

Annual Report

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BANK OF CANADA

H I G H L I G H T S

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The Canadian economy regained strong momentum in 1999 as the U.S. economy remained vigorous, the global economy recovered, and commodity prices moved upwards.

The trend of inflation was well inside the Bank's 1 to 3 per cent target range.

In response to these developments, the Canadian dollar rebounded.

The Bank of Canada, through initiatives such as the new Group of Twenty, continued to play an active role in strengthening the international financial system and reducing the vulnerability of economies to global crises.

The transition to the year 2000 went smoothly for the Canadian financial system, thanks to extensive preparation and effective collaboration.

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4042

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Gordon G. Thiessen
Governor - Gouverneur

Bank of Canada • Banque du Canada

Ottawa K1A 0G9

25 February 2000

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 1999 and the Bank's audited financial statements as at 31 December 1999.

Yours sincerely,

A handwritten signature in black ink, reading "Gordon Thiessen". The signature is written in a cursive style with a large initial 'G' and 'T'.



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The 1986 series of bank notes features portraits of former Canadian prime ministers on the front and Canadian birds on the back.



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

Canada's economic performance improved considerably in 1999. In fact, it was much better than many

Canadians had expected, considering the international difficulties we have had to face. Those difficulties began with the Asian financial crisis in mid-1997 and continued through the autumn of 1998 in the aftermath of Russia's default on its debt payments.

Why did we do so well last year when, in the past, Canada has typically had difficulty coping with adverse international shocks?

An important reason is that Canada's economic policy foundation is stronger today than it has been in several decades. There are two cornerstones of this foundation. One is the improved fiscal positions of governments that have led to a declining ratio of public sector debt relative to the size of our economy. The second is an environment of low and stable inflation that is expected to persist, given the Bank of Canada's target for inflation control.

For most of the 1990s, Canadian monetary policy has been based on an explicit target for controlling inflation. And I believe we are seeing the benefits of this framework. A clear objective for monetary policy and the Bank's firm commitment to that objective have helped to moderate fears of a resurgence of inflation. Inflation targeting has also helped the Bank to take timely action in response to changing economic and financial conditions and has improved our accountability for those actions. But most important of all, achieving a target of low and stable inflation is the best contribution that monetary policy can make to a productive, well-functioning economy.

A crucial part of our monetary policy framework focused on inflation control is Canada's flexible exchange rate regime. Without a flexible exchange rate, we could not have Canadian targets for inflation control. Moreover, exchange rate flexibility encourages and facilitates the necessary adjustments when the Canadian economy is hit by economic and financial disturbances. But this process works effectively only with the kind of solid economic policy foundation we now have.



Nonetheless, there will be times when large movements in the Canadian dollar may be a source of anxiety for Canadians. Indeed, the sharp decline in the external value of our dollar at the peak of the international financial crisis in 1998 was distressing to many. And it carried with it a potential loss of confidence among savers and investors in Canadian dollar assets.

But that was a highly unusual period of intense uncertainty and turbulence. Viewed more broadly from the perspective of how well the Canadian economy has come through the difficulties of the past couple of years, the adjustments in our currency were mainly orderly and illustrated the effectiveness of the exchange rate as a shock absorber. A good measure of its success in this role is that Canadian interest rates have remained lower than

comparable U.S. rates, apart from the period of turbulence, reflecting our lower inflation rate and the greater room for economic expansion in Canada. In the past, a depreciation of our currency has frequently fed fears of inflation and has led to interest rate increases.

The downward movement of the Canadian dollar from mid-1997 to the end of 1998 was largely a response to the sharp decline in world prices of the primary commodities that Canada exports. Our economy had to adjust to

this reality; the exchange rate decline facilitated a shift in activity from the primary sector to manufacturing and other export sectors. It also provided an additional incentive for these sectors to take advantage of a strong U.S. economy. Because of these adjustments, the Canadian economy continued to expand during 1998 and recorded a substantial pickup in 1999.

During 1999, the global economy began to show signs of recovery. This was the result of steps taken by emerging-market economies to address their problems and of earlier reductions in interest rates by central banks in most industrial countries. And with the U.S. economy continuing to expand rapidly, commodity prices began to recover. By mid-1999, the Canadian economy had regained a strong momentum. Over the four quarters of 1999, the economy expanded by about 4 per cent, and 425,000 net additional jobs were created. By year-end, our economy was operating at close to full capacity, the trend of inflation was well inside the Bank's 1 to 3 per cent target range, and the Canadian dollar had rebounded to around 69 U.S. cents.

For most of the 1990s, Canadian monetary policy has been based on an explicit target for controlling inflation. And I believe we are seeing the benefits of this framework.

One lesson from this experience is that the present monetary policy framework—inflation-control targets and a floating exchange rate—is working well. During 1999, there were a number of proposals to adopt a different framework, based on a fixed exchange rate or monetary union with the United States. Proponents of such change need to explain how their alternatives would have worked better.

Another lesson from the global turbulence of the last couple of years is the importance of international co-operation to reduce the likelihood of future crises and to establish mechanisms that would help us to manage better if crises do occur. Since mid-1997, the international community has worked hard to identify and promote ways to strengthen the international financial system. Important steps have been taken to increase the information available on international financial flows and on the financial positions of emerging-market economies. These initiatives are designed to make international markets work better. The importance of an appropriate exchange rate regime is now widely recognized. Many emerging-market economies have adopted, or are considering adopting, floating exchange rates as well as inflation targets to help them manage their economies. And emerging-market economies are now actively involved in new international forums, such as the Group of Twenty countries and the Financial Stability Forum. The activities of these two groups and the role played by Canada are described in more detail on page 36.

Let me now turn to the future and what we should expect from the Canadian economy. I am sure there are a number of questions and concerns on the minds of Canadians. Will the present economic expansion continue? Will living standards improve? By how much can our unemployment rate come down on a sustained basis?

A crucial element in all of this will be our economic productivity. Productivity in Canada has been rising steadily, but we have not narrowed the gap with the higher level of productivity in the United States since the early 1970s. And in the last few years, Canada has not shared in the sharp improvement that has taken place in U.S. productivity.

There are a number of positive signs. Our productivity growth has improved recently, and Canadian businesses have been investing heavily in machinery, equipment, and technology. These investment trends are similar to what occurred much earlier in the United States.

Important steps have been taken to increase the information available on international financial flows and on the financial positions of emerging-market economies. These initiatives are designed to make international markets work better.

You can be certain that any decision by the Bank of Canada to adjust interest rates will be designed to ensure that our economy continues to expand in a sustainable way.

Uncertainty about the future growth of productivity raises an important issue for Canadian monetary policy. How much growth can we expect in the economy's production capacity? On the one hand, our low-inflation environment and the Bank of Canada's commitment to maintaining it give us more room than we have had for some time to explore the economy's full potential. However, because of the current strong momentum of the economy and the high

levels of activity, the Bank must be careful to avoid approaching capacity limits too rapidly. We do not want to trigger bottlenecks and shortages that can put unnecessary pressure on inflation. Because of the time it takes for monetary policy to have its full impact on the economy, we can best achieve and maintain full potential if we approach capacity constraints gradually and carefully. This is likely to be the focus of Canadian monetary policy in the period ahead.

You can be certain that any decision by the Bank of Canada to adjust interest rates will be designed to ensure that our economy continues to expand in a sustainable way. I cannot stress enough that the preservation of a low and stable inflation environment in Canada is the major contribution that monetary policy can make to help our economy achieve its full potential.

I would also like to highlight several of the Bank's other activities in 1999.

Planning for the century date change was one of the Bank's main priorities during 1999. Bank staff worked with numerous groups from the Canadian financial sector. The necessary steps were taken to ensure that the Bank's critical systems were year-2000 ready. The Bank also put in place contingency plans, including arrangements to deal with possible liquidity needs of the financial system. And the Bank worked closely with financial institutions to prepare for possible increases in the demand for currency around the end of the year. These collaborative efforts paid off, and the Canadian financial system made a smooth transition to the year 2000.



PHOTO: BALFOUR PHOTOGRAPHY

Senior Deputy Governor Malcolm Knight and Beverly Ruddy from Banking Operations check out the new signature on a bank note.



Canada's new electronic system designed to handle large-value Canadian dollar payments began full operation in February 1999. Known as the Large Value Transfer System (LVTS), it now forms the core of the national payments system. This system is fully risk-proofed and represents a milestone in promoting the safety and soundness of Canada's financial network.

In 1999, the Bank also continued work on developing a new series of bank notes. Our efforts focused on taking full advantage of advanced security features that have been developed to deter counterfeiting. The Bank consulted widely with various groups on possible design themes for the new notes, the first of which will be issued in 2001.

I would also like to mention the retirement in 1999 of the Bank's Senior Deputy Governor, Bernard Bonin. During five years as Senior Deputy Governor and five years as a Deputy Governor, Mr. Bonin brought new insights to the Bank and made an important contribution to its restructuring.

