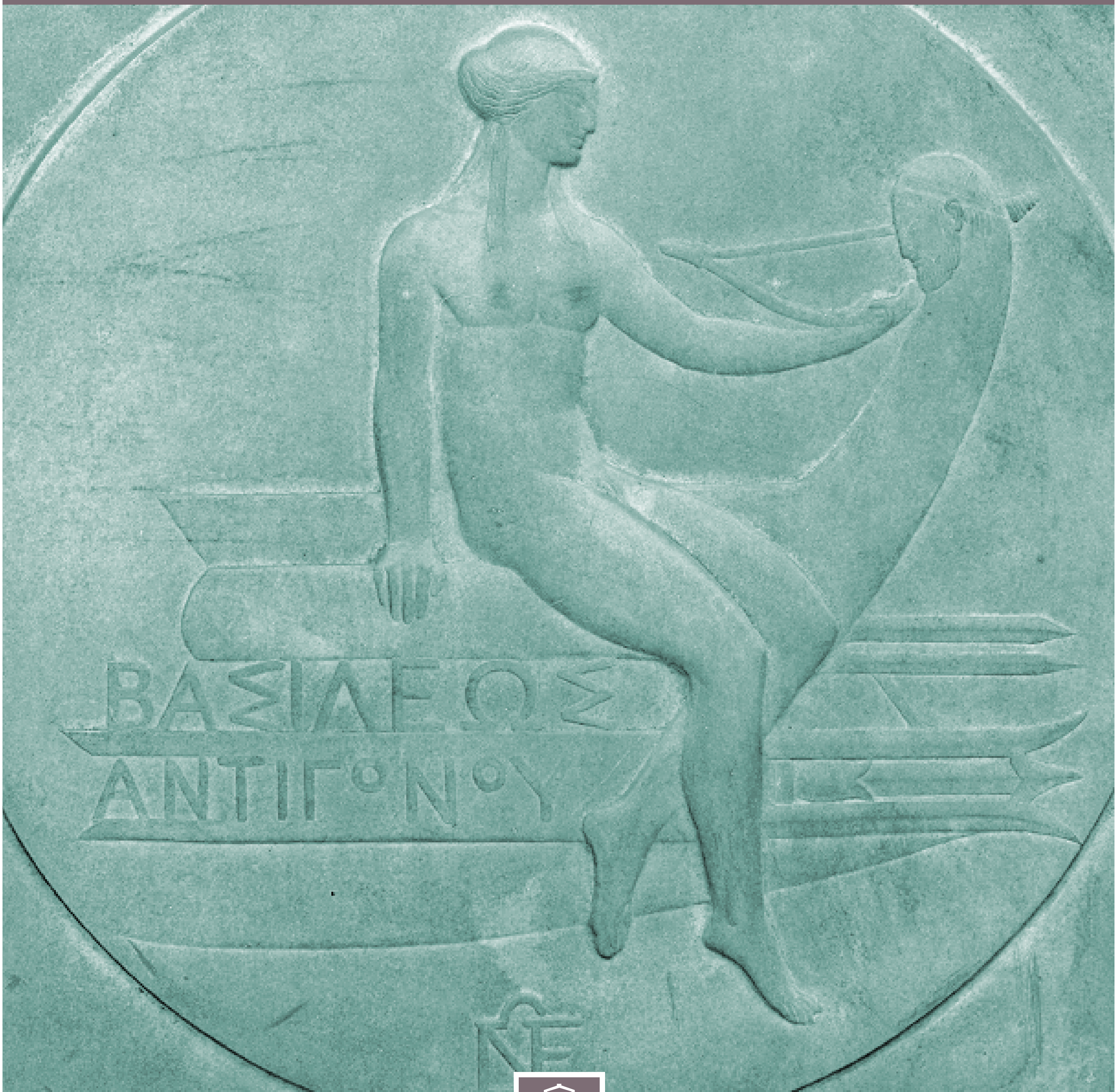
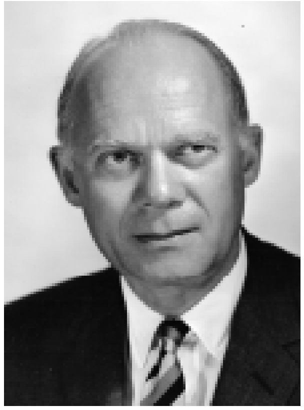
BANK OF CANADA





Louis Rasminsky, Governor of the Bank of Canada from 1961 to 1973, died in September 1998 at the age of 90.

During his remarkable career in public life, Louis Rasminsky was at the centre of some of the most significant international economic events of this century.

Born in Montreal, he was raised in Toronto and educated at the University of Toronto and the London School of Economics. In 1930, he joined the League of Nations as a specialist in monetary and banking matters.

In 1940, he came to the Bank where he organized the research and statistical section of Canada's Foreign Exchange Control Board. He was executive assistant to the Governors of the Bank from 1943 to 1954 and was appointed Deputy Governor in 1955 and Governor in 1961.

He was instrumental in defining the framework through which the Bank and the government should resolve any differences over the conduct of monetary policy, an issue that had played a part in the resignation of his predecessor, James Coyne.

Louis Rasminsky's influence extended far beyond the Bank. He was a highly respected international spokesman for Canada on economic matters. He played a key role at the 1944 Bretton Woods Conference as chairman of the committee that drafted the articles setting up the International Monetary Fund. John Maynard Keynes credited him with helping to shape the consensus that gave birth to the new post-war system for international finance and trade.

In addition to his work at the Bank, Louis Rasminsky served as Canada's executive director at the IMF for 16 years starting in 1946 and as executive director at the International Bank for Reconstruction and Development from 1950 to 1962.

He was made a Companion of the Order of Canada in 1968.

Those who knew him and worked with him remember Lou Rasminsky as a man of brilliant intellect, warm charm, and commanding eloquence.

Bank of Canada
234 Wellington Street
Ottawa, Ontario K1A 0G9

Bank of Canada • Banque du Canada

Gordon G. Thiessen
Governor - Gouverneur

Ottawa K1A 0G9

26 February 1999

The Honourable Paul Martin, PC, MP
Minister of Finance
Ottawa

Dear Mr. Martin,

In accordance with the provisions of the Bank of Canada Act, I am submitting the Bank of Canada's *Annual Report* for the year 1998 and the Bank's audited financial statements as at 31 December 1998.

Yours sincerely,

HIGHLIGHTS

1 9 9 8

Inflation remained low for the seventh consecutive year, and the inflation target range of 1 to 3 per cent was extended to 2001.

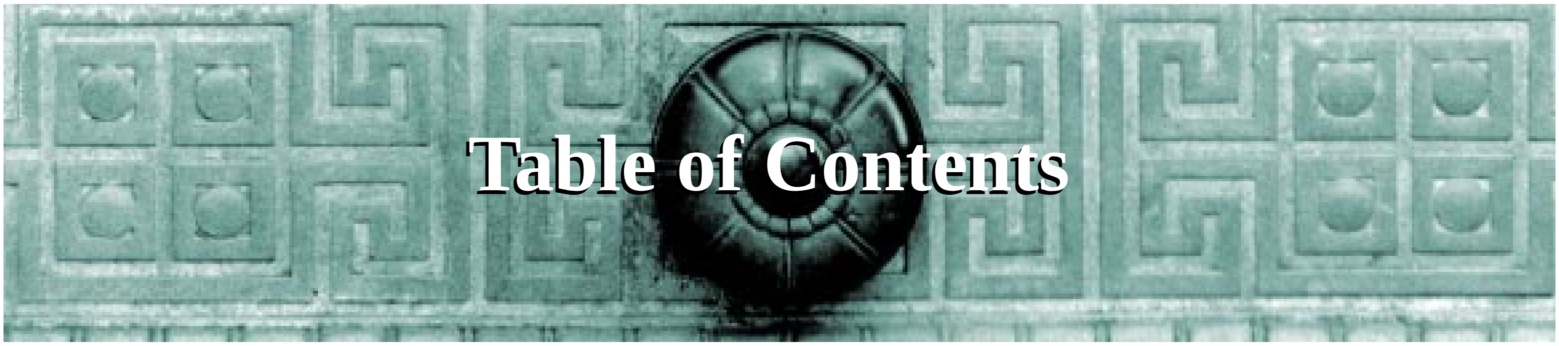
In a year marked by turbulence in global financial markets, Bank staff were involved in international efforts to find ways to strengthen the world financial system.

The corrections required to ensure that all the Bank's critical computer systems will be ready for the year 2000 were completed by the end of 1998. Testing with other institutions in the financial sector will take place during the first half of 1999.

Two major clearing and settlement systems that handle large-value transactions have been placed under the formal oversight of the Bank, contributing to the soundness of the financial system.

The Bank completed the implementation of a more efficient and less costly system for the distribution of bank notes.

The Bank's Web site now gives the public direct access to information about unclaimed bank balances.



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Cover: Macedon,
Antigonos Doson,
tetradrachm, 229-221 BC

One of six cast bronze panels embellishing the main door of the Bank's Ottawa headquarters.
Each panel portrays an ancient Greek coin.

