



BANK OF CANADA  
BANQUE DU CANADA

# ANNUAL REPORT 2007



# THE BANK'S COMPASS

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

## Our commitment to Canadians

To promote the economic and financial welfare of Canada, we

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

## Our commitment to excellence

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

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

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

## Our commitment to one another

We aim to achieve our best in a workplace where we

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





**BANK OF CANADA**  
**BANQUE DU CANADA**

**David A. Dodge**  
Governor - Gouverneur

31 January 2008

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

Dear Minister,

In accordance with the provisions of the Bank of Canada Act, I am submitting the Bank of Canada's Annual Report for the year 2007 and the Bank's audited financial statements as at 31 December 2007.

Yours sincerely,

A handwritten signature in black ink, reading "D.A. Dodge".

# The Year at a Glance

Steady progress was made on the priorities identified in the Bank's 2007-09 medium-term plan.

- *Inflation was kept close to its 2 per cent inflation-control target.*
- *Work began on a multi-year research program to examine possible improvements to the current inflation-targeting regime.*
- *Research was carried out on a variety of issues to strengthen the Bank's work in monetary policy, financial system, funds management, and currency.*
- *Counterfeiting declined significantly, and work began on evaluating technology and materials that provide the greatest improvement in security for the next generation of bank notes.*
- *The Canadian financial system was shown to be sound and resilient as it dealt with a series of events related to the global financial market turbulence and the repricing of risky assets.*
- *The Bank kept the overnight interest rate close to its target as these events unfolded, with injections of liquidity into the financial system.*
- *The Bank's actions in response to the financial market turbulence have helped to foster confidence in the Canadian economy and financial system.*
- *The Bank worked effectively in various international forums, and efforts to reform the IMF started to bear fruit.*
- *The Bank took over responsibility for the sales and marketing of the government's retail debt program.*
- *The Bank continued to strengthen its information technology infrastructure.*
- *A new Governor was appointed for a seven-year term, starting 1 February 2008.*



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# Message from the Governor

The year 2007 was marked by sharply increased volatility in financial and foreign exchange markets, and a widening of credit spreads. Despite financial market turbulence, the Canadian economy continued to expand, and inflation remained close to our target of 2 per cent. In this, my final Annual Report message, I begin by reviewing the economic and financial developments and challenges of the past year. I then highlight seven important ongoing challenges faced by Canada and the Bank during my seven years as Governor.

## Economic Overview

The past year's most significant development was the turbulence in global financial markets that began in late July. The immediate cause was the greater-than-expected deterioration in the market for securities backed by U.S. subprime mortgages. These securities underpinned many structured investment products, including asset-backed commercial paper. Because many of these products were complex and opaque, investors often did not know the extent to which these instruments might be subject to losses stemming from exposure to U.S. subprime mortgages. By mid-August, this lack of transparency and difficulty in pricing caused a breakdown of the market for structured products, as investors began to question the value of the assets backing their structured securities. Credit markets tightened, and banks faced rising funding costs because of uncertainty about their direct or indirect exposure to structured financial products. Liquidity in money markets dried up as banks became reluctant to lend to one another, and investors sought safety in government securities.

In response to these problems, the Bank of Canada used the standard mechanisms at its disposal to keep money markets liquid and maintain the overnight interest rate at the policy target level. When the increased demand for liquidity caused the rate on overnight collateralized loans to move well above the target overnight rate, the Bank engaged in multiple rounds of special purchase and resale



*David Dodge, Governor*

agreements, providing overnight funds to primary dealers at the target overnight rate in exchange for Government of Canada securities. The Bank also increased the level of settlement balances, as necessary, to keep the overnight rate on target. These operations were generally effective in supporting the efficient functioning of capital markets. Nonetheless, the experience did suggest a need to review the statutory framework within which the Bank conducts these operations. This review is under way and is scheduled for completion in early 2008.

Foreign exchange markets were also quite volatile in 2007. While the U.S. dollar depreciated against almost all major currencies during the year, global exchange rates were particularly unsettled in the second half of 2007 as the outlook for the U.S. economy weakened. Reflecting these global trends, as well as the rise in commodity prices, the Canadian dollar appreciated from about 86 cents U.S. at the beginning of the year to just above par with the U.S. dollar at year-end. The Canadian dollar



exhibited unprecedented intraday and intraweek volatility from mid-September to mid-November, at one point reaching an intraday high of just over US\$1.10.

The global economy continued to grow strongly in 2007, although there were signs of some weakening in the fourth quarter. Strong global demand bolstered commodity prices, and prices for crude oil, grains and oilseeds, and precious metals increased, while prices for base metals remained close to the elevated levels of 2006. Buoyed by solid growth in the global economy and improved terms of trade, the Canadian economy operated slightly above its production capacity throughout 2007. The employment-to-population ratio reached a historic high of 63.8 per cent, the unemployment rate fell to a 33-year low of 5.8 per cent, and domestic demand rose strongly.

## Monetary Policy

Financial market turbulence, exchange rate volatility, and unexpectedly strong domestic demand made 2007 a particularly challenging year for monetary policy. The Bank left interest rates unchanged during the first half of the year, but by mid-year it was clear that some tightening of policy was required to keep inflationary pressures in check. We therefore raised our policy rate by one-quarter of a percentage point in July and indicated that further tightening might be necessary. By October, we concluded that several factors would reduce inflationary pressures without a further increase in rates: tightening credit conditions caused by financial market turbulence, the stronger Canadian dollar, and weaker prospects for Canadian exports to the United States. Consequently, we left our policy rate unchanged and indicated that the upside and downside risks to inflation were roughly balanced. By December, however, it was clear that the downside risks to inflation had increased because of further deterioration in the outlook for exports to the United States and further tightening of credit conditions.