Our new Senior Deputy Governor is Malcolm Knight, whose appointment by the Bank's Board of Directors was approved by the government, effective July 1999. Mr. Knight has spent most of his career at the International Monetary Fund, and all of us at the Bank appreciate the skills and experience he brings to his role as chief operating officer.

Finally, I would like to express my gratitude to the Bank's staff, who coped with the year's challenges with skill, creativity, and some very long hours.

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, are grouped into four broad areas.

Monetary Policy

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

Currency

The Bank issues Canada's bank notes. This involves note design (with particular emphasis on anti-counterfeiting features) as well as responsibility for printing and distributing new bank notes and replacing worn notes.

Central Banking Services

The Bank promotes a safe and sound financial system in Canada and provides funds-management services to the federal government. To promote a sound financial system, the Bank regulates the major clearing and settlement systems through which financial institutions transfer funds or process and discharge payment obligations from the purchase and sale of financial instruments such as debt, equity, foreign exchange, or derivatives. As the federal government's banker, the Bank provides advice on managing the public debt, handles new borrowings, maintains bondholder records, and makes payments for interest and debt redemption. It also manages the government's foreign exchange reserves. As a service to the public,

International Activities

Many of the Bank's activities have an international dimension. Bank staff

- ◆ work with Canadian government departments on international economic and financial issues
- ◆ collaborate with other central banks
- ◆ participate in meetings of major international organizations
- ◆ take part in technical assistance programs for developing countries

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 under the direction of Canada Investment and Savings, an agency of the Department of Finance, the Bank is responsible for maintaining debt registers and for servicing the accounts of debtholders.

Corporate services

The work in all of the above areas is supported by staff from five corporate services departments who ensure that infrastructure, human resources, and administrative services are provided reliably and cost-effectively.

How the Bank Works

The Bank's responsibilities are carried out by approximately 1,800 people working on a regular, temporary, or contractual basis in 11 departments at headquarters in Ottawa and in 5 regional offices across Canada.

The Governing Council

The Governor, the Senior Deputy Governor, and five Deputy Governors sit on the Governing Council, which takes collective responsibility for the Bank's affairs. This includes formulating and implementing monetary policy as well as dealing with broad organizational and strategic issues. The Governing Council works closely with the Board of Directors, which oversees the management and administration of the Bank.

The Management Forum

Consisting of the Governing Council, Advisers, and Department Chiefs, this forum meets regularly to exchange information on management issues and to review policy proposals. The group plays a key role in medium-term planning by helping to identify strategic issues and priorities.

Delegation and Accountability

The working environment at the Bank has become increasingly decentralized. Department Chiefs are responsible for operations and services in their own areas and are accountable to one of the Bank's five Deputy Governors or to the Senior Deputy Governor. Agreements established each year between Department Chiefs and Deputy Governors set out the results expected and establish financial constraints for the departments.

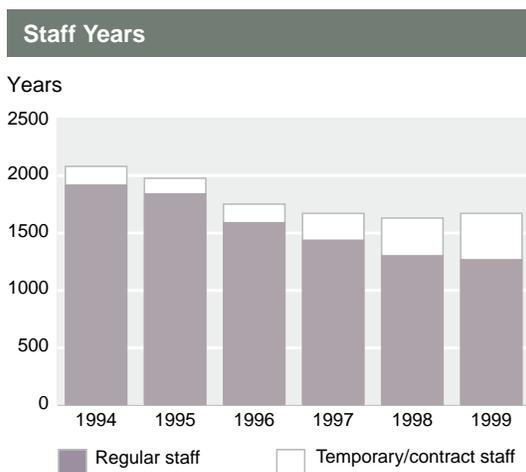


PHOTO: BALFOUR PHOTOGRAPHY

*The Governing Council:
L-R, seated: Tim Noël, Sheryl Kennedy, Gordon Thiessen
Standing: Malcolm Knight, Pierre Duguay, Paul Jenkins, Charles Freedman*

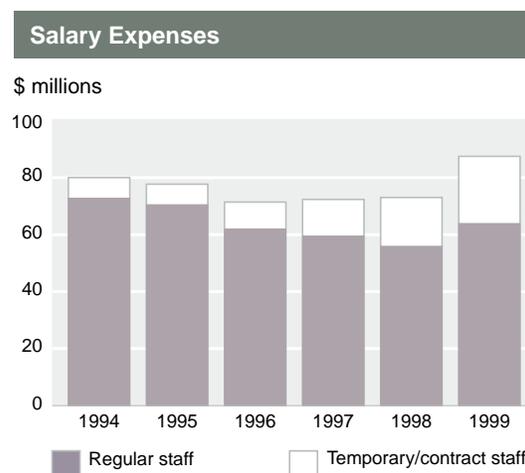
Our Staff

Over the past several years, the Bank's operations have undergone significant change. While there has been considerable expansion of retail debt services to the federal government, the Bank's three core functions have been fundamentally re-structured. As a result, there was an overall decline in the total number of staff years of about 20 per cent from 1994 to 1999. The composition of Bank staff has also shifted. It now includes a higher proportion of temporary and contract staff to provide greater flexibility in meeting varying work volumes and requirements for specialized skills.



To meet its responsibilities to Canadians, the Bank has focused on creating a work environment that would attract, retain, and motivate staff. A cornerstone of this strategy was the development and implementation of a new compensation system between 1996 and 1999. The objective of the new system was to bring

compensation—base pay, re-earnable performance pay, flexible benefits, and recognition—into line with comparable markets and then to maintain a competitive position based on annual market studies.



In 1999, the Bank adjusted its salary ranges by an average of 3 per cent. The Bank's total salary expenses also rose owing to the additional staff needed to support the government's retail debt program and higher costs for information technology professionals. As well, the Bank implemented re-earnable performance pay, which resulted in a one-time increase in salary expenses. For 2000, salary range increases averaging 2.4 per cent have been implemented to maintain a market-competitive position.

Key principles of the work environment are set out in Our Commitment to Each Other. These principles underlie a number of programs at the Bank. In 1999, the Bank invested approximately \$1,700

per regular employee in language training, updating of technical skills, and skill development in the areas of policy and analysis. The Bank also began a mentoring program in 1999 aimed at enhancing the organization's learning culture. Efforts will continue in 2000 to build staff capabilities with an emphasis on recruitment, succession planning, and leadership development.

The Bank also encourages flexible work arrangements, including a telework program. Communication with staff is a priority and is supported by courses on communications skills, staff surveys, and our Bank-wide intranet, which provides information on policies, services available to staff, and news about Bank events.

Our Commitment to Each Other

To foster an environment where

- ◆ people are respected, recognized, and responsible
- ◆ communication is open and honest
- ◆ creativity, excellence, and learning are encouraged and supported
- ◆ work arrangements are flexible
- ◆ responsibilities are defined
- ◆ resources are allocated to get the job done



PHOTO: JACQUELINE BOURQUE

Daniel Racette, Visiting Special Adviser, conducts "Monetary Economics for Non-Economists."

The Bank is committed to employment equity, bilingualism, and workplace health and safety. In support of each of these programs, plans, objectives, and initiatives are developed, and the Bank files annual reports on performance. Over the past few years, improvements have been made in the Bank's bilingualism capacity and in the awareness of workplace health and safety issues. Despite significant staff reductions over the past few years, designated group representation has remained stable.



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 the 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 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 not practical 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 Audit Committee reviews the audit plan of the external auditors and the Bank's financial statements and monitors the adequacy of internal controls. The Board also has a Premises Committee and a Corporate Governance Committee.

The Board, with the approval of the Governor-in-Council, establishes the fees paid to the Directors for the performance of their duties. Total compensation paid to outside Directors in respect of their responsibilities in 1999 was \$176,000.

Harold H. MacKay, QC*
Regina, Saskatchewan
Lead Director



Winston Baker*
St. John's, Newfoundland



J. Bernard Boudreau, QC†
Halifax, Nova Scotia



Kit Chan
Calgary, Alberta



Walter Dubowec, FCA*
Winnipeg, Manitoba



Raymond Garneau, OC*
Westmount, Quebec



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

James S. Hinds, QC
Sudbury, Ontario



Barbara Hislop
Vancouver,
British Columbia



Aldéa Landry, QC
Moncton,
New Brunswick



Paul Massicotte
St-Laurent, Quebec



Judith Maxwell, CM
Ottawa, Ontario



Barbara Stevenson, QC
Charlottetown,
Prince Edward Island



* Member of the Executive and Corporate Governance Committees
** Member of the Executive Committee
† Mr. Boudreau resigned on 4 October 1999.



The Board's Role

Under the Bank of Canada Act, the Governor and the Board of Directors play different, but interactive, roles in the management of the Bank. The Governor is the Bank's chief executive officer and is responsible for monetary policy and for the conduct of other Bank business. The Board is responsible for general oversight of the Bank and, in that capacity, focuses its efforts on financial, human resource, and administrative matters. Of particular significance, the Board is responsible, with the approval of the Governor-in-Council, for appointing the Governor and the Senior Deputy Governor. The Board also appoints the Deputy Governors.