Photo: James Zagon

Our Commitment to Canadians

- To contribute to the economic well-being of Canadians by

  - conducting monetary policy in a way that fosters confidence in the value of money

  - promoting the safety and soundness of Canada’s financial system

  - supplying bank notes that are readily accepted without concerns about counterfeiting

- To provide efficient and effective central banking and debt-management services

- To communicate our objectives openly and effectively and to be accountable for our actions

Gordon Thiessen

Statement from the Governor

This past year has been difficult and worrisome for many Canadians. The crisis that began in Southeast Asia in 1997 turned out to be more persistent and serious than expected. During 1998, it spread to other countries, resulting in nervous and volatile financial markets throughout the world. This led to large outflows of funds from some developing countries. Overall, the expansion of the world economy slowed during 1998 and is expected to slow slightly more in 1999.

All too often during the year, however, assessments of the international situation and its implications for Canada were too pessimistic. Given the seriousness of the difficulties, we have coped with them better on this occasion than in the past. I believe that is because our economy is operating from a firmer base than it has for many years. Canadian businesses have invested in new technologies, governments are no longer absorbing savings to finance deficits, and inflation—with the benefit of the Bank of Canada's policy of inflation control—has been low and stable.

Nevertheless, the decline in the external value of the Canadian dollar through much of 1998 was a source of dismay for many Canadians. So it is important for the Bank of Canada to explain what happened and why.

In Canada, unlike other major industrial countries, we tend to make extensive comparisons of our prices, asset values, and incomes with those of another country—the United States. Thus, when the U.S. dollar was strong against virtually all world currencies during much of 1997 and 1998, many Canadians interpreted the Canadian dollar's decline in relation to the U.S. dollar as a reduction in their economic well-being. In reality, this general strength of the U.S. dollar had little to do with Canada but reflected the good performance of the U.S. economy and the attractiveness of U.S. investments in times of international crisis.

Other sources of downward pressure on the Canadian dollar were more specific to Canada, however. The international financial crisis had its most immediate impact on Canada through a sharp decline in the prices of the primary commodities that we export. While commodities make up a declining share of exports, they still represent over 10 per cent of the total production of our economy. So as commodity prices tumbled more than 15 per cent during the year, the economy was hit hard, especially in British Columbia. Not surprisingly, the Canadian dollar moved downwards in response.

This part of the depreciation in the value of our currency, related to the fall in the international prices we receive for our commodity exports, did reflect a decline in the economic prosperity of Canadians. But the cause was weak commodity prices rather than the currency itself.

The international community is taking steps to ensure that financial markets will have access to better information, that financial institutions will be better regulated, and that any future crises will be managed more effectively to limit their spread.

For the most part, the decline in our currency through to the end of July was orderly. In August, however, the crisis spread to Russia, and investors around the world became concerned about how much further it would spread. Financial markets became disorderly, and in Canada there were signs of a potential loss of confidence in Canadian dollar investments. The Bank of Canada acted quickly to head off such a possibility with a sharp increase in the Bank Rate.

Since then, official interest rates around the world have been coming down. And many of the fears among international investors have diminished. As a result, most of the dire predictions made during the early autumn of a “credit crunch,” world recession, and deflation have moderated or been withdrawn. In Canada, the Bank Rate has come down, reversing three-quarters of its August increase.

Nonetheless, many developing countries were badly hit by the crisis. In addition, Japan, the world’s second largest economy, is in recession and global economic activity is expanding more slowly. As a result, many Canadians are asking what is being done to prevent a further spread or a recurrence of the events of the summer and autumn.

There is no single, simple solution that would prevent such crises. But in the international community, a number of initiatives have been taken, and a series of changes are

Bank representatives at a meeting of G-10 Governors in Basle:
L-R: Hans Tietmeyer, Deutsche Bundesbank; Don Stephenson and Bernard Bonin, Bank of Canada; and Jean-Claude Trichet, Banque de France

beginning to be implemented. None of them is dramatic, and much remains to be done. Nonetheless, the international community is taking steps to ensure that financial markets will have access to better information, that financial institutions will be better regulated, and that any future crises will be managed more effectively to limit their spread. I believe these changes, which are discussed in more detail in this report, will help reduce future risks.

In the midst of all these international concerns, an important event for the Bank passed almost unnoticed. Early in 1998, the joint agreement between the federal government and the Bank on the objective of monetary policy was reaffirmed and extended. The target for monetary policy will continue to be to hold inflation inside a range of 1 to 3 per cent. This target was extended to 2001, when it will be reassessed with the objective of defining long-term price stability. It is important to underline that setting a target for inflation control does not mean that monetary policy ignores broader economic objectives. Low and stable inflation is the best contribution the Bank can make to encouraging a more efficient and productive Canadian economy as well as one that is more stable, avoiding large fluctuations in incomes and employment. This is the third agreement between the Bank and the government since formal targets were introduced eight years ago. I believe this reflects a growing consensus on the appropriate role of monetary policy.

Setting a target for inflation control does not mean that monetary policy ignores broader economic objectives. Low and stable inflation is the best contribution the Bank can make to encouraging a more efficient and productive Canadian economy as well as one that is more stable, avoiding large fluctuations in incomes and employment.

Later in this report, we discuss the Bank's continued success in holding the trend of inflation inside our target range through 1998. As I noted earlier, low inflation was one of the factors that helped the Canadian economy cope with the adverse international environment of the past year. While the growth of economic activity slowed markedly from the strong pace of 1997, the net increase in the number of jobs during 1998 was a remarkable 450,000, a substantially larger gain than in 1997.

We also discuss the year-2000 challenge and explain the actions we have taken to prevent potential disruptions to the Bank's operations. These actions should reassure the financial institutions that deal with the Bank, as well as the public, that the Bank's ability to meet its responsibilities will not be impaired.

More generally, I am encouraged by the actions that have been taken to date by the financial sector in Canada to deal with the year-2000 challenge. Serious disruptions are unlikely. Nevertheless, it is widely recognized that more work is required, and financial institutions are developing contingency plans so that they can respond quickly to unforeseen problems.

Another issue discussed in the report is the counterfeiting of Canadian currency. While the incidence of counterfeiting has increased, it has not reached levels where it is a serious concern. Nonetheless, with an eye to the future, the Bank has decided to prepare a new series of bank notes that will incorporate some of the anti-counterfeiting devices developed in recent years. Work is underway on a new note design, and we hope to present Canadians with the first of a series of more modern, technologically advanced bank notes within the next two to three years.

Low inflation was one of the factors that helped the Canadian economy cope with the adverse international environment of the past year.

At the same time, we are increasing our efforts to educate people who handle currency, and we are co-operating with the RCMP and other police forces to identify false notes and stop counterfeiters as early as possible.

In the Financial Summary, you will find an accounting of the review and restructuring of operations that the Bank has carried out over the last four years. This review resulted in more emphasis on core central banking functions and improvements in the way we perform them. A sharper focus on strategy, planning, and delegation has improved our ability to anticipate and respond to events. The review has also substantially reduced Bank expenses. The success of this undertaking reflects the quality and the energy of the Bank's staff, and I want to thank them for their exceptional performance.

Finally, I would like to draw your attention to the tribute at the beginning of the report to the distinguished career of Louis Rasminsky, Governor of the Bank from 1961 to 1973. He died in September 1998. I would like to record here the debt that those of us who have succeeded him owe to Lou Rasminsky for the high standards he set in the conduct of monetary policy and the management of the Bank of Canada, as well as for his role in setting out clearly the relationship between the Bank and the government that has been incorporated in the Bank of Canada Act.

Gordon Thiessen

THE BANK AT A GLANCE

What the Bank Does

The Bank of Canada's primary responsibilities, as set out in the Bank of Canada Act, can be grouped into four broad areas.

International Activities

Bank staff

- work with government departments on international economic and financial issues
- participate in meetings of major international organizations
- take part in technical assistance programs to developing countries

Monetary policy

The Bank's most important responsibility is monetary policy. The goal of monetary policy is to preserve the value of money. In doing so, monetary policy contributes to rising living standards for Canadians through low and stable inflation.

Currency

The Bank is responsible for issuing Canada's bank notes—perhaps its best-known product. This involves designing (with particular emphasis on anti-counterfeiting features) as well as printing and distributing bank notes and replacing worn notes.

Central banking services

The Bank provides services to financial institutions, to the federal government, and to the public. To promote a safe, sound financial system, the Bank regulates and supports the major clearing and settlement systems through which financial institutions execute securities transactions and transfer funds. As the federal government's banker, the Bank provides advice on debt management, handles new borrowings, maintains bondholder records, and makes payments for interest and debt redemption. It also manages Canada's foreign exchange reserves. As a service to the public, the Bank holds unclaimed bank balances and helps people reclaim money left in unused accounts.

Retail debt services

Millions of Canadians hold Canada Savings Bonds and other debt instruments issued by the federal government. While management of this debt is now under the direction of Canada Investment and Savings, the Bank is responsible for maintaining debt registers and for servicing the accounts of debtholders through extensive computer systems and call centres.

PHOTO: JAMES ZAGON

Professor David Laidler, visiting Special Adviser, in a presentation to Bank employees. The position of Special Adviser was created in 1998 to widen the range of views on monetary policy within the Bank.

How the Bank Works

The Bank's responsibilities are carried out by a highly professional staff of 1,300 regular employees and close to 400 temporary and contract personnel, working in 11 departments.

The Governing Council

Made up of the Governor, the Senior Deputy Governor, and four Deputy Governors, the Governing Council takes collective responsibil-ity for the Bank's affairs. This includes dealing with broad organizational and strategic issues as well as formulating and implementing monetary policy.

The Management Forum

This forum consists of the Governing Council, advisers, and department chiefs. It meets regularly to exchange information on management issues, to review policy proposals, and to plan for the medium term by setting Bank priorities.

