9)	2.5	2.5
Benefit plan expense recognized in the year	13.0	15.9	21.3	18.8

Significant assumptions

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

	Pension benefit plans		Other benefit plans	
	2008	2007	2008	2007
Accrued benefit obligation as at 31 December				
Discount rate	4.00%	4.25%	3.50%	4.20%
Rate of compensation increase	3.50% + merit	3.50% + merit	3.50% + merit	3.50% + merit
Benefit plan expense for year ended 31 December				
Discount rate	4.25%	4.25%	4.20%	4.25%
Expected rate of return on assets	6.50%	5.50%	-	-
Rate of compensation increase	3.50% + merit	3.50% + merit	3.50% + merit	3.50% + merit
Assumed health-care cost trend				
Initial health-care cost trend rate			7.60%	7.70%
Health-care cost trend rate declines to			4.70%	4.70%
Year that the rate reaches the ultimate trend rate			2018	2016

2008 sensitivity of key assumptions

($ millions)

	Change in obligation	Change in expense
Impact of 0.25 per cent increase/decrease in assumptions		
Pension benefit plans		
Change in discount rate	(48.8) / 52.4	(5.8) / 6.1
Change in long-term return on plan assets	n.a. / n.a.	(1.9) / 1.8
Other benefit plans		
Change in discount rate	(7.1) / 7.6	(0.3) / 0.3
Impact of 1.00 per cent increase/decrease in assumptions		
Other benefit plans		
Change in the assumed health-care cost trend rates	22.0 / (16.8)	2.2 / (1.6)

13. Capital

The Bank's objective in managing its capital is compliance with the externally imposed capital requirements of the Bank of Canada Act, which are outlined below. Capital is composed of share capital, a statutory reserve, a special reserve, retained earnings, and accumulated other comprehensive income. The Bank is not in violation of any externally imposed capital requirements at the balance sheet date.

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 have been issued to the Minister of Finance, who is holding them on behalf of the Government of Canada.

Statutory reserve

The statutory reserve was accumulated out of net income until it reached the stipulated maximum amount of $25.0 million in 1955.

Special reserve

The special reserve was created in 2007 further to an amendment to the Bank of Canada Act to offset potential unrealized valuation losses due to changes in fair value of the Bank's available-for-sale portfolio. The amount held in the special reserve is reviewed regularly for appropriateness using Value-at-Risk analysis and scenario-based stress tests and may be amended, pursuant to a resolution passed by the Board of Directors. The Value-at-Risk analysis uses historical data to estimate the maximum possible extent of unrealized valuation losses of the Bank's treasury bill portfolio. The scenario-based stress tests assess the impact of a rapid increase in interest rates on the value of the Bank's treasury bill portfolio. This reserve is subject to a ceiling of $400 million; an initial amount of $100 million was established in September 2007.

Retained earnings

The Bank does not hold retained earnings. The net income of the Bank, less any allocation to reserves, is remitted to the Receiver General for Canada.

Accumulated other comprehensive income

Accumulated other comprehensive income records and tracks unrealized valuation gains and losses on the Bank's available-for-sale portfolio, excluding BIS shares, which are recorded at cost.

14. Expense by class of expenditure

	2008	2007
Staff costs	161.0	149.3
Bank note research, production, and processing	71.8	49.9
Premises maintenance	29.3	25.7
Amortization	15.5	15.9
Other operating expenses	109.3	91.4
	386.9	332.2
Recoveries		
Retail debt services	-	(58.6)
Other	(11.0)	(11.0)
	(11.0)	(69.6)
Restructuring and related costs	-	5.1
	375.9	267.7

The recovery of the cost of retail debt services from the Government of Canada's Department of Finance was discontinued as of 1 January 2008. Other recoveries represent the amounts charged by the Bank for rental of premises, sales of optical security materials, and fees for a variety of other services.

In 2007, the Bank began restructuring its information technology organization in order to optimize processes and enhance the delivery of services, and recorded an expense of $5.1 million in special termination benefits related to this activity. This restructuring initiative commenced in late 2007 and was completed in the current year. No adjustments to these costs are considered necessary.

15. Commitments, contingencies, and guarantees

a) Operations

The Bank has a long-term contract with an outside service provider for retail debt services, expiring in 2021. At 31 December 2008, fixed payments totalling $248.1 million remained, plus a variable component based on the volume of transactions.

The Bank occupies leased premises in Halifax, Montréal, Toronto, Calgary, and Vancouver. At 31 December 2008, the future minimum payments are $8.0 million for rent, real estate taxes, and building operations. The expiry dates vary for each lease, from August 2009 to September 2018.

Minimum annual payments for long-term commitments

	Outsourced services	Leased space	Total
2009	19.5	1.6	21.1
2010	20.3	1.6	21.9
2011	20.3	1.1	21.4
2012	20.3	1.1	21.4
2013	20.3	0.8	21.1
Thereafter	147.4	1.8	149.2
	248.1	8.0	256.1

b) Foreign currency contracts

The Bank is a counterparty to several foreign currency swap facilities as follows:

	Maximum available
Contracts denominated in U.S. dollars	
Federal Reserve Bank of New York	30,000.0
Federal Reserve Bank of New York	2,000.0
	32,000.0
Contracts denominated in Canadian dollars	
Banco de México	1,000.0

The US$30 billion facility with the Federal Reserve Bank of New York expires on 30 April 2009. The other facilities have indefinite terms and are subject to annual renewal.

The Bank is also party to a standing foreign currency swap facility with the Exchange Fund Account of Canada. There is no stated maximum amount under this agreement. This swap facility was not used in 2008 or 2007.

These swap facilities were not used in 2008 or 2007 and, therefore, there were no related commitments at 31 December 2008.

c) Contingency

The 9,441 shares in the BIS have a nominal value of 5,000 special drawing rights (SDRs) per share, 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. The Canadian equivalent of this contingent liability was $66.8 million at 31 December 2008, based on prevailing exchange rates.

d) Legal proceedings

In 2004, 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.

e) 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 CPA. 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 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.

f) 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 risks not insured are recorded in the accounts at the time they can be reasonably estimated.

16. Related party transactions

The Bank is related in terms of common ownership to all Government of Canada departments, agencies, and Crown corporations. To achieve its monetary policy objectives, the Bank maintains a position of structural and functional independence from the Government of Canada through its ability to fund its own operations without external assistance and through its management and governance structures.

All related party transactions are recorded at their exchange amounts, which is the amount of consideration established and agreed upon by the related parties. Related party transactions with the Government of Canada are disclosed as part of the financial statements or the relevant notes.

17. Comparative figures

Certain comparative figures for 2007 have been reclassified to conform to the current year's presentation.

Senior Officers

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Deputy Governors

Pierre Duguay, Timothy Lane, David J. Longworth, John D. Murray

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Daniel Lamoureux, *Director, Operations*
Steve Little, *Director, Enterprise Portfolio Management and Business Solutions*
Janne Shaw, *Director, Project Office*

* *Member of Corporate Management Committee*
1. *Also Chair of the Board of Directors of the Canadian Payments Association*
2. *Visiting Special Adviser*
3. *Also Deputy Chair of the Board of Directors of the Canadian Payments Association*

Note: Positions as of 26 February 2009

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Note: Positions as of 30 January 2009

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.

Senior Loan Officer Survey
Published quarterly on the Bank's website.

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 on the Bank's website.

Weekly Financial Statistics
A 20-page package of banking and money market statistics. Published weekly on the Bank's website.

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Public Information

For general information on the role and functions of the Bank, contact our Public Information Office.
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