Board Stewardship

One of the Board's most important tasks is its role in establishing the Bank's strategic direction and corporate plan. The core businesses of the Bank, in common with other central banks, are being affected by a rapidly changing technological and international environment. During 1999, the Board oversaw a process to help identify these influences and propose appropriate responses. Monitoring the Bank's performance in this changing environment is another important element of the Board's stewardship. During the year, the Board received reports and approved initiatives related to the various functions of the Bank. A particular focus was the century date changeover and, at each of its meetings, the Board reviewed management's internal and external preparations. In its first meeting in 2000, the Board participated with management in an assessment of how the Bank's business objectives for 1999 had been met.

The Board was actively engaged in its human resources responsibilities. A key part of that activity was the completion of the selection process for a new Senior Deputy Governor, which had begun in 1998. In May 1999, the Board appointed Malcolm Knight, effective 5 July 1999, as Senior Deputy Governor to replace Bernard Bonin, who was retiring. The Board also addressed other succession-planning issues. These included the appointment of Pierre Duguay as a Deputy Governor and a series of promotions and rotations to broaden the experience of the present executive management group. More generally, the Board helped shape plans for the development of future managers throughout the Bank with special attention to key leadership skills, employment equity, and bilingualism.

As is its regular practice, the Board reviewed the performance of the Governor and Senior Deputy Governor and contributed to the performance reviews of the Deputy Governors.

Other Governance Issues

To effectively oversee the Bank's affairs, the Board must be able, where required, to operate independently of management. With this in mind, the Board has introduced a number of best practices and governance principles from both the private and public sectors and reviews them regularly to ensure that they remain current. To assist in this process, the Board has established a Corporate Governance Committee composed of the four external Directors who sit on the Executive Committee and chaired by the Lead Director. Among its other duties, the committee reviews the annual cycle of agenda items



and the quality of the information presented to the Board to determine whether agenda revisions are needed or additional information is required. To shape the agenda throughout the year and to ensure an opportunity for independent expression, the external Directors meet privately at the end of each Board meeting. The Lead Director then brings the Directors' input to the attention of the Governor. The Corporate Governance Committee also began a review of the terms of reference of the various committees to ensure that they accurately reflect the responsibilities of each committee.

During the year, the Board assisted management in reviewing the Bank of Canada Act to identify amendments that would address the changing financial environment and other issues affecting the Bank.

The Board annually assesses its own performance. In 1999, the Board concluded that the measures put in place during the year ensured that it would continue to be able to fully exercise its stewardship of the Bank's affairs.

YEAR 2000

The Year-2000 Challenge

Participants in Canada's financial sector, including the Bank of Canada, recognized early the need to address potential problems associated with the date change to the year 2000. Extensive preventive measures were undertaken. Critical systems were identified, changes were made where necessary, and then these systems were tested. Testing with external partners and on an industry-wide basis was also carried out.

The financial sector fully expected to operate on a "business as usual" basis. Nevertheless, contingency plans were examined and revised to address possible year-2000 concerns. In addition, arrangements were put in place to manage the rollover weekend into the new year. These extraordinary activities were regarded as prudent measures to facilitate the uninterrupted delivery of financial services into the year 2000. Indeed, major banks and other deposit-taking institutions guaranteed to their customers that their money would be safe in deposit accounts and that financial records would be fully protected. The Bank of Canada made similar guarantees to holders of Canada Savings Bonds and other retail government debt.

Contingency Planning

Financial institutions and the operators of important systems shared by the financial sector developed contingency plans to deal with possible year-2000 problems, including plans to address possible liquidity needs. Typically, these plans included the availability of alternative operation sites, alternative communication arrangements, and manual backup procedures. The Bank of Canada, like other central

In preparation for the year 2000, the Bank adapted and tested its internal systems and reviewed and modified as necessary its contingency plans. From 1997 to 2000, the cost of meeting the year-2000 challenge was approximately \$23 million (external expenditures of \$11.7 million for year-2000 compliance work; \$5.1 million for contingency planning and bank note transportation; and \$6.0 million for the work of regular Bank staff).

banks around the world, examined the role that it could play in dealing with the consequences of any interruption in the operation of major clearing and settlement systems, or with extraordinary liquidity needs at financial institutions. Some of the special arrangements put in place by the Bank were outlined in its press release of 2 September 1999.

First, the Bank established a Special Liquidity Facility for solvent financial institutions with acceptable collateral that participate directly in the Large Value Transfer System (LVTS). This special facility assured these institutions—as well as users of the financial system—that if unusual demands for liquidity arose, they would be met. This facility was made available from 1 November 1999 to 31 March 2000.

Second, the Bank of Canada expanded the range of collateral it was prepared to accept during this period to support the provision of liquidity under normal or extraordinary circumstances. Ordinarily, liquidity loans must be fully collateralized

by securities such as Government of Canada securities. By expanding the range of collateral to include such things as commercial paper and security in loan portfolios, the Bank helped to address concerns of financial institutions regarding their ability to borrow large amounts from the Bank to meet unusual liquidity demands. The Bank put measures in place to reduce any risks associated with this expansion of eligible collateral.

The third measure addressed concerns that normal year-end technical factors, magnified by year-2000 concerns, might cause the overnight interest rate to move above the top of the Bank's operating band. To keep the average interest rate for overnight funds within the operating band during the year-end period, the Bank stated that it would supply additional settlement balances in the LVTS and extend its use of Special Purchase and Resale Agreements (SPRAs). SPRAs are transactions between the Bank and primary dealers that are used to offset upward pressure on the overnight rate when it is trading above the centre of the operating band.

Bank Notes

The Bank of Canada worked with financial institutions to prepare for possible increases in the demand for bank notes around the end of 1999. Although it normally maintains a large reserve of notes to meet public demand in peak periods and extraordinary circumstances, the Bank felt that it was important for Canadians to be confident that bank notes would be available to meet their needs. The Bank significantly increased its note inventory to approximately \$23 billion, about four times the normal amount. This was done

cost-effectively by printing notes that otherwise would not have been printed until 2000 and 2001 and by stockpiling old notes that would otherwise have been destroyed. The Bank worked closely with armoured car companies and deposit-taking institutions to ensure that the larger-than-normal inventory was distributed across the country, where it would be easily accessible to financial institutions to meet potential increases in demand.

Canadians appeared to be very confident that their financial institutions, as well as payment methods such as debit or credit cards, would continue to function normally going into the year 2000 and beyond.

During December 1999, the value of bank notes in circulation increased somewhat beyond the normal levels for that time of year. As of 31 December 1999, it is estimated that there was about \$5.5 billion more in circulation than would otherwise have been expected. Most of this increase reflected the larger-than-normal inventories of bank notes that were being held by financial institutions as a precaution against possible increases in demand from households and businesses. The demand for extra bank notes from the public did not prove to be very great. Canadians appeared to be very confident that their financial institutions, as well as payment methods such as debit or credit cards, would continue to function normally going into the year 2000 and beyond. By the second week in January 2000, the value of bank notes in circulation had almost returned to normal levels.

Communication

Financial sector participants recognized that informing the public of the extensive preparations that they were undertaking was essential to a successful rollover into the year 2000. As 1999 wound down, many believed that the Canadian financial sector was so well prepared that the major issue was no longer a technical one. Rather, it was an issue of dealing with possible responses by individuals or market participants, whose year-2000 concerns could prove to be more damaging than the year-2000 problem itself.

As part of the effort to inform the public of the high degree of financial sector preparedness and to encourage the public to take appropriate and well-considered responses to year-2000 concerns, the Bank of Canada established an extensive Y2K Web page (with links to other year-2000 Web sites).

There were also speeches by members of the Governing Council, media interviews and briefings, articles, and press releases. The Bank emphasized that no problems were expected with various non-cash methods of payment including credit cards, debit cards, other forms of electronic funds transfer, and cheques. The Bank advised Canadians that the safest place for their money was with their financial institutions and that they should prepare for the century-changeover weekend much as they would for any other long weekend.

The Changeover

The transition into the year 2000 went very smoothly, both in Canada and abroad. In the financial sector, markets and institutions closed normally on 31 December. Retail payment systems, including debit cards, credit cards, and automated banking machines functioned with no disruptions into the new year. Services such as on-line and telephone banking operated smoothly, and branches reopened without incident following the long weekend. The increased demand for bank notes was easily accommodated from the larger-than-normal inventories held by the Bank of Canada and financial institutions. Major financial service infrastructures, such as payments systems operated by the Canadian Payments Association and clearing and settlement systems that handle transactions involving securities, equities, derivatives, and mutual funds all performed normally. The Bank did not receive any requests for loans from financial institutions eligible to borrow under the Special Liquidity Facility. Primary dealers did make some use of SPRAs in December. No unusual movements occurred in overnight interest rates. As expected, it was “business as usual” during the century-changeover weekend and beyond. Nevertheless, financial sector participants will continue to monitor developments over the next year for any year-2000-related issues.

Cross-Border Communication

Efficient communication among financial market authorities around the world was essential for a smooth transition into 2000.