We therefore reduced our policy rate by one-quarter of a percentage point to 4.25 per cent, the level at which it had started the year.

*Financial market turbulence, exchange rate volatility, and unexpectedly strong domestic demand made 2007 a particularly challenging year for monetary policy.*

Total CPI inflation was quite volatile in 2007 because of movements in energy prices and changes in the GST. Nevertheless, it remained within the 1 to 3 per cent control range, averaging 2.1 per cent and ending the year at 2.4 per cent. Core inflation, which had risen to 2.5 per cent by mid-year, fell sharply to 1.5 per cent at the end of the year, partly because of increased competitive pressures in the retail sector related to the appreciation of the Canadian dollar. Inflation expectations in Canada remained well anchored at close to 2 per cent.

## Challenges for Canada and the Bank

Let me now reflect on seven challenges that Canada and the Bank have faced over my seven years as Governor, challenges that will persist in the future.

The first has been the need for flexibility in the reallocation of economic resources in response to changing circumstances. Over the past seven years, Canadians have had to adjust to a rapidly changing global economic environment—sharply higher commodity prices, more intense competition from Asia, and a quickly changing global financial system. The good news is that we have adjusted much faster in this decade than we did in the 1970s and 1980s when we faced similar shocks.

Employment is high, real incomes are increasing, and inflation has been kept very close to our 2 per cent target. But the challenge continues. Canadians must be prepared to seize new opportunities as they arise and to let go of activities that are no longer economic. The best contribution that the Bank of Canada can make to this difficult process of adjustment is to give Canadians confidence in the future value of their money by controlling inflation.

A second challenge has been to build a stronger international monetary and financial order. To this end, the Bank has worked with the Department of Finance, other central banks, and officials from the International Monetary Fund to strengthen the IMF and improve its effectiveness. The Bank believes that the IMF can play a vital oversight role through its bilateral and multilateral surveillance activities. We've worked hard to make these activities more effective and to improve the governance of the IMF. Our efforts helped to bring about some important progress. The IMF's Executive Board has adopted a new legal framework for bilateral surveillance that focuses on maintaining international economic stability. But more work is required to improve the governance of the IMF to make its activities more effective. We must continue to build a market-based international monetary and financial order in which countries abide by the "rules of the game," including allowing real exchange rates to adjust to facilitate the resolution of global imbalances.

A third challenge has been to maintain sustainable levels of public debt. Federal and provincial governments in Canada have wisely used the favourable economic conditions of the past seven years to bring the level of public debt down to a more sustainable level. This has contributed directly to good economic performance and has facilitated the Bank's task of maintaining low and stable inflation. Governments should continue to reduce the debt burden. But our population will continue to age, and Canada's terms of trade will not keep improving indefinitely. Hence, achieving continued reduction in the ratios of public debt to GDP may be more challenging over the next seven years.

A fourth challenge has been to improve the efficiency and stability of our Canadian financial system. During my term as Governor, the Bank has undertaken research on efficiency and stability issues, and, since 2002, we have published the results in our *Financial System Review*. We have worked closely with Canadian securities administrators, the Office of the Superintendent of Financial

Institutions, the Canada Deposit Insurance Corporation, and the Department of Finance to promote more efficient domestic capital markets and institutions. And we have worked with other central banks, the Bank for International Settlements, and the Financial Stability Forum to improve global financial stability. Progress has been made, and there is a growing appreciation of the need for further coordinated action. But more remains to be done if Canada is to continue to have the competitive markets and institutions that we need to facilitate the most efficient use of savings and allocation of investment.

*The final important challenge is to keep inflation low, stable, and predictable. The Bank has been successful in meeting this critical challenge, but the task of keeping inflation close to the target will continue in the years ahead.*

A fifth challenge has been the renewal of our infrastructure. At the national level, the challenge is to renew outdated physical infrastructure in the most efficient and timely fashion—a task that can perhaps be met in part through the use of public-private partnerships. Just as the country has begun the process of renewing its infrastructure, so we at the Bank have been making major investments in renewing and improving our infrastructure. We're in the process of improving the efficiency and reliability of our IT systems, and we've invested in research and development to improve bank note security. Again, there's more to be done, and we have budgeted for further improvements to the Bank's infrastructure over the next few years.

A sixth challenge has been, and will continue to be, to foster greater growth in productivity. Higher productivity is the only way that we can achieve sustained increases in income and economic well-being. Over the past seven years, labour productivity has been weak, growing at only 1 per cent per year, well below the Bank's assumption of 1½ per cent. This weak performance may partly reflect the major shift in resources taking place across sectors of our economy, and may therefore be temporary. The challenge for governments is to ensure that education and

training policies are sound and that barriers to efficiency are reduced. For our part, we will continue to improve the effectiveness of our operations. We will also strive to ensure that monetary policy supports sustained economic growth. This brings me to the seventh challenge.

The final important challenge is to keep inflation low, stable, and predictable. Keeping inflation close to the 2 per cent target hasn't been easy over the past seven years, as the economy experienced several shocks. The Bank has been successful in meeting this critical challenge, but the task of keeping inflation close to the target will continue in the years ahead.