Delegation and accountability

The working environment at the Bank has become increasingly decentralized through more delegation of responsibility—following a review of operations that clarified the Bank's core functions and objectives. Department chiefs are responsible for operations and services in their own areas and are accountable to one of the Bank's four Deputy Governors or to the Senior Deputy Governor. Agreements established each year between department chiefs and Deputy Governors define the results that are expected and the resources that are needed to achieve them.

PHOTO: ANDREW BALFOUR

The Governing Council:
L-R, seated: Tim Noël, Sheryl Kennedy, Charles Freedman;
standing: Bernard Bonin, Paul Jenkins, Gordon Thiessen

Corporate Governance

Under the Bank of Canada Act, the Governor is responsible for monetary policy and for directing other Bank business. The Board of Directors is responsible for general oversight of the Bank. It also has duties related to financial and human resources management and general administration. For example, the Board participates in the strategic planning process, reviews major administrative policies, and approves the Bank's budget and accounting practices.

The Board's most important contribution to the operation of the Bank is its selection of the Bank's management team. The Board appoints the Governor and Senior Deputy Governor, subject to approval by the government. It also appoints the Deputy Governors and, through the Executive Committee, the advisers and department chiefs. During 1998, the Board began the process of selecting a Senior Deputy Governor to replace Bernard Bonin, who will retire in 1999.

In 1998, the Board focused on succession planning at the Bank. Board members helped shape plans for future management with special attention to employment equity, bilingualism, and skills in key areas such as communications. The Board also approved the creation of a rotating one-year post of visiting Special Adviser to increase the range of views available to management and to the Board, and to provide first-hand knowledge of the Bank to outside experts. The year-2000 challenge is a priority, and during the year the Board appointed a group of directors to review the Bank's preparations. The Board helped establish the Bank's medium-term objectives and reviewed how well past objectives were achieved. Although not directly responsible for monetary policy, the Board reviewed the standards of information, research, and analysis that go into monetary policy decisions and met with representatives of the International Monetary Fund to obtain an international comparison.

Always concerned with good corporate governance, the Board has incorporated at the Bank the best practices and principles from the public and private sectors. At the heart of the process is the Corporate Governance Committee created in 1996. The committee is composed of the four external directors who sit on the Executive Committee and is chaired by the lead director. The committee meets several times a year to review practices such as the frequency and timing of Board meetings, the annual cycle of agenda items, and the type and quality of information presented to the Board. In addition, at each Board meeting, the lead director chairs sessions in which only external directors participate. Through this process, the Board works independently to fulfill its oversight responsibility.

To ensure that its practices are effective, the Board reviews its work each year. In the 1998 review, the Board concluded that the right structures are in place and that it is receiving the information it needs to exercise its stewardship of the Bank's affairs.

The Board of Directors

The Board of Directors is composed of 12 directors from outside the Bank plus the Governor and the Senior Deputy Governor. The Deputy Minister of Finance sits on the Board as a non-voting member. Directors are appointed for three-year terms by the Minister of Finance (subject to approval by Governor-in-Council) and may be reappointed at the end of their terms. The directors come from across Canada, thereby providing an important link between the Bank and all regions of the country.

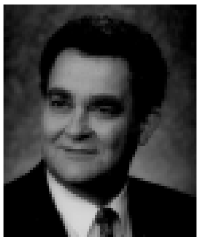
The Board meets at least seven times a year and also works through a series of standing committees. The Executive Committee, which is composed of four external directors, the Governor, the Senior Deputy Governor, and the Deputy Minister of Finance, may deal with any matter within the mandate of the Board and meets when it is impractical to assemble the full Board. The Planning and Budget Committee and the Human Resources and Compensation Committee play important roles in approving key financial and staffing plans. The Human Resources Committee also assesses the performance of the Governor and Senior Deputy Governor. The other committees are the Premises Committee, the Audit Committee, and the Corporate Governance Committee.

Judith Maxwell, CM * Ottawa, Ontario
Lead Director

Chairperson of the Corporate Governance Committee

Winston Baker
St. John's, Newfoundland

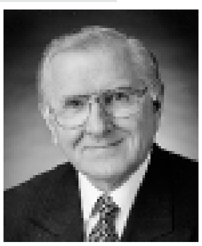
Chairperson of the Planning and Budget Committee



J. Bernard Boudreau
Halifax, Nova Scotia

Walter Dubowec, FCA *
Winnipeg, Manitoba

Chairperson of the Audit



Raymond Garneau, OC *
Westmount, Quebec

Chairperson of the Human Resources and Compensation

James S. Hinds, QC
Sudbury, Ontario

Chairperson of the Premises Committee

Barbara Hislop
Vancouver, British Columbia

Aldéa Landry, QC
Moncton, New Brunswick

Paul Massicotte
St-Laurent, Quebec

James S. Palmer, QC†
Calgary, Alberta

Barbara Stevenson, QC *
Charlottetown, Prince Edward Island

C. Scott Clark **
Deputy Minister of Finance
(Ex officio)

* Member of the Executive and Corporate Governance Committees
** Member of the Executive Committee
† Mr. Palmer resigned in September 1998.

Note:
Mr. Harold MacKay, QC, Regina, Saskatchewan, was appointed to the Board in January 1999.

MEETING THE YEAR-2000 CHALLENGE

The Challenge

The potential for disruptions to computer systems when the year 2000 arrives has been recognized as a problem that must be addressed to prevent or limit possible interruptions to services that could have more widespread economic implications. The Bank has been working for several years to prepare its own systems and is co-operating with government and the private sector to minimize any effects on the Canadian financial system.

The Bank has been working for several years to prepare its own systems and is co-operating with government and the private sector to minimize any effects on the Canadian financial system.

Inside the Bank

Among the Bank's most important operations are supplying currency, settling financial transactions, and acting as fiscal agent for the government. Included in the latter are paying interest on government debt and providing banking services to the government.

During 1997, the Bank prepared an inventory of the systems supporting these operations and identified elements that were not ready for the year 2000. This identification process revealed that the Bank was in a favourable position, in large part because so many systems had been upgraded and replaced in recent years. A schedule was then developed to ensure that the Bank's critical systems would be thoroughly tested and ready for the year 2000. By the end of December 1998, all of the Bank's main systems requiring attention had been corrected. A very small number of new systems that are still being developed will be year-2000 ready when they are completed this summer. To reduce the number of changes to systems that already meet year-2000 standards, a controlled freeze on further developments in automated systems has been put in place.

Coordination with government and the private sector

Much of what the Bank does involves external partners in government and in the private sector, and the Bank is co-operating closely with them as the year 2000 approaches. Joint testing of automated systems has already begun and will be completed through the spring and summer of 1999.

The financial system

The Department of Finance meets regularly with representatives of the Bank, the Office of the Superintendent of Financial Institutions, and the Canada Deposit Insurance Corporation to share information on the preparations of participants in the financial sector. The Bank pays particular attention to major clearing and settlement systems such as the Large Value Transfer System and the Debt Clearing Service. The operators of these systems have reported excellent progress in preparing for the year 2000. The Office of the Superintendent of Financial Institutions supervises over 400 institutions (banks and federally incorporated trust and loan companies and insurance companies) and has established target dates for their preparations. The vast majority of these institutions have met their December 1998 targets.

Bank notes

The Bank is working with financial institutions to prepare for possible increases in the demand for bank notes towards the end of 1999. The Bank routinely maintains a large reserve of notes to meet public demand in peak periods and in extraordinary circumstances such as the 1998 ice storm in eastern Canada. While the Bank does not expect demand to increase dramatically, it is important that Canadians be confident that bank notes will be available to meet their needs in advance of the year-2000 date change. Consequently, in 1999, inventories of bank notes will be increased significantly. Additional notes will be printed, and old notes that would otherwise have been destroyed are being stockpiled.

Canada Savings Bonds and marketable debt

The Bank maintains the register of Canada Savings Bonds and other retail government debt and pays interest based on the register. The main systems supporting the register have been completely redeveloped and are year-2000 ready. The Bank is confident that the register will continue to operate without problems after 1 January 2000. Internal testing has also been successfully completed on the systems that issue treasury bills and marketable bonds for the federal government and pay interest on the outstanding amounts. Testing of these systems with other institutions will take place mainly in the first half of 1999.

Contingency planning

The Bank is confident that its ability to meet its responsibilities will not be impaired by disruptions related to the year-2000 issue. Nevertheless, it is developing contingency plans to address any problems that might arise in its critical systems. In addition, the Bank, the government, and the private sector are establishing contingency plans to deal with the consequences for payment flows in the unlikely event that they are interrupted.

The smooth functioning of the Bank's operations and those of the financial sector depend on various infrastructure services such as electricity and telecommunications. Canada started early to prepare these essential services for the year 2000, and progress to date indicates that, should there be any disruptions, they would have only a limited and localized impact on the financial sector.

Expenses

The extra cost to the Bank over the 1997–99 period of the resources needed to meet the year-2000 challenge is estimated to be about $14 million. The bulk of these costs are for external specialists in information technology. In addition, the equivalent of about 55 person-years of Bank staff time will have been devoted to year-2000 preparations. Close to half of the allocated funds had been spent by the end of 1998, most of it to make the mission-critical systems year-2000 ready. The remaining funds will be spent on completing the testing of these systems with external parties, completing the development of contingency plans, and bringing non-mission-critical systems to a year-2000-ready status. This work is scheduled to be completed by the third quarter of 1999.