The Joint Year 2000 Council—representing banking, insurance and securities supervisors, and payments-system experts worldwide—established the Market Authorities Communications Services to help share information and coordinate action.

Developed and operated by the Bank for International Settlements, this service provided timely contact information for regulators in major financial markets. It collected and disseminated information on the operational status of core financial markets, institutions, and infrastructures, and created an electronic service to post announcements on developments in national markets. It also made arrangements for conference calls within the global regulatory community.

The Bank of Canada, along with the Office of the Superintendent of Financial Institutions and the Ontario Securities Commission, provided information regarding year-2000 developments in Canadian financial markets.

The extraordinary preparations taken by the private and public sectors during the last few years undoubtedly contributed a great deal to the smooth transition to the year 2000. Of particular note was the high degree of co-operation between private and public sector entities. Information was readily shared, and contingency plans and communications initiatives were harmonized. As a result, the financial sector now has more robust contingency plans and better communications networks that will stand it in good stead in the future.

**AN ACCOUNT OF OUR
STEWARDSHIP**

Monetary Policy

The goal of Canadian monetary policy is to contribute to solid economic performance and rising living standards for all Canadians by keeping inflation low and stable. Specifically, the Bank aims to keep the trend of inflation, as measured by the consumer price index (CPI), inside a target range of 1 to 3 per cent. This target range, established jointly with the government, was extended in February 1998 to the end of 2001. A long-term target consistent with price stability will be established by the end of 2001.

“Inflation has been maintained at very low levels as a result of the Bank of Canada’s successful inflation targeting policy.”

*Statement of IMF Mission to Canada,
16 November 1999*

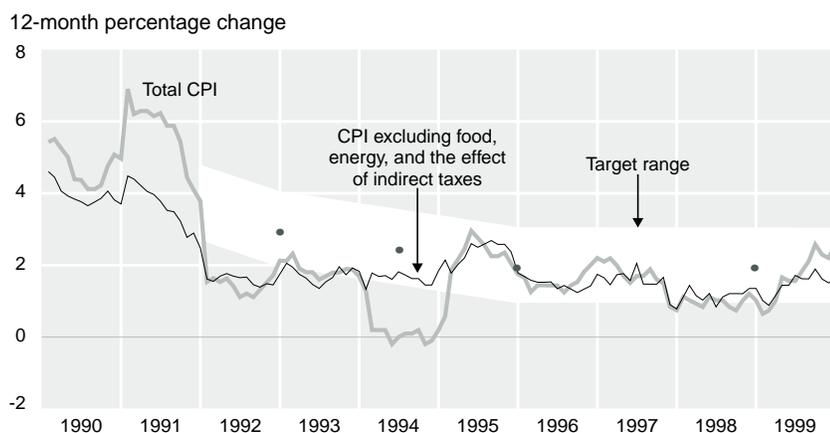
The Bank carries out monetary policy through its influence on short-term interest rates and thereby on the whole range of rates of return and on the exchange rate for the Canadian dollar. Monetary policy actions affect inflation only indirectly and are usually felt over a period of 18 months to two years. Therefore, the Bank focuses on the trend of inflation, using a measure of core consumer prices that excludes volatile food and energy prices and the effect of changes in indirect taxes.

Meeting the Inflation Target

The Bank’s core measure of inflation, which had fallen to the bottom of the target range in 1998, moved up towards the middle of the range by the second half of 1999. At the end of the year, core inflation was 1.6 per cent. This movement largely reflected the reduction of excess capacity brought about by Canada’s strong economic expansion. It also reflected some temporary factors, such as the lagged effects of the depreciation of the Canadian dollar in 1998, which pushed up the prices of imported goods and services. The overall consumer price index rose 2.6 per cent through the year, significantly higher than core inflation because of sharp increases in fuel oil and gasoline prices.

The average private sector forecast for the CPI has remained near the centre of the Bank’s inflation-control target range. For example, the Conference Board’s latest *Survey of Forecasters* calls for an average of 2.2 per cent this year and 2.0 per cent in 2001.

Consumer Price Index



Longer-term expectations of inflation, as reported in surveys of business forecasters, also remained at the midpoint of the Bank's target range. The yield spread between conventional and inflation-indexed bonds, which also tends to reflect longer-term inflation expectations, narrowed significantly in the autumn of 1998 amid talk of global deflation. During 1999, it widened again to settle near the centre of the Bank's target range for inflation.

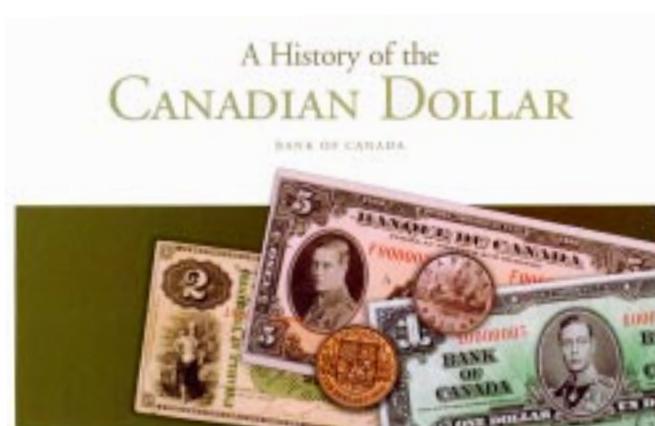
The Canadian economy posted an impressive performance in 1999. It grew by close to 4 per cent, and the unemployment rate fell to a 23-year low of 6.8 per cent at year-end. The economy benefited greatly from the remarkable strength of the U.S. economy. The pickup in Europe and the recovery of some of the Asian economies that had been most hurt by the financial crisis also helped, as did the turnaround in the prices of the key primary commodities that we export. The economy was also buoyed by relatively low interest rates, rising employment, and a growing sense of consumer confidence, which supported stronger domestic spending. In light of the strong momentum of the Canadian economy, the Bank Rate was raised on 17 November 1999 and 3 February 2000, to preserve the low rate of inflation needed for a sustainable economic expansion.

Assessing International Developments

International developments influence the Canadian economy and our financial markets. The Bank therefore devotes considerable time and energy to understanding and anticipating events in other countries. It also advises the Government of Canada on international financial and economic

issues. The Bank works closely with other central banks on matters of monetary policy and financial stability. It also maintains close contacts with international economic and financial institutions, sharing information and debating current issues.

There were significant changes in world currency arrangements during 1999. The year began with the launching of the European single currency (the euro), an event that generated increased interest in the feasibility of common currency arrangements for other areas of the world. The merits of currency boards and "dollarization"—the adoption of the U.S. dollar as currency—were also widely debated, particularly in Latin America. Equally significant was the adoption of floating exchange rates and inflation targets in a number of emerging-market countries. In 1999, Brazil and Colombia joined this group. The Bank responded to calls from a number of countries for technical advice on the conduct of monetary policy based on its experience with inflation targeting.



In the past, it was illegal to reproduce images of bank notes. Changes to the legislation in 1999 made it possible for the Bank to use bank notes as illustrations in this new publication by James Powell, Chief of the International Department.



With the global economy recovering from the turmoil of 1997–98, the international community investigated new and better ways to prevent and resolve financial crises. Flexible exchange rates figured prominently in these discussions about how to prevent financial crises and minimize the damage they cause. It became apparent that, in general, those countries with floating exchange rates were able to adjust more promptly to disturbances and achieve a stronger economic turnaround.

Carrying Out Research and Analysis

The formulation of monetary policy rests primarily on analysis and research. To ensure that its research is sound, the Bank cultivates relationships with academics and other researchers through conferences, seminars, informal contacts, and publication of staff research.

In 1999, the Bank hosted a conference dealing with the role of monetary aggregates in policy deliberations. The confer-

ence proceedings will be published later this year and will also be posted on the Bank's Web site. A seminar will be held in the spring of 2000 to discuss research on the issues involved in designing a long-term target for price stability.

A significant amount of research has been carried out on the merits of flexible exchange rates for Canada and on the consequences of alternative currency arrangements. Some of this work was discussed in national and international forums in 1999 and will be the central theme of the Bank's next conference in the autumn of 2000. Also featuring prominently in the Bank's research program were the conduct of monetary policy under uncertain conditions and the identification of a broad set of indicators of capacity and inflation pressures when the economy is operating near its potential. Efforts continued to be devoted to deepening the Bank's understanding of how Canadian financial markets function and how the evolving structure of these mar-

kets affects the behaviour of the Canadian economy.

Promoting Understanding of Monetary Policy

With the Canadian economy approaching its production capacity, the Bank's external communications have focused on the risks facing monetary policy. They also stressed the need for timely adjustment of the Bank Rate to preserve the low trend of inflation and thus support sustainable economic expansion in Canada.



PHOTO: JAMES ZAGON

Bank of Canada conference on Money, Monetary Policy, and Transmission Mechanisms, November 1999

In 1999, the Bank reviewed its communications activities to ensure a continuous and well-integrated approach. To further this objective, the Bank will now publish a formal update of its semi-annual (May and November) *Monetary Policy Report* each February and August.