Canadians have learned that the best contribution the central bank can make to their welfare is to maintain confidence in the future value of money. In the 1970s, we witnessed the economic and social instability caused by high and volatile inflation. In the 1980s, we paid the price of recession to get inflation under control. Since the early 1990s, our inflation-targeting regime has helped to keep inflation very close to the target. But complacency is not an option. To meet the challenge of inflation control going forward, the Bank must stay at the forefront of monetary policy thinking. In 2006, the Bank embarked on an ambitious research program to determine whether

the current inflation-targeting regime might be improved. This research will assess two important issues: the potential costs and benefits of targeting a lower rate of inflation, and the costs and benefits of pursuing a price-level target, which would take past inflation performance into account. The Bank will publish the results of this research well in advance of its next inflation-control agreement with the federal government in 2011. Whatever the outcome, I am confident that my colleagues at the Bank and my successor, Mark Carney, will continue to keep inflation low and predictable for the benefit of all Canadians.

## Conclusion

In closing, I would like to thank all staff of the Bank, my colleagues on the Governing Council, and members of the Bank's Board of Directors for their hard work and the support they have given me, not only this past year but throughout my term as Governor. Their expertise and commitment to excellence are directly responsible for the Bank's many successes.



# Governance

## The Bank's Mandate

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

## Corporate Governance in 2007

Corporate governance at the Bank is guided by a solid legislative framework in the Bank of Canada Act that sets out the roles and responsibilities of the Governor, the Senior Deputy Governor, the Board of Directors, and the federal government. Based on this framework, and with due consideration of the best practices of other public institutions and central banks, and of relevant private sector practices, the Bank's mandate is fulfilled through strategic planning, risk management, open communication, and clear accountability for the priorities established and the results achieved.

The Bank committed to certain priorities in 2007, the first year of a three-year medium-term plan. The Board of Directors approved the strategic direction and the plan in 2006. It was closely involved in monitoring implementation of the plan in 2007. This included an assessment of the consequences of unanticipated developments related to implementing several technology initiatives, including delays in some of the objectives regarding infrastructure renewal. The Board formed an Advisory Committee on Information Technology, chaired by Mr. Philip Deck,

to allow consideration of these issues in depth. Throughout the year, the Board provided input regarding the adjustments required to the Bank's plan, and, as part of its annual review of the Bank's stewardship, the Board evaluated management's overall achievement of the plan's objectives.

The Bank's approach to risk management identifies key areas of risk, based on its responsibilities and strategic priorities. In an annual assessment, senior managers examine business, reputational, financial, operational, security, and disaster-recovery risks. They then identify and assess those risks that could impede the fulfillment of the Bank's objectives. In 2007, risks to the Bank's plans, arising from changes in several technology initiatives, were managed by reallocating resources, delaying other initiatives, and adjusting overall timelines for the completion of work. In recognition of the importance of technology priorities in the Bank's plan, the information technology area was made into a separate department.

An important component of the Bank's risk management is to ensure that plans are in place for the continuity of operations in the event of any disruption to regular business. These plans focus on providing critical banking operations and on the safety of staff. Management monitors the risk strategies established, and these are periodically reviewed by the internal Audit Department. The Board of Directors oversees the risk-management framework.

The Bank's Financial Risk Office is independent of operations and is responsible for monitoring and reporting on risks and investment performance arising from the management of the government's debt and foreign reserves. The Bank shares oversight of the results of

# Board of Directors



**David Dodge**  
Governor  
Appointed in 2001



**Paul Jenkins**  
Senior Deputy Governor  
Appointed in 2003



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



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



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



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



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



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



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



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



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



**Gilles Lepage**  
Corporate Director  
Caraquet, New Brunswick  
Appointed in May 2005



**Michael O'Brien**  
Corporate Director  
Charlottetown,  
Prince Edward Island  
Appointed in October 2006



**Thomas J. Rice**  
Chairman, Jovian Capital Corp.  
Winnipeg, Manitoba  
Appointed in June 2005



**Robert Wright**  
Deputy Minister of Finance  
Member ex officio



**Executive Management Committee** (left to right): Sheila Niven, Chief, Corporate Services; Paul Jenkins, Senior Deputy Governor; David Longworth, Deputy Governor; Sheryl Kennedy, Deputy Governor; Mark Jewett, General Counsel/Corporate Secretary; Janet Cosier, Adviser on Strategic Planning and Risk Management; David Dodge, Governor; Pierre Duguay, Deputy Governor; Tiff Macklem, Deputy Governor; Carole Briard, Chief, Information Technology Services; Sheila Vokey, Chief, Financial Services

this monitoring with the Department of Finance, which represents the interests of the government in this function.

Transparency through effective and regular communication continues to be a critical part of the Bank's governance framework. The Governor and Senior Deputy Governor appeared several times before committees of the House of Commons and the Senate. In speeches during the latter part of the year, senior Bank officials focused on liquidity and credit issues affecting financial markets. The Bank strives to demonstrate its accountability in achieving its public policy objectives through its extensive publishing program and by posting a wide variety of information and research on its website <<http://www.bankofcanada.ca>>.

## Highlights

In April 2007, Governor Dodge announced his intention not to seek a renewal of his term when it expired on 31 January 2008. In May, the Board of Directors established a Special Committee composed of all the independent Directors to search for candidates for the position of Governor, to be appointed, as provided for

in the Bank of Canada Act, with the approval of the Governor-in-Council. The process was outlined on the Bank's website and included the formation of a subcommittee of the Special Committee, the engagement of an executive recruitment firm, advertisements in national journals, numerous meetings to review potential candidates, and interviews. On 4 October, the Board announced the appointment of Mark Carney as the next Governor for a seven-year term. Mr. Carney joined the Bank as an Adviser to the Governor on 1 November for a transition period prior to beginning his term as Governor on 1 February 2008.