AN ACCOUNT OF OUR STEWARDSHIP

Monetary Policy

The goal of Canadian monetary policy is to contribute to rising living standards for all Canadians through low and stable inflation. Specifically, the Bank aims to keep the rate of inflation, as measured by the annual rate of increase in the consumer price index, inside a target range established jointly with the government. Since 1995, the target range has been 1 to 3 per cent.

The Bank implements monetary policy through its influence on short-term interest rates and thereby on monetary conditions. The concept of monetary conditions incorporates the effects on the economy of both short-term interest rates and the exchange rate for the Canadian dollar. Changes in monetary conditions affect inflation only indirectly and are usually felt over a period of 18 months to two years.

One of the most important results of the targets has been an increase in the internal discipline of the policy-making process.

Gordon Thiessen
The Canadian Experience with Targets for Inflation Control
The 1998 Gibson Lecture

Extending the inflation targets

In early 1998, the government and the Bank agreed to maintain the current target range for inflation to the end of 2001. Both judged that it would be useful to have a longer period in which the economy could demonstrate its ability to perform well under conditions of low inflation before determining the appropriate long-run target that would be consistent with price stability. The Bank reiterated that, because of the lags in the effect of monetary policy on inflation, it will continue to focus on bringing the *trend* rate of inflation (gauged by a measure of core consumer prices, which excludes volatile food and energy prices and the effect of indirect tax changes) towards the centre of the range over a period of about two years.

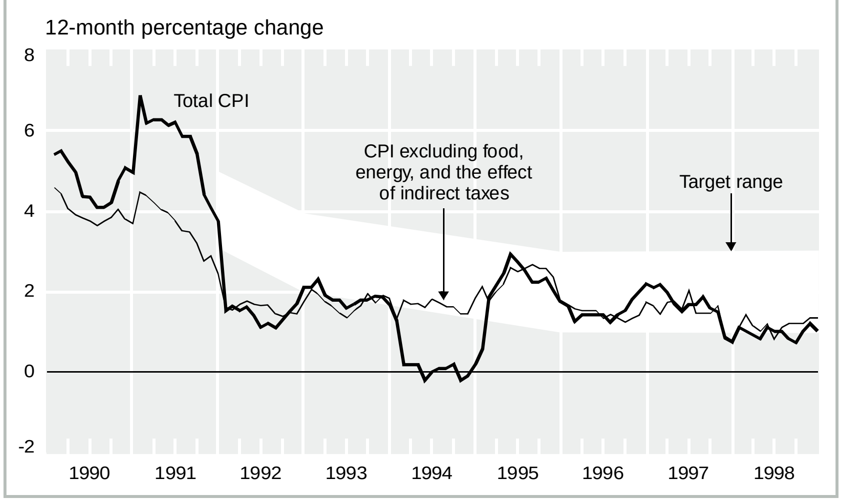
Meeting the target

The Bank's core measure of inflation fluctuated around the lower end of the target range throughout 1998, ending the year at 1.4 per cent. It was held down because adverse global economic developments led to a more pronounced slowing in the pace of domestic economic expansion than had been anticipated and to downward pressures on import prices. The fall in the external value of the Canadian dollar provided an offsetting influence by raising prices in certain sectors. The overall consumer price index rose more slowly—only 1 per cent—because of declines in oil prices.

Over the past year, global developments resulted in an exceptionally high degree of economic and financial uncertainty. The most significant consequences of these developments for the Canadian economy have been reduced world prices of primary commodities and the unsettling effect of financial market instability on business and consumer confidence.

Because Canada has a floating exchange rate, much of the adjustment has taken place through a decline in the external value of the Canadian dollar, rather than through deflationary pressure on output, employment, and wages. While that adjustment was taking place, the Bank had to guard against any potential loss of confidence in Canadian dollar investments. That task became more exacting in late summer, when global financial markets became increasingly edgy following the Russian debt moratorium. In this unsettled environment,

Consumer Price Index



the inflation-control targets provided an essential medium-term focus for the conduct of monetary policy.

Longer-term expectations of inflation, as reported by surveys of business forecasters, remained slightly below the midpoint of the target range. The yield spread between conventional and inflation-indexed government bonds narrowed further, indicating that investors are increasingly confident that inflation will remain low over the long run.

Promoting understanding of monetary policy

In the face of substantial economic and financial uncertainty, the Bank's regional offices, which opened in 1997, played a key role in explaining the issues confronting monetary policy. Staff from these offices assisted directors and members of the Governing Council with their communications activities across the country. They made numerous presentations to business, academic, and community groups; established contact with provincial government officials; and greatly expanded the number of companies and industry associations visited and the geographic area covered. These visits provide valuable opportunities to discuss monetary policy and to gather information on economic developments.

The inflation-targeting approach used by the Bank of Canada to implement monetary policy has been very successful in lowering inflation and maintaining it at a low level.

Statement of
IMF Mission to Canada
30 November 1998

Assessing international developments

Because international developments influence the Canadian economy and financial markets, the Bank devotes considerable time and energy to understanding and anticipating events in other countries. This involves close contacts with international economic and financial organizations, where information is shared and views are debated.

Also in 1998, the Bank of Canada hosted the fifth annual meeting of central bank governors of francophone countries. The participants, who came from 18 countries and from the International Monetary Fund, were invited to compare their respective challenges under different exchange rate regimes.

Research and analysis

The formulation of monetary policy rests on research and analysis. To ensure sound research, the Bank maintains contact with academics and other researchers in Canada and abroad. This involves networking, participating in and hosting conferences, and publishing research. To bring additional views on monetary policy from outside the Bank, a new visiting Special Adviser position was created in 1998. The one-year term position was filled in August by Professor David Laidler from the University of Western Ontario. Professor Laidler is one of Canada's most distinguished economic scholars and a world authority on monetary economics.

Research in 1998 focused on policy-making under uncertainty, the consequences of downward nominal wage rigidity for the choice of a long-run inflation target, and the explanation and prevention of international currency crises. The Bank also hosted a conference at which market practitioners and researchers from universities and other central banks discussed the information that can be derived from financial market prices. The proceedings of that conference will be published in the spring of 1999. The next conference, in the autumn of 1999, will examine

Foreign Exchange Markets

A survey of foreign exchange markets conducted in 1998 by central banks in 43 countries shows that Canada's foreign exchange market is the 11th largest in the world, with a daily turnover of about US$37 billion and that the Canadian dollar was the 7th-most-traded currency in the world.

The Exchange Rate and Price Stability

The exchange rate is an important price in the Canadian economy. It affects how much Canadians pay for imported goods and services and how much Canadian producers receive for goods that are exported, including primary commodities. Import and export prices in turn influence our purchasing patterns as consumers as well as the production and pricing decisions of Canadian producers.

A floating exchange rate can help keep inflation in check—inside the target range—by sheltering domestic prices from foreign inflation and by enabling monetary policy to stimulate or slow demand for Canadian products as needed. Without a floating exchange rate, the adjustment to shocks—internal or external—would fall upon wages and prices and would involve larger fluctuations in output and employment.

At the same time, Canada's inflation-control targets provide an essential anchor for the floating exchange rate. Without this anchor, the freedom of the currency to float could potentially undermine confidence in its value, both in world markets and at home.

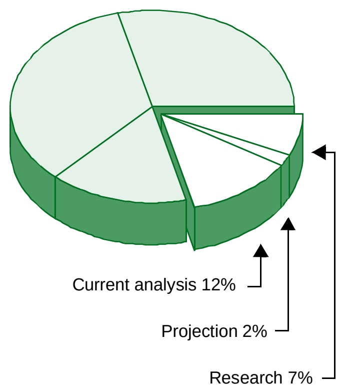
Maintaining price stability is the best way that monetary policy can help improve economic performance, and the flexible exchange rate is a vital component in that process.

the role of monetary aggregates in the transmission of monetary policy.

Operating expenses

The Bank spent nearly $41 million, or approximately 21 per cent of its total operating expenses, on the formulation and implementation of monetary policy. This represents an increase of about $3 million or 8 per cent from 1997. Contributing to this increase were the higher costs of information technology and an expansion of communication programs, particularly at the Bank's new regional offices.

Operating Expenses Related to Monetary Policy Formulation



Currency

Every year, Canadians make billions of payments using bank notes and coins. They rely on the Bank of Canada to furnish notes that are well protected from counterfeiting and to manage the supply of bank notes as economically as possible. The Bank took several steps in 1998 to accomplish these objectives. It broadened and intensified a public education program about the security features of genuine bank notes; it continued to pursue research and development on bank note technology and security; and it completed the implementation of a new distribution system for bank notes.

Protecting bank notes from counterfeiting

Counterfeiting remains at relatively low levels in Canada—only a small fraction of one per cent of the total value of notes in circulation. It has, however, increased recently. The value of counterfeit notes found in circulation in 1998 was double that of the previous year, mainly because of a sharp increase in the number of counterfeit $100 notes. A number of these high-quality counterfeit $100 notes appeared for the first time during the second half of 1998 and are believed to have originated from a single source. Their most notable characteristic is the excellent reproduction of the micro-printing found on genuine bank notes.

Counterfeit notes can still be distinguished by the absence of the gold-to-green colour shift in the Optical Security Device—the shiny rectangle in the upper left-hand corner of $20, $50, $100, and $1,000 notes. Counterfeits also lack the distinctive look and feel of other security features such as the raised ink in the portrait on genuine notes.