Staff in the Bank's regional offices assisted Directors and Governing Council members with their communications activities across Canada. They maintained contact with provincial governments, industries, educational institutions, and the general public. They also continued to refine their methodology for gathering information on current and prospective economic developments. Each quarter, the regional offices presented the Governing Council with the results of a survey of about 100 firms and associations—a "grassroots" assessment of the state of the economy and a complement to the economic projection prepared by Bank staff.

The Bank's Web site has become a convenient source of information, offering an ever-widening range of financial statistics, publications, and Bank-related material. A module illustrating the transmission of monetary policy was added in 1999, as well as an interactive inflation calculator that demonstrates the effects of inflation on the value of money over the past 85 years.

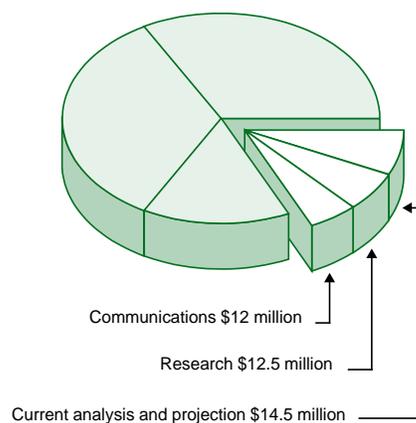
Operating Expenses

The Bank spent \$39 million in 1999 (approximately 18 per cent of its total operating expenses) on formulating and implementing monetary policy. This represents a decrease of nearly \$1.7 million from 1998. Two main factors explain this decline: the completion in 1998 of the

redevelopment of the Bank's system for processing data collected from financial institutions; and the collection of fees under a cost-sharing agreement with the Office of the Superintendent of Financial Institutions and the Canada Deposit Insurance Corporation for the processing of these data.

As pointed out earlier, communication is an important aspect of the conduct of monetary policy. External communications activities accounted for 31 per cent of monetary policy expenses. This includes the time spent by all members of the Governing Council on speeches and regional outreach, the preparation and production costs of publications, and the activities of regional representatives.

Monetary Policy Activities as a Proportion of Total Bank Expenses



Currency

Every day, Canadians make hundreds of millions of transactions using bank notes. They rely on the Bank of Canada to provide an adequate supply of quality bank notes that are secure against counterfeiting.

During 1999, the Bank broadened and intensified its program of public education about the security features of genuine bank notes. It continued to pursue research and development work on bank note technology and security. It carried on with activities related to the issuance of a new series of bank notes and, together with its partners in the Bank Note Distribution System, completed thorough and extensive preparations for the year 2000.

The Incidence of Counterfeiting

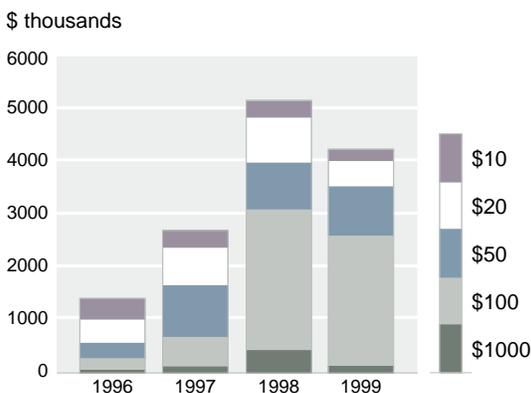
Counterfeiting remains at relatively low levels in Canada. Counterfeits make up only a small fraction of one per cent of the total value of notes in circulation. Nevertheless, counterfeiting has increased in recent years.

The value of counterfeit notes found in circulation doubled between 1997 and 1998, owing mainly to a sharp increase in the number of counterfeit \$100 notes. In contrast, the value of counterfeit notes found in circulation fell during 1999. The change from 1998 to 1999 can be attributed chiefly to declines in the counterfeiting of \$10, \$20, and \$1,000 notes.

Counterfeit bank notes can be readily 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 genuine \$20, \$50, \$100, and \$1,000 notes. Counterfeit notes also lack the other security features found on genuine notes, such as the raised ink in the portraits and the green dots or planchettes that can be peeled off.

For more information, telephone **1-888-513-8212** or visit the Bank's Web site (<http://www.bank-banque-canada.ca>).

Value of Counterfeit Bank Notes Found in Circulation



The Bank works closely with the Royal Canadian Mounted Police (who are responsible for enforcing Canada's anti-counterfeiting laws) to monitor and analyze counterfeiting in Canada. This provides valuable support both to counterfeiting investigators and to the Bank's currency education program.



Bob Dolomont, from our Atlantic regional office, in a presentation to the Canadian Society for Industrial Security, Moncton, New Brunswick

Currency Education

The best defence against counterfeiting is an informed public that readily recognizes the security features of genuine bank notes.

Throughout 1999, the Bank continued to broaden its currency-education program. Bank staff made some 280 presentations to cash handlers in the retail and financial services sectors, business groups, educational institutions, and law enforcement agencies to increase their awareness of the key security features of genuine bank notes. Those presentations were complemented by the distribution of posters, leaflets, and training videos and by the programs of the Currency Museum.

Over the next two to three years, the Museum will develop Web-based programs and exhibits on Canada's numismatic heritage and on the roles and responsibilities of the Bank.

Research and Development

New bank note technology and security are a powerful defence against counterfeiting.

The Bank's research and development program focuses on combating counterfeiting threats from advances in copier and computer technologies and on improving bank note production methods.

During 1999, the Bank studied new anti-counterfeiting devices as well as the material on which bank notes are printed. The overall aim of

the program is to develop a new type of Canadian bank note, one that can be modified over time in response to new technological threats. Accordingly, the Bank is drawing upon expertise from bank note printing companies, law enforcement agencies, and leading note-issuing authorities around the world. The Bank is also consulting the general public, government officials, and visually impaired Canadians about design themes and features for the new notes.

The New Note Series

The Bank is planning to begin to issue the first notes in the new series during 2001. The introduction of the new notes would continue over the next two to three years.

During 1999, efforts were focused on integrating advanced security features into an overall note design. The new notes will incorporate a suite of security

features using improvements in bank note technology, production techniques, and durability. In addition to enhancing security, the improvements are expected to reduce the costs of bank note production. As a result of work with financial institutions and equipment manufacturers, the introduction of the new series is not likely to require significant changes to current note-handling facilities and equipment.

Going . . . going . . .

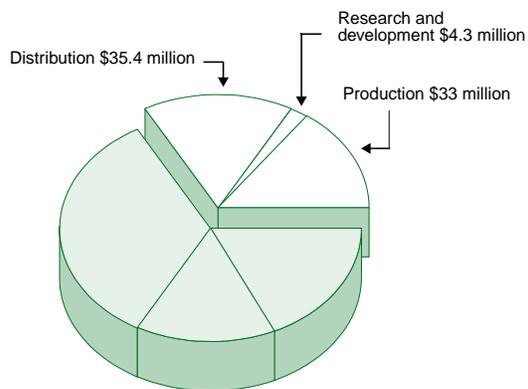
In November 1999, for the first time in its history, the Bank of Canada auctioned off surplus bank note material to collectors. None of this material was part of the National Currency Collection. The public auction route was chosen to ensure that the sale was open to all Canadians.

Specimen bank notes of earlier series and low serial number notes from the 1969–79 series were offered at an auction in Toronto and through fax and e-mail bids. The sale generated considerable interest among collectors and the general public, and lots sold well above their expected values.

Operating Expenses

Expenses for currency operations were \$72.7 million during 1999, or about 33 per cent of the Bank's total operating expenses during the year. These expenses represent

Currency Activities as a Proportion of Total Bank Expenses



an increase of \$15.2 million, or some 26 per cent, over 1998. This significant increase is attributable to year-2000 preparations. New notes that would have been printed in 2000 and 2001 were printed in 1999 and were also distributed across the country.

Currency expenses are reduced by revenue from the sale of optical security material. For many years, the Bank has been producing the optical security material for its own use in the rectangular gold-green security patch on high-value Canadian notes. Other versions of the material have been made available for sale on a commercial basis to official issuers of bank notes in other countries. In 1999, revenue from these sales increased significantly.

Without expenses related to the year-2000 date change, expenses for currency operations during 1999 would have been \$56 million, still a significant percentage of the Bank's total operating expenses during the year, but some 3 per cent below actual expenditures during 1998.

Central Banking Services

The Bank's central banking services function has two main objectives: to promote a safe and sound financial system in Canada and to provide efficient funds-management services to the federal government.

Promoting a Safe Financial System

Oversight of major clearing and settlement systems

Under the Payment Clearing and Settlement Act (PCSA), the Bank of Canada is responsible for the oversight of Canada's major clearing and settlement systems. These are the systems through which financial institutions transfer funds or process and discharge payment obligations from the purchase and sale of financial instruments such as debt, equity,

foreign exchange, or derivatives. The Bank reviews the arrangements that are used to manage and control risks in these systems to ensure that the financial system would not be seriously disrupted if a participant failed.