Later in the year, the Board began the selection process for a new Deputy Governor, following the resignation of Tiff Macklem to take up an appointment as Associate Deputy Minister of Finance. The process resulted in the appointment of John Murray on 4 January 2008.

## Governance Structure

Responsibility for governance of the Bank lies primarily with the Board of Directors through its oversight of all administrative functions and of the process by which the Bank manages its responsibilities.

The Executive Management Committee provides overall direction and guidance to the Bank's management and recommends, for the Board's consideration and approval, issues and policies of broad organizational, financial, and strategic importance.<sup>1</sup>

Under the Bank of Canada Act, the Governor is solely accountable for monetary policy. However, in practice, the Governor shares this responsibility with the other members of the Governing Council: the Senior Deputy Governor and the four Deputy Governors. A Financial System Committee deals with specific issues related to the safety and soundness of the Canadian financial system, international financial architecture, and the Bank's role in regulatory matters.<sup>2</sup>

## Board of Directors

In addition to the Governor (who by statute is the Chairman of the Board) and the Senior Deputy Governor, the Board is composed of 12 independent Directors and the Deputy Minister of Finance (who has no vote but provides an important link with the Department of Finance). The 12 independent Directors are appointed by the Minister of Finance (with the approval of the Governor-in-Council) for renewable three-year terms. In 2007, three new Directors joined the Board and attended orientation meetings with Bank staff in order to become familiar with the Bank's functions, operations, and plans.

As noted earlier, the Board's responsibilities include reviewing and approving the Bank's corporate objectives, plans, and budget. The Board annually reviews the Bank's succession planning to ensure that continuity of knowledge is in place for the effective ongoing management of the Bank.

In 2007, the independent Directors elected a new Lead Director, Mr. Jean-Guy Desjardins, following the departure of Dr. David Barnard in June. As Chairperson of the Board's Corporate Governance Committee, the Lead Director oversees the corporate governance practices of the Board and the Bank. The Lead Director also chairs private meetings of the independent Directors at each Board

meeting and leads the Board's annual self-assessment process, an exercise that facilitates a full discussion of the Board's practices and its satisfaction with management's provision of information and support.

Although the Board is not responsible for monetary policy, it has an oversight responsibility to monitor the effectiveness of the process for formulating monetary policy. One opportunity for the Board to explore the Bank's process is an annual private session between the Board and the Special Adviser, an external expert appointed annually. Professor Steve Ambler, an economist from the Department of Economics, Université du Québec à Montréal, was the Bank's Special Adviser for a one-year period ending July 2007, during which time he focused his research and advice on inflation targeting and applied macroeconomics modelling.

To fulfill its responsibilities of governance and oversight, the Board has six standing committees summarized in the table on page 13.

Temporary advisory committees are created from time to time to provide a forum for discussion of issues of particular interest. There is currently an advisory committee to discuss information technology matters. The Advisory Committee on Currency, chaired by Mr. Tom Rice and created in 2002, concluded in December that, with the successful implementation of the currency strategy, it had fulfilled its mandate and was no longer needed. In 2007, in addition to seven Board and related Committee meetings, there were numerous meetings of the Special Committee and its subcommittee during the recruitment process for the next Governor. (See <<http://www.bankofcanada.ca/en/about/board.html>> for details on Directors' attendance at meetings.)

Directors are paid according to a fee structure established by the government, approved by the Governor-in-Council and published in the *Canada Gazette*. The fees may be viewed on the Bank's website. In 2007, the total of fees paid to independent Directors was \$312,125 (up from \$274,400 in 2006, owing to meetings of the Special Committee).

<sup>1</sup> This committee includes the Governor, Senior Deputy Governor, the four Deputy Governors, the General Counsel/Corporate Secretary, the Adviser on Strategic Planning and Risk Management, the Chief of Corporate Services, the Chief of Financial Services, and the Chief of Information Technology Services.

<sup>2</sup> Membership consists of the Governing Council, the General Counsel/Corporate Secretary, the Chief of Communications, and an Adviser.



**Governing Council** (left to right): Paul Jenkins, Senior Deputy Governor; Pierre Duguay, Deputy Governor; Sheryl Kennedy, Deputy Governor; David Dodge, Governor; David Longworth, Deputy Governor; Tiff Macklem, Deputy Governor.<sup>3</sup> Photo right: John Murray, Deputy Governor

## Governing Council

Under the Bank of Canada Act, the Governor is responsible for implementing monetary policy. In practice, however, the Governor shares that responsibility with fellow members of the Bank's Governing Council. The Governing Council works by consensus to formulate, implement, and communicate monetary policy with the support of the Bank's economics and communications departments.

A central element of the accountability framework for monetary policy is the agreement between the Bank and the federal government on the inflation-control

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

<sup>3</sup> Tiff Macklem was Deputy Governor from 2004 until 31 October 2007 when he accepted an appointment as Associate Deputy Minister, Department of Finance. On 4 January 2008, John Murray was appointed Deputy Governor.