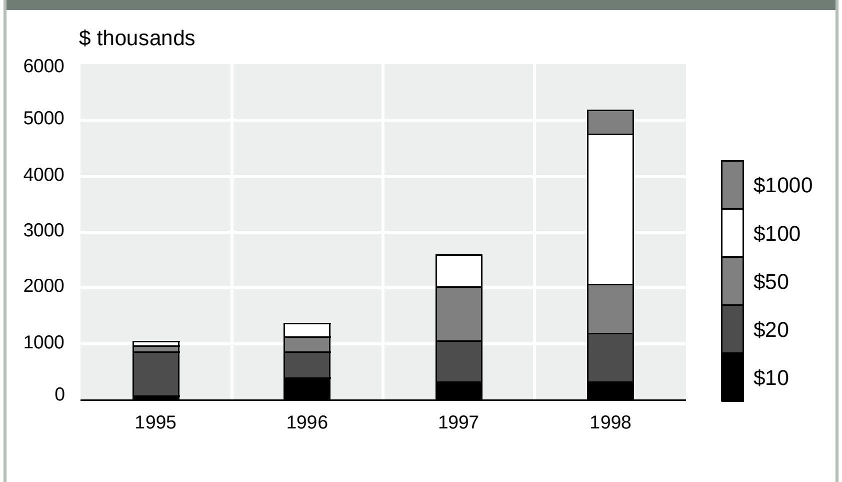
> *The best guarantee of bank note security is a public that readily recognizes the security features in bank notes.*

The best guarantee of bank note security is a public that readily recognizes the security features in bank notes. During 1998, the Bank added a new training video to its currency education program. This complemented the poster and leaflet introduced in 1997. Bank staff made presentations to cash handlers in the retail and financial services sectors and to police forces, to increase their awareness of the key security features of bank notes. Nearly one million leaflets were also distributed to the general public through financial institutions and provincial tourist bureaus.

The public can get more information about identifying counterfeit bank notes by calling 1-888-513-8212.

The Bank also keeps Canadians informed about the features of genuine bank notes through presentations by its regional representatives and through the Currency Museum in Ottawa.

Value of Counterfeit Bank Notes Found in Circulation

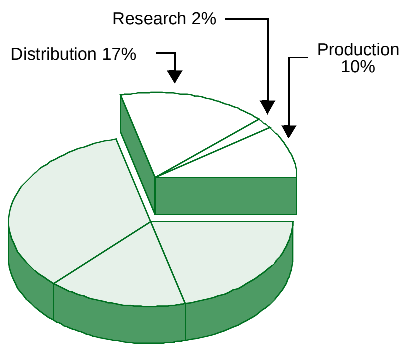


The Bank works closely with police forces, especially the RCMP, which is responsible for the enforcement of counterfeiting laws across the country.

Research and development

The Bank's program of research and development in bank note technology and security is a key defence against counterfeiting. This program focuses on developing technology to combat counterfeiting threats from advances in reproduction technology and on improving bank note production and distribution techniques. During 1998, the Bank's program centred on new anti-counterfeiting devices and the materials on which bank notes are printed. The current phase of this research and development will extend over the next two to three years, culminating in the issue of the first note in a new series. The goal is to develop new notes with better protection against counterfeiting technologies—notes that can be modified over time in response to new technological threats. The Bank is using expertise from the bank note printing companies, from law-enforcement agencies, and from leading note-issuing authorities around the world. It is also consulting with the public, the visually impaired, and with government officials. Consideration is being given to printing bank notes on polymer or polymer-based materials. These new materials could offer both increased security and longer note life, which would result in important savings.

Operating Expenses Related to Currency



Implementing the new bank note distribution system

During January 1998, the Bank of Canada and participating major Canadian deposit-taking institutions finished implementing a new system for the distribution of bank notes. It is more efficient and less costly than the old system, which was based on the Bank's nine agencies across the country. Under the new system, the participating institutions manage the flow of notes among themselves in co-operation with the Bank. The Bank is responsible for distributing the notes when they are first issued, maintaining records of note inventories in the system, withdrawing notes when they are no longer fit for circulation, and overseeing note quality and authenticity. The latter is an important responsibility of staff in the Bank's regional offices in Halifax, Montreal, Toronto, Calgary, and Vancouver.

The Bank also consults with the Royal Canadian Mint (which is responsible for the production and distribution of coins) on issues of mutual concern, particularly the distribution of coins to financial institutions.

Operating expenses

Expenses for currency operations were $56 million, or about 29 per cent of the Bank's total operating expenses. This represents a decrease of almost $10 million or about 15 per cent compared with 1997. The decline is the result of the implementation of the new bank note distribution system and lower requirements for notes.

Central Banking Services

Central banking services encompass a wide range of activities. Many involve the Bank and other government agencies working with the financial industry to promote a safe and sound financial system. Others include services provided to clients, including the federal government, financial institutions, and the general public. The Bank's goal is to provide these services as efficiently and effectively as possible.

Promoting a safe and sound financial system

Payment Clearing and Settlement Act

The Payment Clearing and Settlement Act (PCSA) gives the Bank of Canada responsibility for overseeing major clearing and settlement systems in Canada. These systems play a crucial role in the Canadian economy. The Bank's task is to ensure that appropriate arrangements are in place to manage and control risk so that if a participant in one of these systems should fail, the financial system would not be seriously disrupted.

Early in 1998, the Debt Clearing Service (DCS) was designated as subject to the Bank's oversight under the PCSA. In early 1999, similar action was taken with the Large Value Transfer System (LVTS). This did not result in any significant change in the risk-control arrangements of these systems because the Bank had been closely involved in their design. But the designation has provided greater legal certainty that the obligations of the system's participants would be settled according to the rules of the system even if one of the participants were to fail.

LVTS begins full operations

Canada's payments system became safer and more efficient early in 1999 when, after some unanticipated delays, the LVTS became fully operational. This new electronic payments system forms the core of the national payments system, providing a crucial central mechanism for reducing and controlling systemic risk. Other major clearing and settlement systems, such as the DCS, will use the LVTS to settle payment obligations among participants.

Bringing money market securities into DCS

The safety and efficiency of the financial sector was further enhanced in 1998 when over $150 billion of corporate money market securities were brought into the DCS. These securities are now traded, and the payment obligations arising from the trades are settled, in a system that is risk-proofed. Efficiency has been improved by eliminating the need for physical delivery of the securities and the exchange of the physical payment items.

In addition to these corporate securities, over $380 billion in Government of Canada securities were in this system at the end of 1998.

Acting as settlement agent

To further reduce the risk in the financial system, the Bank of Canada has agreed to act as settlement agent for the DCS. This role eliminates the so-called "banker risk" in the system—the risk arising from the possible failure of a private sector institution acting as the settlement agent.

Clearing and Settlement

A clearing and settlement system processes and discharges payment obligations among its participants (usually financial institutions). For example, the Debt Clearing Service, operated by The Canadian Depository for Securities Limited, is an electronic clearing and settlement system involving Canadian dollar bonds and money market securities. The Large Value Transfer System, operated by the Canadian Payments Association, is a real-time funds transfer system that handles large-value or time-critical Canadian dollar payments.

Clearing and settlement systems for foreign exchange

The Bank continues to have discussions with the operators and participants of clearing and settlement systems designed to reduce or eliminate the settlement risk in foreign exchange transactions. The discussions concern the development of arrangements for settling the Canadian dollar portion of these transactions and the Bank's role as settlement agent for these systems. One proposal would have the Bank, the LVTS, and the DCS open at 12:30 a.m. each business day to overlap with the business hours of payments systems in Europe and the Far East.

The method for implementing monetary policy is tied to the way payments are cleared and settled each day. In 1998, the Bank determined the method that it would employ under the new LVTS. Details can be found in the autumn issue of the Bank of Canada Review.

Services to the federal government

Managing the public debt and the government's cash balances

As fiscal agent for the federal government, the Bank provides advice on managing the public debt and handles new borrowings in the domestic treasury bill and bond markets. Borrowings are done through auctions. Over 50 were run by the Bank during the year. As the government's banker, the Bank also manages the government's cash balances. This too involves auctions. To maximize the government's revenue, portions of the cash balances are offered almost daily as term deposits and are bid for by financial institutions. In the autumn of 1998, a new automated system was introduced for handling all of these auctions.

Improving financial market efficiency

The Bank has an interest in the development of Canadian financial markets and actively supports measures to improve their efficiency. In 1998, after extensive consultations with market participants, the Bank and the Department of Finance introduced new rules governing dealer and client bidding at Government of Canada treasury bill and bond auctions. The Bank also co-operated with the Investment Dealers Association of Canada in developing a new code of conduct governing trading in wholesale markets for outstanding domestic debt. To support the liquidity of the bond market, the Bank undertook, on behalf of the government, a pilot operation that involved buying amounts of smaller outstanding government issues that are not actively traded. This allows for larger issues of more-liquid debt maturities.

Managing the government's foreign reserves and financial risk

The Bank manages the government's foreign exchange reserves. It invests the assets of the Exchange Fund Account and is involved with borrowings when necessary to maintain an adequate level of reserves. The Bank also intervenes in the foreign exchange market, on behalf of the government, to influence trading in the Canadian dollar. Because of the dollar's weakness, intervention was heavy at times during 1998, as were foreign currency borrowings to increase reserve holdings.