LVTS begins full operations

On 4 February 1999, the Large Value Transfer System (LVTS) began full operations. It was designed and built by the Canadian Payments Association, which is made up of deposit-taking institutions and the Bank of Canada. The LVTS now forms the core of the national payments system, processing large-value or time-critical payments quickly and continuously throughout the day. The LVTS plays a particularly important role in the settlement of Canadian dollar payment obligations arising from securities and foreign

The LVTS and the Bank of Canada

Once it began operations, the LVTS was designated under the Payment Clearing and Settlement Act as subject to Bank of Canada oversight. This ensures ongoing monitoring of the arrangements to control potential risks. It also provides greater legal certainty that payments will be settled even if one or more participants should fail. To address any remaining concerns about risk in the existing payments system—the Automated Clearing Settlement System—the Bank of Canada and LVTS participants are working to bring most large-value payments into the LVTS.

The LVTS has also enabled the Bank to act as settlement agent for the Debt Clearing Service (DCS) without incurring significant risk. The DCS is an electronic clearing and settlement system that handles transactions involving Canadian dollar bonds and money market securities. With the Bank acting as settlement agent, so-called “banker risk” has been eliminated for the DCS and its participants. Banker risk refers to the possible failure of a private sector institution acting as settlement agent.

exchange transactions. By providing certainty of settlement for each payment message it accepts, the LVTS significantly reduces risk in Canada's payments system. Its introduction has brought Canada in line with the best international practices for handling large-value payments. The system currently processes an average of 13,500 payments each day for a total daily average of just over \$100 billion.

Clearing and settlement systems for foreign exchange

The LVTS will permit the Canadian dollar to be included in cross-border, multi-currency clearing and settlement systems, such as arrangements to be operated by the CLS Bank International. This arrangement is designed to significantly reduce and control the risks associated with the settlement of foreign exchange transactions. To do this, the CLS Bank requires the co-operation of central banks whose

The CLS Bank will be a special-purpose bank under U.S. federal law and will be supervised by the Federal Reserve. Headquartered in New York, it will have operations in London and New York. The Bank is wholly owned by CLS Services (CLSS), a holding company with headquarters in London. CLSS currently has over 60 shareholders from 14 countries (including a number of Canadian banks). Ownership is open to qualified financial institutions.

currencies (such as the Canadian dollar) will be part of this service. The Bank of Canada has indicated that it will provide a settlement account and act as the settlement agent for the CLS Bank. Under this arrangement, the Bank of Canada, the LVTS, and the DCS will be required to 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 Bank of Canada is part of a group of central banks that is discussing with CLS Services the exact nature of its risk-containment and settlement arrangements. While a firm start-up date has not yet been determined, the service is likely to start operations in 2001.

Core principles for major payments systems

The Bank of Canada is a member of a task force made up of 23 central banks, the International Monetary Fund (IMF), and the World Bank. The task force is developing a set of core principles that major payments systems should satisfy to be considered safe and efficient by public sector authorities. It has also addressed the responsibilities of a central bank in applying these principles. A draft of the core principles was released for comment in December 1999. After publication of the final report, the Bank intends to incorporate the core principles into the guidelines issued under the PCSA and to apply them to systems designated under the Act.

As part of its recent review of Canada's financial sector stability, the IMF agreed with the Bank of Canada's assessment that the LVTS is in full compliance with the draft core principles.

IMF Assesses the Stability of Canada's Financial Sector

In the autumn of 1999, as part of a pilot project, the IMF conducted an assessment of the Canadian financial system. Formally called a Financial System Stability Assessment, the exercise is aimed at helping governments make improvements to increase the resilience of the financial sector. The IMF noted that Canada has a financial system that is sound and stable and that its regulatory framework shows a high degree of compliance with major international standards.

Entry of foreign bank branches into Canada

In June 1999, the federal government amended banking legislation to permit foreign banks to operate in Canada through branch offices. This raised a number of risk issues for clearing and settlement systems because foreign banks will be subject to the legal regime of their incorporating jurisdiction as well as to Canadian law. To address these issues, the PCSA was amended to allow the Governor of the Bank of Canada to judge whether the direct participation of a foreign bank branch in a clearing and settlement system designated under the Act would pose an unacceptable risk. Where the Governor concludes that such risks exist,

the Governor can prohibit or place conditions on the participation of a foreign bank branch in the designated system.

Policy development for the financial sector

Following the September 1998 report by the Task Force on the Future of the Canadian Financial Services Sector, the federal government published a policy paper in June 1999 outlining a modified policy framework for the Canadian financial sector.

The Bank played a significant role in the work leading up to the policy paper, providing analysis and advice to the Department of Finance on many issues affecting the safety and efficiency of the financial sector. Of particular importance to the Bank were proposals to give life insurance companies, securities dealers, and money market mutual funds access to the payments system. And, given the Bank's oversight responsibilities under the PCSA, another area of considerable interest was greater public oversight of the operations of the Canadian Payments Association and possibly other payments systems.

Publication of policies, standards, and procedures

During 1999, as part of its activities aimed at promoting the stability of Canada's financial system, the Bank developed policies, standards, and procedures governing the purchase and sale by the Bank of certain securities and other financial instruments under conditions of severe and unusual financial market or financial sector stress. The Bank of Canada Act gives the Bank the discretionary power to carry out such transactions, and



the policies, standards, and procedures clarify the types of securities that would be eligible and the circumstances under which such transactions might be considered. As required by the Act, the policies, standards, and procedures were published in the *Canada Gazette*; they are also posted on the Bank's Web site.

Funds-Management Services

Government borrowing

As fiscal agent for the federal government, the Bank manages the government's borrowings through treasury bill

and bond offerings and advises on the structure of the public debt. Initiatives in 1999 were directed towards enhancing the liquidity of the government's outstanding debt. For example, the pilot bond buyback program, designed to increase the supply of more actively traded benchmark issues and to encourage broader participation in the market, was improved to permit faster turnaround of buyback results to market participants. Almost \$2.8 billion was repurchased from the market in five buyback operations.

International Financial Stability

In 1999, two new international forums began work to promote financial stability.

- ◆ **The Financial Stability Forum (FSF)** was established by the Group of Seven (G-7) countries to promote information exchange and to coordinate the activities of national authorities (including central banks), international institutions, and international regulatory or expert groups with responsibilities for various aspects of financial stability. Canada is represented on the Forum by the Department of Finance, the Bank of Canada, and the Office of the Superintendent of Financial Institutions. Among the FSF's first initiatives was the establishment of three working groups to recommend policy actions in the areas of highly leveraged institutions, international capital flows, and offshore financial centres. More recently, work has begun on two further topics: the implementation of standards relevant to the strengthening of financial systems and a review of recent experience with deposit insurance schemes.

- ◆ **The Group of Twenty (G-20)** was also established by the G-7 countries to encourage informal dialogue on important economic and financial policy issues among systemically important economies. Canada's Minister of Finance, Paul Martin, was chosen to chair the G-20 for the first two years. At their first meeting in December, ministers of finance and central bank governors from the 20 countries discussed ways to reduce the vulnerability of economies to international developments, including the role played by an appropriate exchange rate regime and a strong and stable financial sector.

Investing government funds

Last year, the Bank worked with the government to formulate new investment guidelines for Canada's foreign exchange reserves. These guidelines will help the Bank minimize the cost of holding reserves while continuing to practise prudent risk management. During the year, reserves increased by US\$5.2 billion, largely through market operations conducted by the Bank, as fiscal agent, including purchases of foreign currency. Adjustments to reserves became more transparent when Canada became one of the first countries to comply with a new international format for reporting foreign exchange reserves. These data are released regularly on the Bank's Web site. The Bank will also publicly confirm any official intervention in the foreign exchange market by an announcement on the same day. There were no interventions during 1999.

Since February 1999, the Bank has been using the Large Value Transfer System to settle most of the government's payment and revenue flows.

Other Banking Services

Security registry services

Federal legislation requires the Bank of Canada to provide security registry services in all provinces. Since mid-1998, the Bank has provided this service through a

privately owned and operated company. Not only has the response time for searches improved, but authorized users are now able to conduct searches via the Internet.

Multilateral financial assistance packages

The Bank of Canada advises and assists the government when it participates in multilateral financial assistance packages for emerging-market economies. Only one such arrangement involving Canada was active in 1999—a facility provided to the Brazilian central bank by a group of industrial countries in December 1998. Canada's share of the credit facility was US\$500 million. The Brazilian authorities made several drawings and repayments on this facility during the year.

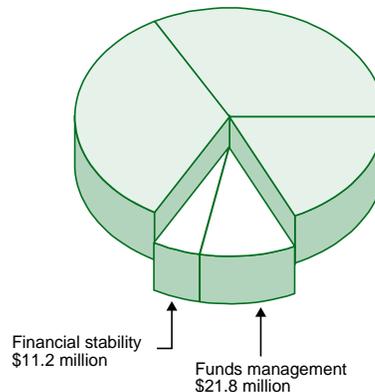
Unclaimed balances

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. New methods of access that have been introduced in recent years have had a dramatic impact on the levels of service provided by the Bank. During 1999, the Bank responded to over 17,400 general inquiries, completed more than 61,600 searches, and paid a total of \$6.4 million to satisfy approximately 11,700 claims.