# Committees of the Board of Directors

Committee and Mandate	Composition (31 December 2007)
<p><b>The Executive Committee</b> provides a forum for Bank management to seek comment on broad policy and planning matters relating to the administration of the Bank and makes decisions on behalf of the Board when it is not feasible to convene a full Board meeting. This Committee is provided for in the Bank of Canada Act.</p>	<p>D. A. Dodge (Chair)            W. P. Jenkins            W. A. Black            J.-G. Desjardins            B. D. DuPont            C. Hansell            R. A. Wright (<i>ex officio</i>)</p>
<p><b>The Corporate Governance Committee</b> reviews the effectiveness of the Bank's governance practices and any relevant governance issues.</p>	<p>J.-G. Desjardins (Chair)            W. A. Black            B. D. DuPont            C. Hansell</p>
<p><b>The Planning and Budget Committee</b> oversees the overall strategic planning, budget and reporting process, stewardship and related reporting of the Bank.</p>	<p>J.-G. Desjardins (Chair)            All Board members</p>
<p><b>The Audit Committee</b> oversees the Bank's internal control framework, as well as the adequacy of the Bank's risk-management and governance framework.</p>	<p>M. L. O'Brien (Chair)            D. A. Emsley            D. H. Laidley            G. Lepage</p>
<p><b>The Human Resources and Compensation Committee</b> oversees the human resource and compensation functions of the Bank, including its total compensation arrangements and retirement benefits.</p>	<p>B. D. DuPont (Chair)            W. A. Black            P. D. Dicks            J. A. Finlayson</p>
<p><b>The Pension Committee*</b> performs all acts required of the Bank in its capacity as administrator of the pension plan, supplementary pension arrangements, and trust funds.</p>	<p>W. P. Jenkins (Chair)            P. D. Dicks            C. Hansell            M. L. O'Brien</p>
<p>* In addition to Board members, the Pension Committee includes three other senior officers of the Bank appointed by the Board.</p>	

# Our People and Work Environment

The Bank has a staff of about 1,200, located mainly at the head office in Ottawa. About 10 per cent of staff work at operations centres in Montréal and Toronto, and in regional offices in Vancouver, Calgary, Toronto, Montréal, and Halifax. As a research and knowledge-based organization, the Bank strives to create a superior work environment that attracts and engages the best employees to achieve its goals. Talented professionals conduct research, develop policy, provide services, and manage operations—all with the aim of promoting the nation's economic well-being.

Among the Bank's values are commitments to excellence and to each other. (See "The Bank's Compass" on the inside front cover.) Clear and open communication, recognition, respect, and the sharing of knowledge are fundamental to these commitments, and produce a workplace in which staff are fully engaged and where collaborative work and professional growth are part of the job.

The Bank is committed to, and benefits from, diversity, with its staff representing a wide range of backgrounds. Staff are supported in learning both official languages and refining their language skills, and with 70 per cent of staff functionally bilingual, both languages are used



*Glen Provost and Mary McGrath, Information and Data Management Division, Research Department*

regularly in the workplace. The Bank fosters diversity by encouraging new ideas and creative approaches to the challenges of work.

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

## More than Money — Architecture and Art at the Bank of Canada

*The third book in the Bank's "souvenir" series, More than Money — Architecture and Art at the Bank of Canada, traces the Bank's efforts to build the facilities needed to carry out its responsibilities as Canada's national monetary institution. In so doing, the Bank placed its architectural stamp on Ottawa and on major cities across the country.*

*The book takes the reader on an intimate tour of the head office complex, one of Ottawa's landmark buildings. The tour highlights the building's architecture and decorative features, as well as works from the Bank's art collection—a collection that reflects the country's diversity and the richness of its artistic achievements.*





# Monetary Policy

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

**Strategy:** *Keep inflation low, stable, and predictable by the use of a clearly defined inflation target*

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

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

## Ongoing Work towards Goals and Desired Outcome

### Achieving the 2 Per Cent Inflation Target

In 2007, the Bank faced several challenges in the conduct of monetary policy. These included stronger-than-expected domestic demand leading to greater-than-expected capacity pressures, high energy prices, a rapid rise in the value of the Canadian dollar in U.S.-dollar terms, and turbulence in credit markets following a sharp contraction in U.S. housing demand and losses in subprime mortgages. Throughout the year, the Canadian economy was operating slightly above its production potential. Despite these challenges, monetary policy was successful in keeping the average rate of CPI inflation within the 1 to 3 per cent control range and close to the 2 per cent target.

In the first half of 2007, economic growth and inflation were stronger than expected. Core inflation varied between 2.2 and 2.5 per cent over this period. Although total CPI inflation ranged between 2.0 and 2.3 per cent

from February to June, slightly above the 2 per cent target, it would have been 0.5 per cent higher had it not been for the effect of the July 2006 reduction in the GST and other changes in indirect taxes.

By July 2007, the Bank judged that capacity pressures had risen, and, against this background, on 10 July the Bank raised the policy interest rate to 4.50 per cent from the 4.25 per cent rate that had prevailed since May 2006. The Bank indicated at that time that some modest further increase in the policy rate might be required to keep inflation on target. The main upside risk to the inflation outlook was identified as stronger-than-expected household demand, and the main downside risks as a stronger-than-projected adjustment in the Canadian economy to the rapid appreciation of the Canadian dollar and a deeper and more prolonged contraction in the U.S. housing sector.