To reflect the growth of the exchange market in Canada, the Bank and

MacKay Report

The *Report of the Task Force on the Future of the Canadian Financial Services Sector* (the MacKay report) was released in September. The report proposes significant changes to the current arrangements in the Canadian financial sector. The Bank is working closely with the Department of Finance to ensure that these important issues are given careful consideration.

the Department of Finance established a new intervention policy in September. This approach is less automatic and allows more discretion in the timing and amount of intervention. The Bank also participated with other industrialized countries in efforts to standardize and improve the quality of the information on reserve holdings that is reported to the public.

In addition, the Bank measures and monitors the government's exposure to financial risk. In 1998, a joint committee of the Department of Finance and the Bank of Canada was established to oversee this operation.

International activities on behalf of the government

Throughout 1998, the Bank of Canada advised and assisted the government concerning Canada's participation in several multilateral financial assistance packages arranged for emerging-market economies. Early in the year, a group of countries, led by the Group of Seven (G-7), agreed to establish bilateral credit lines for South Korea in support of a large financial package that had been arranged for them in December 1997 by the International Monetary Fund (IMF). Canada's contribution was an amount up to US$1 billion. South Korea did not need to draw on the facility.

In July, for the first time in 20 years, the IMF activated the General Arrangements to Borrow (GAB) to help finance a loan to Russia. Similarly, in December, the New Arrangements to Borrow (NAB), which are similar to the GAB, were activated to support an IMF financial package for Brazil. Canadian loans extended to the IMF under both the GAB and the NAB form part of Canada's international reserves.

In addition to the IMF arrangement, a multilateral credit facility was provided to the Brazilian central bank by a group of 20 industrialized countries. Canada's share in this facility was US$500 million.

GAB and NAB

The General Arrangements to Borrow (GAB) were established by the Group of Ten (G-10) countries in 1962 to supplement the regular quota-based resources of the International Monetary Fund.

The New Arrangements to Borrow (NAB) came into force in November 1998. Like the GAB, they provide additional resources to the IMF to forestall or cope with emergencies that threaten the stability of the international financial system. There are 25 participants in this new arrangement, including the G-10 countries.

Although the GAB remains in existence, the NAB is the facility of first and principal recourse. Together, they provide the IMF with supplementary resources roughly equivalent to US$48 billion, of which Canada's share is currently about US$2 billion.

Services to financial institutions

Federal legislation requires the Bank of Canada to provide a security registry service in all provinces. Lenders register with the Bank their intention to take collateral from borrowers in the form of certain financial assets as security against loans. This registry can be searched for prior registrations.

For more than a year, the Bank has been looking at alternative ways of delivering this service. It decided to contract out the development and operation of a new computer-based system, which was in place by mid-1998. Under the new arrangements, lenders register their intention to take security directly with the operator of the system at various points throughout the country. As before, the registry can be searched in response to requests submitted by mail, facsimile, and

Strengthening the International Financial System

Over the past year, a number of important initiatives were taken to strengthen the international financial system.

Particularly important was the work of three groups that were set up in April to look at a range of issues to reform the financial system. The working groups were made up of representatives of 22 industrial and emerging-market economies. Their reports were published in October and are available on the Web sites of the Bank for International Settlements and the International Monetary Fund (IMF).

The first group considered how transparency and accountability can improve economic performance. The second group studied the principles and policies that foster the development of a stable and efficient financial system. Highlighting this study was a Canadian initiative supporting "peer reviews" of national supervisory systems. The third group focused on policies that would help prevent international financial crises and contribute to their orderly resolution. It stressed the importance of appropriate exchange rate regimes, better risk management by lenders, limits on guarantees provided by governments, and effective insolvency regimes. The third group's report also set out a framework that would allow debt obligations to be worked out in a co-operative and orderly way to serve the interests of both debtors and creditors.

The Bank of Canada was represented on the first and third of these working groups, while the Department of Finance participated in the second.

At the end of October, G-7 finance ministers and central bank governors issued a communiqué in which they made a commitment to implement many of the reforms recommended by these three groups. The objective, they said, is to create "an international financial system for the twenty first century that captures the full benefits of global markets and capital flows, minimizes the risk of disruption, and better protects the most vulnerable while promoting the international monetary stability which is an element of a stable international financial system." They also pledged to work with other countries to promote the adoption of these reforms.

Two other developments that have helped to strengthen the international financial system were the establishment of the New Arrangements to Borrow in November, and the general increase in IMF quotas that came into effect in January 1999.

courier. In the future, searches by authorized users will be possible through remote Internet access.

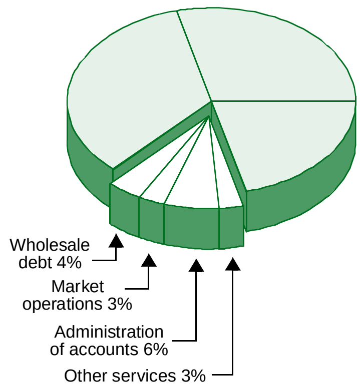
Services to the general public

Chartered banks are required to transfer to the Bank of Canada all unclaimed bank balances maintained in Canada in Canadian currency that have been inactive for a period of 10 years. In 1998, for the first time, the Bank's Web site provided direct public access to information about these unclaimed bank balances. There were more than 300,000 visits to the site after it became operational in November. This service supplements the 1-800 telephone service and Internet e-mail address introduced in 1997.

In 1998, the Bank responded to 10,500 general inquiries (46 per cent more than in 1997), completed more than 50,000 searches (79 per cent more than in 1997), and paid a total of $4.7 million (36 per cent more than in 1997) to settle approximately 9,800 claims (61 per cent more than in 1997).

Further rapid growth in claim settlements is expected now that the Web site is up and running.

Operating Expenses Related to Central Banking Services



Unclaimed Bank Balances

The public can search for unclaimed bank balances on the Bank's Web site at

http://www.bank-banque-canada.ca/

For those without Internet access, many public libraries are equipped with Internet stations. The public can also access information on unclaimed bank balances at the Bank's five regional offices.

Information is also available by calling 1-888-891-6398.

Operating expenses

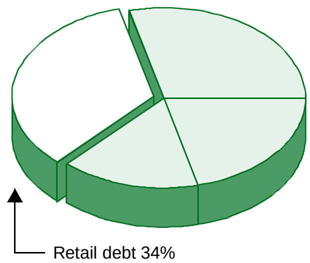
Expenses for central banking services were $32 million in 1998, or just under 17 per cent of the Bank's total operating expenses. This represents a decline of about $1.5 million or 4.5 per cent from 1997, mainly attributable to more efficient delivery of these services. Revenues received for services provided totalled just under $1 million.

Retail Debt Services

In its role as fiscal agent, the Bank provides many services related to handling the federal government's debt. Those that relate to debt held mainly by large institutional investors were described under Central Banking Services. The remainder relate to the government's retail debt, which includes Canada Savings Bonds (CSBs) and other debt held by individ-uals.

The Bank's retail debt services are distinct from its other operations. The Bank provides these services for Canada Investment and Savings, an agency of the Department of Finance, and recovers its costs from the federal government. Canada Investment and Savings is responsible for directing the retail debt program, while the Bank's role is to provide operational and systems support. (The annual report of Canada Investment and Savings is available from the Department of Finance.)

Operating Expenses Related to Retail Debt Services



Because millions of Canadians hold the government's debt, extensive computer systems and call-centre facilities are needed to service the accounts. As a result, the resources committed to retail debt are considerable, and they have been growing in recent years, as key underlying computer systems have been redesigned to allow the introduction of new services.

Activities in 1998

During 1998, a new computer-based system for handling the retail debt register was brought on stream after four years of development. This was a major overhaul of a system that had been built in the 1970s. Over the year, progress was made on another multi-year undertaking—a complete revamping of the process for handling the CSB payroll savings plan. This plan is offered across the country through more than 15,000 employers. Many of these employers had complained about the administrative work involved in being part of the payroll savings plan. The new process sharply reduces their work and eliminates fees paid by the government for services from financial institutions. It adds to the Bank's activities, however, and was a significant part of the increase in retail debt operating expenses in 1998.

The Bank also provided operational support as new features were added to the government's retail debt program during the year. This included the introduction of the Canada Premium Bond, which offers a higher interest rate but can be redeemed only annually. It also included an extension of the sales period, beyond the traditional autumn campaign, for both Canada Premium Bonds and CSBs.

During 1998, the Bank completed the consolidation in Ottawa of services to bondholders that were previously offered through the Bank's agencies.

Operating expenses

Expenses for retail debt services were $65.5 million in 1998, or 34 per cent of the Bank's total operating expenses. This represents an increase of about $18 million or 37 per cent over 1997. The increase is due to new computer systems and support for the expanded retail debt program. All of these costs are recovered from the federal government.

FINANCIAL SUMMARY

Financial Summary

Operating expenses

Monetary policy, currency, and central banking services

In the past few years, the Bank's core functions—monetary policy, currency, and central banking services—have been extensively reviewed and restructured to focus more sharply on the Bank's public policy activities, the needs of its clients, and the efficiency and effectiveness of its operations. This strategy has yielded cost savings, a reduction in regular staff, and the sale of 9 of the 13 buildings owned by the Bank.

At the same time, the review and restructuring required new investments in technology and staff training, as well as spending to improve communications and expand regional offices. The net result has been a saving of more than $39 million, or 24 per cent, in 1998 compared with expenditures in 1994.

In 1998, expenses for monetary policy, currency, and central banking services were more than $8 million lower than in 1997, a 6 per cent saving. This was mainly due to a decrease in the number of bank notes printed and other cost savings from the rationalization of operations and service delivery.