Unclaimed Bank Balances

To increase public access to information on unclaimed bank balances, the Bank operates a toll-free telephone service (1-888-891-6398) and maintains an e-mail address (ucbalances@bank-banque-canada.ca). Individuals can also use a search facility on the Bank's Web site (<http://www.bank-banque-canada.ca>) to find out if there is an unclaimed balance to which they may be entitled. They will also be told how to claim a balance. For those without Internet access, most public libraries are now equipped with Internet stations. The public can also access information on unclaimed bank balances at any of the Bank's five regional offices. The addresses of these offices can be found on page 60.

Central Banking Services Activities as a Proportion of Total Bank Expenses



Operating Expenses

Expenses for central banking services were \$33 million, or 15 per cent of the Bank's total operating expenses in 1999. This is an increase of \$2.3 million over the 1998 levels, attributable mainly to increased staff and systems-development costs in the function's two main service areas—particularly in government funds management. Revenues received for services totalled \$750,000, down 19 per cent from 1998 due to a revised fee schedule for custodial services to The Canadian Depository for Securities Limited.

Retail Debt Services

The Bank provides services for the federal government's retail debt program. Under this program, the government issues traditional Canada Savings Bonds (CSBs), Canada Premium Bonds offering a higher interest rate than CSBs but redeemable only annually, and other debt held by individuals.

The program is directed by the Department of Finance and its agency Canada Investment and Savings, who determine products to be offered, interest rates to be paid, and strategies for sales and marketing. The Bank provides operational and systems support for these activities. This is a major undertaking, involving millions of accounts and extensive computer systems and call centre facilities.

Activities

During 1999, a key focus was the consolidation of the new business processes introduced for the retail debt program in recent years. These processes related to

- ◆ a new computer-based system developed over four years to handle the retail debt register
- ◆ a multi-year project to completely revamp the handling of the CSB Payroll Savings Plan offered through more than 15,000 companies
- ◆ support for the concurrent offering of two products—CSBs and Canada Premium Bonds

A new Payroll Savings Plan is being phased in. Some 200,000 participants were added in 1999. A pilot was run to accommodate smaller employers who are unable

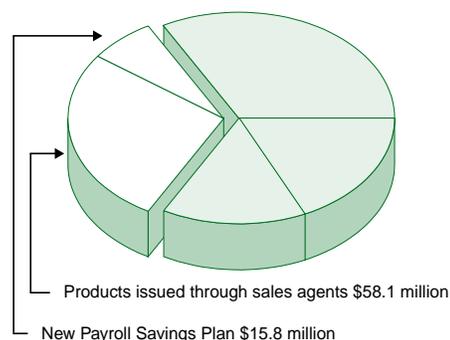
to meet the standard requirements of the program for transmitting data. Satisfaction with the new plan remains high with both sponsoring employers and participating employees.

Improving service to the public was a high priority in 1999. Customer service demands have increased in line with the expanded range of retail debt products and an extended sales period of six consecutive months. As a result, the call centre has been expanded and reorganized to handle the increased volume—more than 1 million calls were received in 1999.

Operating Expenses

Expenses for retail debt services were \$73.9 million in 1999, or 34 per cent of the Bank's total operating expenses. Reflecting the increased activities noted above, retail debt expenditures were up \$8.4 million from the previous year. The government reimburses the Bank for all of these costs.

Retail Debt Services Activities as a Proportion of Total Bank Expenses

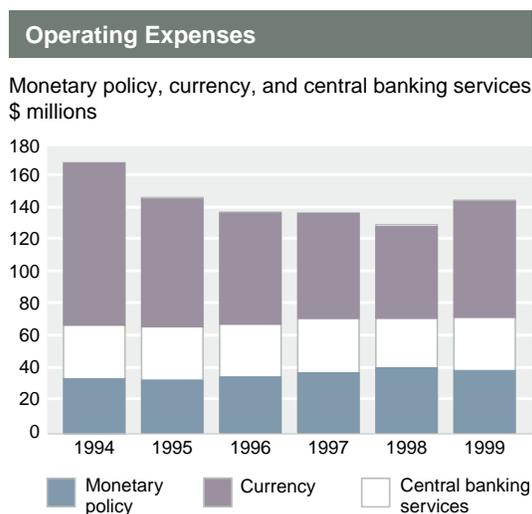


FINANCIAL SUMMARY

Operating Expenses

Monetary Policy, Currency, and Central Banking Services

Over the past five years, the activities of the Bank's core functions—monetary policy, currency, and central banking services—have been reviewed to focus more sharply on the Bank's public policy objectives, the needs of its clients, and efficiency and effectiveness. This resulted in a net reduction in operating expenses of \$39 million by 1998 to a level of \$129 million.



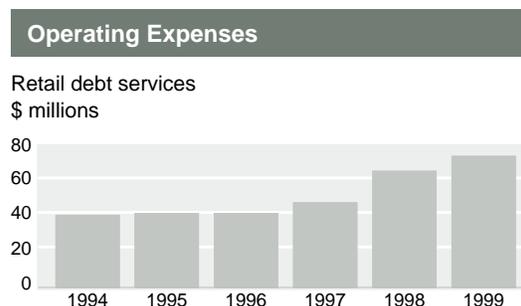
In 1999, expenditures rose to almost \$145 million, with the increase almost entirely attributable to the advance of the bank note order from 2000 and 2001 as a contingency for a possible increase in demand for notes arising from year-2000 concerns. Excluding this special expenditure, the total costs for these three core functions remained at the previous year's level. The increase in expenditures for year-2000-related systems compliance and contingency planning, as well as investments in automated systems, was

offset by lower premises costs from the previous years' sale of a number of the Bank's buildings and by revenue generated from the commercial sales of optical security material.

Next year, operating expenses for the Bank's three core functions are expected to decrease overall by 7 to 10 per cent from the 1999 level of \$145 million because of reduced note-printing requirements. In 2000, central banking services will focus on investing in improvements to the effectiveness of its operations. Monetary policy will enhance its communications and regional-presence programs.

Retail Debt Services

The Bank has been providing services for Canada Investment and Savings—the agency of the Department of Finance responsible for the retail debt program—since the agency's inception in 1996. Expenses have grown considerably over this period from \$42 million in 1996 to \$74 million in 1999. This growth reflects changes to major computing systems and the number of staff required to support a broader range of customer services and government debt products. Expenditures include changes necessary to ensure year-2000 compliance of computing systems and the development of contingency plans.





For 2000, retail debt services will continue efforts to complete the significant business changes initiated over the past several years. Any expenditures required to support the retail debt program will be recovered from the federal government, as has been the case since legislation was changed in mid-1997 to allow the Bank to charge for these services.

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.

Revenue from Investments

Total revenue from investments was \$1.9 billion in 1999, an increase of 6 per cent from 1998. 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 1999 was \$1.8 billion.



Financial Statements

YEAR ENDED 31 DECEMBER 1999

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 these principles 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 that 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, Caron Bélanger Ernst & Young and Raymond Chabot Grant Thornton, 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

OTTAWA, CANADA
K1P 5P9

P.O. BOX 813, STATION B

CARON BÉLANGER ERNST & YOUNG

RAYMOND CHABOT GRANT THORNTON

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 1999 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 1999 and the results of its operations and cash flow for the year then ended in accordance with generally accepted accounting principles.


Chartered Accountants


Chartered Accountants

Ottawa, Canada
21 January 2000

Bank of Canada Statement of revenue and expense

Year ended 31 December 1999

	1999	1998
	Millions of dollars	
REVENUE		
Revenue from investments	<u>1,910.8</u>	<u>1,799.4</u>
EXPENSE by function (notes 1 and 4)		
Monetary policy	39.0	40.7
Currency	72.7	57.5
Central banking services	<u>33.0</u>	<u>30.7</u>
	144.7	128.9
Retail debt services – expenses	73.9	65.5
Retail debt services – recoveries	(73.9)	(65.5)
Other revenue – net	<u>–</u>	<u>(8.3)</u>
	144.7	120.6
NET REVENUE PAID TO RECEIVER GENERAL FOR CANADA	<u>1,766.1</u>	<u>1,678.8</u>

(See accompanying notes to the financial statements.)