In the second half of the year, overall conditions facing the Canadian economy shifted as a result of the global financial turbulence that began in the summer. (See page 24 of the Financial System section for a more detailed discussion of these events and the Bank's response to them.) To some extent, the risks the Bank had identified earlier in the year had materialized by early autumn: household demand in Canada was stronger, the adjustment in the U.S. housing sector was sharper, and the Canadian dollar had continued to rise, from about

94 cents U.S. in mid-July to almost 103 cents U.S. in mid-October. In addition, credit conditions had begun to tighten in reaction to the financial market turbulence, with the cost of credit for firms and households increasing by an estimated 25 basis points relative to the Bank's target for the overnight rate. Against this backdrop, the

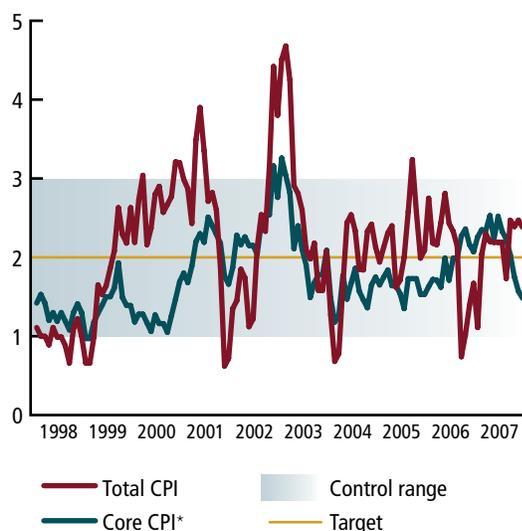
target rate was left unchanged in September and October. In its October *Monetary Policy Report*, the Bank updated its analysis and economic projection, incorporating the implications of the tightening credit conditions.

In announcing its December interest rate decision, the Bank noted that "there had been a shift to the downside in the balance of risks around its October projection," and that both total CPI inflation and core inflation over the coming months were expected to be below expectations. Difficulties in global financial markets had also worsened and were expected to persist for a longer period. In these circumstances, bank funding costs had increased globally and in Canada, and credit conditions had tightened further. Although important upside risks remained, in light of the shift in the balance of risks, the Bank lowered its target for the overnight rate to 4.25 per cent.

Research is key to helping the Bank achieve its desired monetary policy outcome. In 2007, the Bank commissioned a committee of five outside economists to evaluate the Bank's research in all its economic functions. The committee will report its findings in early 2008.

## Consumer Price Index

Year-over-year percentage change



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

## Canadian-Dollar Exchange Rate

Monthly average



## Improving Our Models

To evaluate and project economic developments, the Bank develops and uses a variety of econometric models, which are constantly being improved. In 2007, particular attention was given to the Terms-of-Trade Economic Model (ToTEM) and to the Bank's model of the global economy (GEM).

Work on ToTEM, the model used to assess developments in the Canadian economy, focused on enhancing its performance through formal estimation of the model's parameters and modifications to its structure. These efforts should improve the model's predictive accuracy and allow a better assessment of the degree of uncertainty surrounding a projection.

The Bank's version of the global economy model (BoC-GEM) was enhanced and was used to address new issues such as the implications of global savings patterns and investment flows, and the effects of rising oil prices.

## Priorities for 2007 and the medium term

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

## Progress on Priorities

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

At the time of the November 2006 agreement with the federal government on the renewal of the inflation target, the Bank launched an ambitious multi-year research program to examine whether the current inflation-targeting regime is making the greatest possible contribution to Canadian economic performance, or whether it might be improved. This concerted effort will draw on the expertise of many external researchers, as well as Bank staff, and will aim at clarifying two key issues by determining the potential costs and benefits of i) targeting a lower rate of inflation and ii) pursuing a price-level target instead of an inflation target.

In 2007, the first full year of the program, a solid foundation was laid. The Bank helped to organize conferences and conference sessions on issues related to optimal inflation and price-level targeting. Bank staff also collaborated with a number of external experts on these issues.

Some preliminary research has indicated that, in a number of models, lower rates of inflation tend to produce overall “welfare improvements”—particularly, reduced labour market distortions—and that, with some caveats, price-level targeting appears to have some advantages in terms of stabilizing the business cycle. Much more research is needed, however, before any tentative policy conclusions can be drawn.

The Bank has established a website to serve as a clearing house for research on inflation and price-level targeting. The site can be accessed at <<http://www.inflationtargeting.ca/>>.

### *Improve our understanding of the process and implications of globalization*

A thorough understanding of how globalization affects the Canadian economy is vital to sound monetary policy. In 2007, the Bank enhanced its monitoring of the Chinese economy, and research addressed the impact of China and, more broadly, of emerging Asia, on global prices. Preliminary studies examined the direct and indirect effects of low-cost Chinese imports on inflation, and suggested estimates in the order of minus 0.1 to minus 0.4 percentage points per year for Canada in recent years.

Work to assess the robustness of the traditional relationship between commodity prices and the Canadian dollar continued, and suggested that the dollar has become more sensitive to commodity prices in recent years. Research was also conducted on the impact of emerging Asia on commodity prices.

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

Through research and analysis, the Bank is seeking to increase its understanding of how changes in financial conditions—such as those that emerged in the late summer and autumn of 2007—affect key macroeconomic variables such as output and inflation. For example, in 2007, a structural model was estimated in which house prices and business and household credit play an active role in the transmission of monetary policy. This will help in assessing the balance of risks in the staff's main economic projection.