The financial impact of the restructuring concluded in 1998. Several new programs in currency and central banking services are expected to increase expenditures over the next few years. There will also be some increase in the cost for bank notes in 1999 due to the buildup of additional inventories, but these will be offset by lower costs in 2000.

Retail debt services

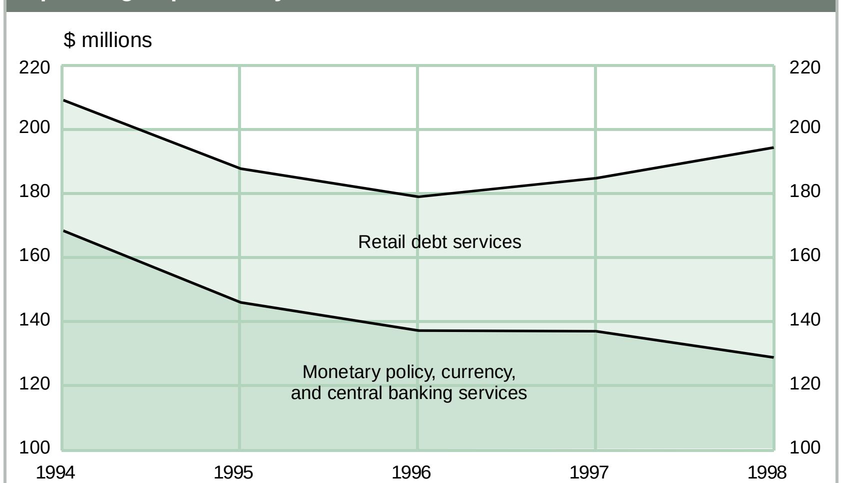
The Bank also provides services for Canada Investment and Savings—the agency responsible for the retail debt program. Legislation was changed in mid-1997 to allow the Bank to charge for these services in order to clarify accountability for the program. The first full year of cost recovery was 1998.

Like other functions of the Bank, retail debt services has been restructured over the past several years. In 1998, expenses were $18 million higher than in 1997 because of significant changes to major computing systems and expenditures to support new services. At the same time, there have been savings from the introduction of new technology and the consolidation of bond transactions.

Salary expenses

In 1998, the Bank adjusted salaries on average 3 per cent, consistent with its objective of assuring a competitive, equitable salary structure. In addition, salary expenses increased by a further 4 per cent as a result of higher costs for information technology professionals. These increases were largely due to market pressures created by the need to prepare computer systems for the year 2000.

Operating Expenses by Function



Other expenses/revenue

The Bank had one-time net revenue of $8.3 million. This was mainly from the sale of four Bank buildings in Winnipeg, Montreal, Toronto, and Saint John, N.B. These buildings were no longer needed because of the new bank note distribution system and the consolidation of bond and banking services. The gain from the sale was partly offset by a $1.0 million expense associated with the completion of the Bank's workforce adjustment program in 1998.

Revenue from investments

Total revenue from investments was $1.8 billion in 1998, an increase of 14 per cent from 1997. The main source of revenue is interest earned on holdings of federal government securities, financed primarily by the bank notes that are issued by the Bank. Net revenue paid to the Government of Canada in 1998 was $1.7 billion, an increase of 17 per cent from 1997.

Net revenue is not a good indicator of the Bank's management performance. The Bank deals in financial markets to achieve policy goals, not to maximize its revenues, and these revenues are highly dependent on interest rates. For these reasons, the level of operating expenses is a better indicator of the Bank's stewardship of public resources.

Operating expenses by function

Millions of dollars

Operating expenses by function

	1998	**1997**	**1996**	**1995**	**1994**
Monetary policy	40.7	37.6	35.0	33.0	33.8
Currency	56.0	65.7	69.6	80.0	101.4
Central banking services	32.2	33.7	32.7	33.1	33.3
	128.9	137.0	137.3	146.1	168.5
Retail debt services	65.5	47.7	41.7	41.7	40.7
Retail debt recoveries*	(65.5)	(28.9)			
Other expenses/(revenue)	(8.3)	(11.6)	34.7	33.0	
Net operating expenses	**120.6**	**144.2**	**213.7**	**220.8**	**209.2**

* See page 42, note 1: Retail debt services.

Financial Statements

YEAR ENDED 31 DECEMBER 1998

Bank of Canada
Financial reporting responsibility

The accompanying financial statements of the Bank of Canada have been prepared by management in accordance with accounting principles generally accepted in Canada and have been consistently applied. The integrity and objectivity 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, management maintains financial and management control systems and practices to provide reasonable assurance that the financial information is reliable, that the assets are safeguarded, and the operations are carried out effectively. The Bank has an internal audit department whose functions include reviewing internal controls and their application, on an ongoing basis.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control and exercises this responsibility through the Audit Committee of the Board. The Audit Committee reviews the Bank's annual financial statements and recommends their approval by the Board of Directors. The Audit Committee meets with management, the internal auditor, and the Bank's external auditors appointed by Order-in-Council.

These financial statements have been audited by the Bank's external auditors, Coopers & Lybrand and Caron Bélanger Ernst & Young, and their report is presented herein.

G.G. Thiessen, Governor

L.T. Requard, Corporate Secretary

Ottawa, Canada

AUDITORS OF THE BANK OF CANADA
VÉRIFICATEURS DE LA BANQUE DU CANADA

C. P. 813, SUCCURSALE B | P.O. BOX 813, STATION B
OTTAWA, CANADA
K1P 5P9
CARON BÉLANGER ERNST & YOUNG | COOPERS & LYBRAND

AUDITORS' REPORT

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

We have audited the balance sheet of the Bank of Canada as at 31 December 1998 and the statement of revenue and expense for the year then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with 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 1998 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles.

Caron Bélanger Ernst & Young
Chartered Accountants
Ottawa, Canada
22 January 1999

Coopers & Lybrand
Chartered Accountants

Bank of Canada
Statement of revenue and expense

Year ended 31 December 1998

	1998	1997
	Millions of dollars	
REVENUE		
Revenue from investments	**1,799.4**	1,578.6
EXPENSE by function (notes 1 and 3)		
Monetary policy	**40.7**	37.6
Currency	**56.0**	65.7
Central banking services	**32.2**	33.7
	128.9	137.0
Retail debt services - expenses	**65.5**	47.7
Retail debt services - recoveries	**(65.5)**	(28.9)
Other revenue - net	**(8.3)**	(11.6)
	120.6	144.2
NET REVENUE PAID TO RECEIVER GENERAL FOR CANADA	**1,678.8**	1,434.4

(See accompanying notes to the financial statements.)

Bank of Canada
Balance sheet

As at 31 December 1998

ASSETS	1998	1997
	Millions of dollars	
Deposits in foreign currencies		
U.S. dollars	**321.1**	383.1
Other currencies	**6.2**	3.2
	327.3	386.3
Advances to members of the Canadian Payments Association	**655.7**	363.3
Investments (note 8)		
Treasury bills of Canada	**10,563.8**	14,065.0
Other securities issued or guaranteed by Canada maturing within three years	**6,302.2**	4,165.7
Other securities issued or guaranteed by Canada not maturing within three years	**10,880.1**	8,799.7
Other investments	**4,455.7**	3,434.1
	32,201.8	30,464.5
Bank premises (note 4)	**188.0**	189.0
Other assets (note 5)	**436.4**	346.1
	33,809.2	31,749.2

(See accompanying notes to the financial statements.)

LIABILITIES	1998	1997
	Millions of dollars	
Capital paid up (note 6)	**5.0**	5.0
Rest fund (note 7)	**25.0**	25.0
Bank notes in circulation	**32,637.5**	30,542.0
Deposits		
Government of Canada	**10.6**	40.6
Chartered banks	**578.7**	539.0
Other members of the Canadian Payments Association	**73.5**	24.6
Other deposits	**243.7**	278.3
	906.5	882.5
Liabilities in foreign currencies		
Government of Canada	**162.0**	231.2
Other liabilities	**73.2**	63.5
	33,809.2	31,749.2

Governor, G.G. Thiessen

Chief Accountant, F.J. Mahoney

On behalf of the Board

Chairman, Audit Committee, W. Dubowec FCA

Lead Director, J. Maxwell

Bank of Canada
Notes to the financial statements

Year ended 31 December 1998

1. Bank functions

The Bank of Canada's primary responsibilities are set out in the Bank of Canada Act and can be grouped into four broad functions which are described below. Net operating expenses in the *Statement of revenue and expense* are reported on the basis of these four corporate functions. Certain comparative figures have been reclassified to conform with the financial statement presentation adopted in the current year. Net operating expenses by major classes of expenditure are presented in note 3.

Monetary policy

The Bank's most important responsibility is monetary policy. Monetary policy is concerned with managing the rate of monetary expansion in a way that is consistent with preserving the value of money.

Currency

The Bank is responsible for issuing bank notes in Canada. This responsibility involves note design (including anti-counterfeiting features), as well as the printing and distribution of bank notes and their eventual replacement.

Central banking services

The Bank carries out a variety of activities that regulate and support Canada's principal systems for clearing and settling payments and other financial transactions. The Bank also provides a number of central banking services and advice to the federal government, financial institutions, and the general public. The Bank advises the federal government on matters relating to the public debt and is responsible for issuing market debt, maintaining bondholder records, and making payments on behalf of the government for interest and debt redemption.