Bank of Canada Balance sheet

As at 31 December 1999

ASSETS	1999	1998
	<u>Millions of dollars</u>	
Deposits in foreign currencies		
U.S. dollars	605.6	321.1
Other currencies	4.4	6.2
	<u>610.0</u>	<u>327.3</u>
Advances to members of the Canadian Payments Association	560.7	655.7
Investments (note 3)		
Treasury bills of Canada	12,020.6	12,115.5
Other securities issued or guaranteed by Canada maturing within three years	7,515.1	6,302.2
Other securities issued or guaranteed by Canada not maturing within three years	12,975.7	10,880.1
Other investments	5,130.9	4,455.7
	<u>37,642.3</u>	<u>33,753.5</u>
Bank premises (note 4)	175.2	188.0
Other assets		
Securities purchased under resale agreements	3,669.6	-
All other assets (note 5)	405.5	436.4
	<u>4,075.1</u>	<u>436.4</u>
	<u>43,063.3</u>	<u>35,360.9</u>

(See accompanying notes to the financial statements.)

LIABILITIES	1999	1998
	<u>Millions of dollars</u>	
Capital paid up (note 6)	5.0	5.0
Rest fund (note 7)	25.0	25.0
Bank notes in circulation	40,142.6	32,637.5
Deposits		
Government of Canada	11.8	10.6
Banks	1,827.8	578.7
Other members of the Canadian Payments Association	119.5	73.5
Other deposits	428.5	243.7
	<u>2,387.6</u>	<u>906.5</u>
 Liabilities in foreign currencies		
Government of Canada	454.5	162.0
 Other liabilities		
Securities sold under repurchase agreements	-	1,551.9
All other liabilities	48.6	73.0
	<u>48.6</u>	<u>1,624.9</u>
	<u><u>43,063.3</u></u>	<u><u>35,360.9</u></u>


Governor, G.G. Thiessen


Chief Accountant, F.J. Mahoney


Chairman, Audit Committee, W. Dubowec, FCA


Lead Director, H.H. MacKay, QC

(See accompanying notes to the financial statements.)

Bank of Canada Notes to the financial statements

Year ended 31 December 1999

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.

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. As fiscal agent, 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

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.

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 cash flow 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.

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 9(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 which are fully collateralized and generally overnight in duration. The Bank charges interest on advances under the Large Value Transfer System (LVTS) at the Bank Rate. For advances under the Automated Clearing Settlement System, the Bank charges the Bank Rate plus a margin, which was 150 basis points at 31 December 1999 (Bank Rate prior to introduction of the LVTS on 4 February 1999).

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) Special purchase and resale agreements (SPRAs)

SPRAs are repo-type transactions in which the Bank of Canada offers to purchase Government of Canada securities from designated counterparties with an agreement to sell them back at a predetermined price the next business day. Within the operating band for the overnight interest rate, the Bank is prepared to enter into SPRAs at the policy target rate (i.e., the midpoint of the band) if overnight funds are generally trading above the indicated target level. SPRAs are transacted with primary dealers, a subgroup of government securities distributors that have

reached a threshold level of activity in the Government of Canada debt markets. The balance sheet category *Securities purchased under resale agreements* represents the value receivable by the Bank upon resale of the securities. As such, this amount includes the purchase of treasury bills and bonds, the purchase of accrued interest on bonds, and the interest earned by the Bank over the duration of the SPRAs. The treasury bills and bonds purchased under resale agreements are not recorded as investment assets.

In the course of 1999, the Bank adopted the method of accounting for SPRAs described above. Previously, securities acquired under SPRAs were included in the Bank's investment holdings. There were no SPRAs outstanding at 31 December 1998. Thus, no restatements have been required for the comparative year.

g) Deposits

The liabilities within this category are Canadian dollar demand deposits. The Bank did not pay interest on deposits for *Banks* and *Other members of the Canadian Payments Association* prior to the introduction of the LVTS on 4 February 1999. For members of the Canadian Payments Association, the Bank pays interest on positive balances associated with the Large Value Transfer System (LVTS) at the lower end of the operating band for the overnight interest rate, and on positive balances related to the Automated Clearing Settlement System at the lower end of the operating band for the overnight interest rate less a margin, which was 150 basis points at 31 December 1999. On Special Deposit Accounts, which serve as collateral for LVTS participants, the Bank pays interest at the published overnight rate less a margin, which was 6.25 basis points at 31 December 1999.

h) Sale and repurchase agreements (SRAs)

SRAs are reverse repo-type transactions in which the Bank of Canada offers to sell Government of Canada securities to designated counterparties with an agreement to buy them back at a predetermined price the next business day. Within the operating band for the overnight interest rate, the Bank is prepared to enter into SRAs at the policy target rate (i.e., the midpoint of the band) if overnight funds are generally trading below the indicated target level. SRAs are transacted with primary dealers, a subgroup of government securities distributors that have reached a threshold level of activity in the Government of Canada debt markets.

The balance sheet category *Securities sold under repurchase agreements* represents the value payable by the Bank upon repurchase of the securities. As such, this amount includes the sale of treasury bills and bonds, the sale of accrued interest on bonds, and the interest owed by the Bank over the duration of the SRAs. The treasury bills and bonds sold under repurchase agreements continue to be recorded as investment assets.

In the course of 1999, the Bank adopted the method of accounting for SRAs described above. Previously, securities sold under SRAs were excluded from the Bank's investment holdings. SRA repurchase commitments, valued for settlement

on 4 January 1999 and totalling \$1,552.5 million, were outstanding at 31 December 1998. Thus, it has been necessary to make the following restatements for the comparative year. The Bank's assets under *Investments – Treasury bills of Canada* have been increased by the value of the securities sold under SRAs (\$1,551.7 million). The Bank's liabilities in the new category *Other liabilities – Securities sold under repurchase agreements* have been increased by the value of the securities sold under SRAs and the one day of interest owed by the Bank for 1998 (\$1,551.9 million). Finally, the category *All other liabilities* has been reduced by the one day of interest payable for 1998 (\$0.2 million) that is now reflected in *Securities sold under repurchase agreements*.

i) 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. 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 9(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 4.9 per cent (5.0 per cent in 1998), while the average yield for bonds maturing within three years was 6.5 per cent (6.6 per cent in 1998), and for those maturing in over three years was 6.6 per cent (6.9 per cent in 1998).

4. Bank premises

	1999			1998		
	Millions of dollars					
	Cost	Accumulated depreciation	Net book value	Cost	Accumulated depreciation	Net book value
Land and buildings	168.0	68.5	99.5	168.0	65.1	102.9
Computer hardware/ software	62.0	28.8	33.2	61.6	24.6	37.0
Other equipment	137.1	94.6	42.5	136.5	88.4	48.1
	<u>367.1</u>	<u>191.9</u>	<u>175.2</u>	<u>366.1</u>	<u>178.1</u>	<u>188.0</u>

Total depreciation on Bank buildings, computer hardware and software, and other equipment was \$28.3 million for 1999 (\$23.7 million in 1998).

5. All other assets

This category includes accrued interest on investments of \$325.6 million (\$352.1 million in 1998).

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. 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 1 January 1999, the estimated present value of the accrued pension benefits as at 31 December 1999 was \$478.2 million (\$449.6 million in 1998), and the estimated market-related value of the pension plan assets was \$600.5 million (\$565.5 million in 1998).

Pension expense for 1999 was in a credit position of \$4.6 million (\$4.3 million in 1998). 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.

9. 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 5.5 per cent (6.0 per cent in 1998).

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 1999 or 1998.

All commitments outstanding at 31 December are settled in the subsequent year. A summary of these outstanding commitments follows.

		1999	1998
		Millions of dollars	
Foreign currency contracts	– purchases	117.6	95.6
	– sales	5,299.9	4,644.3

As at 31 December 1999, outstanding foreign currency contracts included sale commitments of \$5,182.4 million (\$4,548.7 million in 1998) 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. All commitments outstanding at 31 December are settled in the subsequent year. A summary of these outstanding commitments follows.

		1999	1998
		Millions of dollars	
Investment contracts	– purchases	–	1,552.5
	– sales	3,675.0	–

As at 31 December 1999, there were no outstanding purchase investment contracts (\$1,552.5 million at an interest rate of 4.75 per cent at the end of 1998 under Sale and Repurchase Agreements). Outstanding sale investment contracts of \$3,675.0 million, at an interest rate of 4.75 per cent under Special Purchase and Resale Agreements, were settled by 13 January 2000 (nil at the end of 1998).

10. Year 2000

The year-2000 computer issue arose chiefly because many date-sensitive automated systems had not been designed to recognize correctly the year 2000. This represented a significant challenge for all organizations. If not addressed properly, the year-2000 issue could have had an impact on operations and financial reporting, ranging from minor errors to the failures of critical systems. The year 2000 arrived without incident for the Bank. However, as is the case generally, it is not yet possible to conclude definitively that all aspects of the year-2000 issue affecting the Bank, including those related to the efforts of clients, suppliers, or other third parties, have been fully resolved.



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W. Paul Jenkins Sheryl Kennedy
Pierre Duguay

L. Theodore Requard, Corporate Secretary

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Audit

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
* On leave of absence

Note: Positions as of 25 February 2000

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Note: Positions as of 25 February 2000

For Further Information about the Bank of Canada

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.

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 financial and economic data. Published monthly. By subscription.

Weekly Financial Statistics

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

Internet

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

Provides timely access to press releases, speeches by the Governor, many of our major publications, and current financial data.

Public information

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

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