## Fellowship Program

### *New Governor's Award Launched*

*In September 2007, the Bank launched the Governor's Award, aimed at researchers in the relatively early stage of their careers, working as assistant or associate professors in economics or business programs at Canadian universities, who have demonstrated the potential to make exemplary research contributions in the areas critical to the Bank's mandate. This annual award, together with the Fellowship Award established in 2002, is designed to foster excellence in research and analysis and to develop partnerships with experts outside the Bank.*

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

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



***Fellowship Award for 2007*** (left to right): Senior Deputy Governor Paul Jenkins; Dr. David Barnard, Director and Chair of Nominating Committee; Professor Jean-Marie Dufour of McGill University (Fellowship recipient); and Governor David Dodge

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

In 2007, staff examined empirical links between the terms of trade and the growth of labour productivity in Canada. Research indicated that, in response to recent relative-price shocks, the manufacturing sector, having shed its least-productive labour and plants, should see somewhat faster growth in labour productivity in the short run. In contrast, the primary sector should experience slower growth in labour productivity, since relatively high commodity prices encourage the production of resources that are more costly to extract and lead to rapid

growth in the demand for employment and increasing reliance on less-efficient labour sources.

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

Potential output determines the rate at which the economy can grow in a sustainable, non-inflationary fashion. The aging of the baby-boom generation, declining fertility rates, and a stabilization in the number of women joining the labour force all point to a slowing in the growth of trend labour input over the coming decades.

Without an offsetting increase in labour productivity, this implies lower potential output growth. Research in 2007 suggested that the decline in labour supply resulting from an aging population should lead to greater investment in machinery and equipment, which would help to mitigate the decline in potential output growth. But the extent of this capital deepening will depend on the relative productivity of different cohorts and on education policy.

An article in the *Bank of Canada Review* examined the evolution of Canadian productivity since the mid-1990s, a period in which trend productivity growth remained modest in Canada, but strengthened in the United States. Analysis indicated that potential causes of Canada's low productivity performance included lower investment in information and communication technology, reallocation and adjustment costs associated with large movements in relative prices, and weaker demand for innovation.

#### *Explore the bounds of transparency, and enhance the Bank's communications*

In 2007, research in the area of transparency focused on the reactions of Canadian financial markets to official Bank of Canada communications, particularly to forward-looking policy statements. Research was also conducted on how best to communicate uncertainty and risk in the economic outlook.

## Priorities for 2008

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

# Currency

**Desired outcome:** Canadians use bank notes with confidence

**Strategy:** Reduce counterfeiting below a clearly defined threshold

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

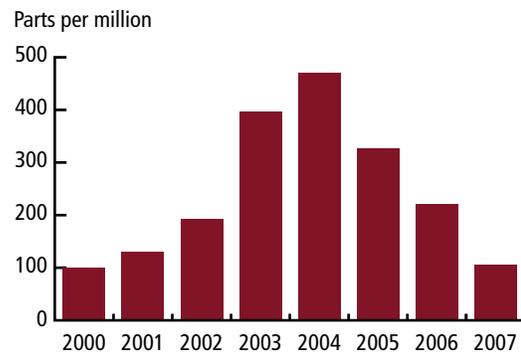
The Bank of Canada is responsible for supplying Canadians with bank notes they can use with confidence. In 2007, the Bank issued 460 million new bank notes and removed 375 million worn notes from circulation. At year-end, there were approximately 1.7 billion bank notes in circulation with a total value of just over \$50 billion.

## Ongoing Work towards Goals and Desired Outcome

The Bank has put in place a comprehensive strategy to foster confidence in Canadian bank notes. The strategy has four elements: making bank notes more difficult to counterfeit, encouraging the routine verification of bank notes, promoting the deterrence of counterfeiting, and withdrawing counterfeits and vulnerable older-series notes from circulation.

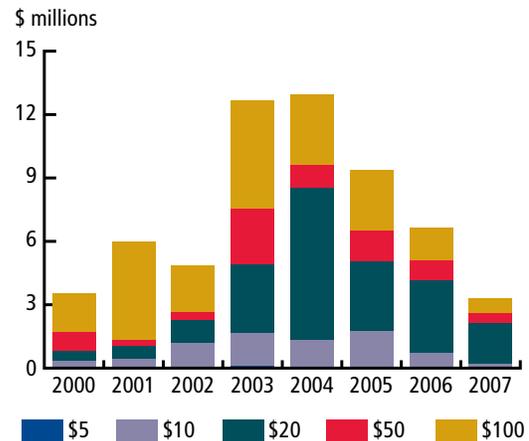
Efforts by the Bank of Canada, in concert with law-enforcement agencies and prosecutors, led to a decline in counterfeiting in 2007 for the third consecutive year. The number of detected counterfeits per million genuine notes in circulation fell from a peak of 470 in 2004 to 105 in 2007. This latest level, which was down from 221 in 2006, is just slightly above that targeted for 2009. Nearly two-thirds of counterfeit notes are from older, less-secure note series, even though older-series notes represent only 5 per cent of the notes in active circulation. The \$20 note is the denomination counterfeited most often.

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



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

Value of Counterfeit Bank Notes Found in Circulation



## Priorities for 2007 and the medium term

- Conduct research on security features, theme, and design of the next generation of bank notes, while continuing to evaluate various substrates
- Redirect education efforts to engage retailers in authenticating bank notes
- Further understanding of bank note usage, counterfeiting behaviour, and alternative payment methods and technologies
- Continue to support and promote counterfeit deterrence
- Replace notes from older series, and enhance the bank note distribution system
- Refurbish aging note-processing equipment

## Progress on Priorities

*Conduct research on security features, theme, and design of the next generation of bank notes, while continuing to evaluate various substrates*

The Bank's goal is to begin issuing a new series of notes in 2011. In 2007, the Bank put in place a comprehensive plan for the development of this series, identified the technologies and materials that promise the greatest improvement in security, and began evaluating them.