Retail debt services

As fiscal agent, the Bank provides systems and operational support services to the Canada Investment and Savings agency (CI&S) in support of the federal government's retail debt program and is responsible for issuing debt, maintaining bondholder records, and making payments on behalf of the federal government for interest and debt redemption. The Bank recovers the cost of retail debt operations on a full cost basis. Recoveries from the federal government began with amendment of the Bank of Canada Act, effective June 1997.

2. Significant accounting policies

The financial statements of the Bank are in accordance with generally accepted accounting principles and conform to the disclosure and accounting requirements of the Bank of Canada Act and the Bank's by-laws. As all material changes in financial position are evident from the financial statements, a separate statement of changes in financial position has not been prepared as it would not provide any additional useful information. The significant accounting policies of the Bank are:

a) Revenues and expenses

Revenues and expenses are accounted for on the accrual basis, except for interest on advances to a bank ordered to be wound up which is recorded as received.

b) Translation of foreign currencies

Assets and liabilities in foreign currencies are translated to Canadian dollars at the rates of exchange prevailing at the year-end. Foreign currency assets held under short-term foreign currency swap arrangements with the Exchange Fund Account of the Government of Canada, as described in note 11(a), are converted to Canadian dollars at the contracted rates. Gains and losses from translation of, and transactions in, foreign currencies are included in revenue.

c) Advances

Advances to members of the Canadian Payments Association are liquidity loans for which the Bank charges the Bank Rate. These loans are fully collateralized and generally overnight in duration.

d) Investments

Investments, consisting mainly of Government of Canada treasury bills and bonds, are recorded at cost and are adjusted for amortization of purchase discounts and premiums. The amortization, as well as gains and losses on disposition, is included in revenue.

e) Bank premises

Bank premises, consisting of land, buildings, computer hardware/software, and other equipment, are recorded at cost less accumulated depreciation. Computer software is capitalized only when its cost exceeds $2 million. Depreciation is calculated using the straight-line method and is applied over the estimated useful lives of the assets, as shown below.

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

f) Deposits

The liabilities within this category are generally Canadian dollar non-interest-bearing demand deposits.

g) Insurance

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

3. Expense by classes of expenditure

	1998	1997
	Millions of dollars	
Salaries	**77.2**	72.3
Benefits and other staff expenses	**14.8**	17.7
Currency costs	**14.8**	18.4
Premises maintenance, net of rental income	**22.2**	26.1
Services and supplies	**43.4**	30.7
Depreciation	**23.7**	22.3
	196.1	187.5
Recoveries		
Retail debt services	**(65.5)**	(28.9)
Other	**(1.7)**	(2.8)
	128.9	155.8
Other expenses (revenue)		
Workforce adjustment (note 9)	**1.0**	2.5
Miscellaneous	**(9.3)**	(14.1)
Total	**120.6**	144.2

Salaries and benefits of Bank staff engaged in premises maintenance are not included in the *Salaries* or *Benefits and other staff expenses* categories, but rather as part of *Premises* expenses.

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

Miscellaneous revenue for 1998 and 1997 principally reflects net book gains on the sale of Bank buildings.

4. Bank premises

	1998			1997		
	Millions of dollars					
	Cost	Accumulated depreciation	Net book value	Cost	Accumulated depreciation	Net book value
Land and buildings	**168.0**	**65.1**	**102.9**	201.0	88.2	112.8

	1998			1997		
Computer hardware/software	**61.6**	**24.6**	**37.0**	36.1	24.0	12.1
Other equipment	**136.5**	**88.4**	**48.1**	132.5	83.0	49.5
	366.1	**178.1**	**188.0**	369.6	195.2	174.4
Projects in progress	**–**	**–**	**–**	14.6	–	14.6
	366.1	**178.1**	**188.0**	384.2	195.2	189.0

5. Other assets

This category includes accrued interest on investments of $352.1 million ($286.4 million in 1997).

6. Capital paid up

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

7. Rest fund

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

8. Investments

This category includes Government of Canada treasury bills and bonds as well as other investments which are held under short-term foreign currency swap arrangements with the Exchange Fund Account of the Government of Canada as described in note 11(a).

The Bank typically holds its investments in treasury bills and bonds until maturity. The amortized book values of these investments approximate their par values. At the year-end, the average yield on the Bank's holdings of treasury bills which average three months to maturity was 5.0 per cent (3.9 per cent in 1997), while the average yield for bonds maturing within three years was 6.6 per cent (6.6 per cent in 1997), and for those maturing in over three years was 6.9 per cent (7.8 per cent in 1997).

9. Workforce adjustment

Following extensive reviews of its activities, the Bank has streamlined a number of its operations resulting in a total reduction of approximately 640 of its staff positions over the past 3 years. The position reductions have been accomplished through early retirements and voluntary departures, as well as staff layoffs concentrated at the Bank's agency locations across Canada where redeployment opportunities were limited. To record termination costs, the Bank made provisions in its accounts of $33 million in 1995, $5 million in 1996, and $2.5 million in 1997. As at 31 December 1998, when the workforce adjustment program ended, the total cost of the program was $41.5 million compared with the provision of $40.5 million. The difference was included in expenses for 1998.

10. Pension plan

The Bank sponsors a defined-benefit pension plan for its employees which is registered under the Pension Benefits Standards Act. The plan provides pension benefits based on length of service and rates of pay.

Actuarial valuations of the pension plan are made periodically by an independent actuary using the projected benefit method prorated on service. Market-related values are used to value pension plan assets. Based on the latest actuarial valuation as at 31 December 1995, the estimated present value of the accrued pension benefits as at 31 December 1998 was $449.6 million ($436.5 million in 1997), and the estimated market-related value of the pension plan assets was $565.5 million ($512.3 million in 1997).

Pension expense for 1998 was in a credit position of $4.3 million ($1.3 million in 1997). These amounts comprise the actuarially computed cost of pension benefits in respect of current year service and the amortization of past service costs and experience gains and losses. Amortization is calculated on a straight-line basis over the expected average remaining service life of the plan members, currently 12 years.

11. Commitments

a) Foreign currency contracts

In the ordinary course of business, the Bank enters into commitments involving the purchase and sale of foreign currencies. In particular, the Bank enters into short-term foreign currency swap arrangements with the Exchange Fund Account (EFA) of the Government of Canada as part of its cash management operations within the Canadian banking system. These transactions, which are made with the concurrence of the Minister of Finance under a standing authority, involve the temporary acquisition by the Bank of foreign currency investments from the EFA. These investments are paid for in Canadian dollars at the prevailing exchange rate with a commitment to reverse the transaction at the same rate of exchange at a future date. The fair values of these investments are not materially different from their book values. At the year-end, the average yield for these investments was 6.0 per cent (6.1 per cent in 1997).

As well, the Bank of Canada is a participant in two foreign currency swap facilities with foreign central banks. The first, amounting to US$2 billion, is with the U.S. Federal Reserve. The second, amounting to Can$1 billion, is with the Banco de México. There were no drawings under either facility in 1998 or 1997.

A summary of outstanding commitments follows.

		1998	**1997**
		Millions of dollars	
Foreign currency contracts	- purchases	**95.6**	95.8
	- sales	**4,644.3**	3,573.8

As at 31 December 1998, outstanding foreign currency contracts included sale commitments of $4,548.7 million ($3,476.2 million in 1997) under swap arrangements with the EFA.

b) Investment contracts

In the ordinary course of business, the Bank enters into commitments involving the purchase and sale of securities. A summary of these outstanding commitments follows.

1998	**1997**
Millions of dollars	

		1998	1997
Investment contracts	- purchases	**1,552.5**	-
	- sales	-	-

As at 31 December 1998, outstanding investment contracts included purchase commitments of $1,552.5 million under Sale and Repurchase Agreements (nil at the end of 1997) which were settled on 4 January 1999.

12. Year 2000

The year-2000 computer issue arises chiefly because many date-sensitive automated systems have not been designed to recognize correctly the year 2000. This represents a significant challenge for all organizations. If not addressed properly, the year-2000 issue could have an impact on operations and financial reporting, ranging from minor errors to the failures of critical systems. The effects of the year-2000 issue could be experienced before, as well as on or after, 1 January 2000. Despite best efforts, it is not possible to be certain that all aspects of the year-2000 issue affecting the Bank, including those related to the efforts of clients, suppliers, or other third parties, will be fully resolved.

The Bank of Canada has a business plan for dealing with the year-2000 issue. The objectives of that plan are to ensure that the Bank's critical internal systems will function properly, to coordinate with business partners the testing of shared systems, and to ensure that appropriate contingency plans are in place in the event of disruptions or system failures. Since 1997, the Bank has had a team assigned solely to implementation of the plan, which entails the overall management, direction, and support of year-2000 initiatives.

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1. Also Chairman of the Board of Directors of the Canadian Payments Association
2. Visiting Special Adviser
3. Also Deputy Chairman of the Board of Directors of the Canadian Payments Association

Note: Positions as of 26 February 1999

Governing Council

Audit Department
Peter Koppe, Internal Auditor

1. Also Chairman of the Board of Directors of the Canadian Payments Association
2. Visiting Special Adviser
3. Also Deputy Chairman of the Board of Directors of the Canadian Payments Association

Note: Positions as of 26 February 1999

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Note: Positions as of 26 February 1999

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Publications

Monetary Policy Report
A detailed summary of the Bank of Canada's policies and strategies as well as a look at the current economic climate and its implications for inflation. Semi-annual. Without charge.

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