The Bank works closely with other central banks, the security printing industry, and equipment manufacturers to facilitate the development of new security features for bank notes, and to gain a better understanding of the threat posed by emerging reprographic technology available to counterfeiters. For example, the Bank is a member of the Central Bank Counterfeit Deterrence Group, an association of 28 central banks that collaborate to identify and analyze counterfeiting threats and develop strategic responses. In addition, the Bank teamed with the Bank of England, Dalhousie University, and Bangor University (Wales) to investigate how design and printing techniques can help to increase bank note security.

This innovative study is the first of its kind to be carried out by a central bank, and its findings should provide useful input for the design of Canada's next generation of bank notes.

## *Redirect education efforts to engage retailers in authenticating bank notes*

Familiarity with the security features found on every bank note and their routine use to verify that a note is genuine are key to bank note security. To promote bank note verification, the Bank makes available a wide variety of print, audiovisual, and computer-based educational material. More detailed information can be found at <<http://www.bankofcanada.ca/en/banknotes/index.html>>. Staff in the Bank's regional offices deliver customized training sessions to retailers and other cash handlers.

In 2007, training efforts concentrated on cash-intensive businesses such as gasoline retailers and convenience stores. An education module for high school students (many of whom will handle cash in their first jobs) was successfully launched in 2007 in collaboration with the Durham District School Board, the RCMP, the Ontario Provincial Police, and the Sûreté du Québec. The Bank also began talks with provincial education and school board officials about the possibility of integrating this module, which was developed in partnership with the Durham Board, into high school curricula across the country.

## *Further the Bank's understanding of bank note usage, counterfeiting behaviour, and alternative payment methods and technologies*

The Bank conducts regular surveys of Canadians to improve its understanding of their use of bank notes and to assess their confidence in them, as well as to gauge retailers' verification practices. The Bank uses this information to formulate training and communication strategies.

The Bank also conducts research to study particular methods of payment, such as cash, debit cards, and credit cards, used by consumers and merchants. This research informs the Bank about consumers' perceptions and use of retail payment alternatives, as well as the factors that influence the behaviour of merchants and consumers.

## Currency Museum

The Bank of Canada is home to the Currency Museum. Its mission is to preserve Canada's numismatic heritage through stewardship of the National Currency Collection, and to inform the public about money, the central bank, and the economy. About 42,000 visitors participated in Museum programs on-site in 2007, while another 30,000 were involved in programs outside Ottawa.

Initiatives in 2007 to support the stewardship of the Collection included establishing an Acquisition Advisory Committee and planning for improved facilities for preserving the Collection. New Museum programs included the exhibit "Sacred Money, Damned Money" (prepared and presented in partnership with the Musée de la civilisation de Québec); an audio tour on counterfeiting; and a youth-focused exhibition on counterfeit detection, which will open in early 2008.

Explore the Museum and access material from its learning centre on the Museum website at <http://www.bankofcanada.ca/currencymuseum>.

### Continue to support and promote counterfeit deterrence

In 2007, the Bank established a Compliance Unit, reflecting the growing intensity of its efforts to increase the recognition of counterfeiting as a serious crime. The Bank supports counterfeiting deterrence by providing information to help the police to investigate counterfeiting offences and the Crown to prosecute offenders.

In partnership with the RCMP, the Ontario Provincial Police, the Sûreté du Québec, and the Canadian

Association of Chiefs of Police, the Bank launched a new campaign, *Counterfeit Money—It's Criminal*, aimed at providing Canadian police officers with information about counterfeiting and tools to assist in their deterrence efforts. As part of this program, an educational video and a leaflet were distributed to all law-enforcement agencies in Canada. The Bank and its law-enforcement partners were also active in providing anti-counterfeiting instruction at community colleges with criminal justice programs, and at police academies throughout the country. A quarterly newsletter, *Anti-Counterfeiting Connections*, aimed primarily at law-enforcement officers and prosecutors, was developed and published in 2007.

### Replace notes from older series, and enhance the bank note distribution system

The Bank works with the financial institutions that are part of the Bank Note Distribution System (BNDS) to supply bank notes to Canadians. The Bank's two note-processing centres sort notes received from financial institutions for quality and authenticity. The centres return good-quality notes to circulation, destroy worn notes and older-series notes, which are less secure, and send counterfeits to the RCMP. At the end of 2007, over 95 per cent of notes in active circulation were from the latest, more secure series.

The BNDS provides for the joint management of the flow of notes among participating financial institutions. In 2007, a committee of senior representatives from the Bank and financial institutions was formed to consider



*Gerry Gaetz, Chief, Department of Banking Operations (centre), presented the 2007 Law Enforcement Award of Excellence for Counterfeit Deterrence to Acting Detective Brian Wintermute (left) and Detective Thomas Warfield (right), both of the Peel Regional Police Service, Ontario. Their investigation led to the shutdown of a significant counterfeiting ring and the arrest of 30 suspects.*

and implement steps to improve the capacity of the BNDS to identify and remove unfit and counterfeit notes from circulation.

### *Refurbish aging note-processing equipment*

Within its own operations centres, the Bank is in the process of refurbishing its high-speed bank-note-processing equipment. This upgrade, which will be completed in 2008, is being done to improve efficiency and extend the useful life of the equipment.



*Print quality control, Currency Production and Services*

## Priorities for 2008

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

# Financial System

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

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

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

The financial system consists of financial institutions, financial markets, and clearing and settlement systems. The Bank of Canada promotes the safety and efficiency of the financial system by providing central banking services, including a lender-of-last-resort facility; overseeing key domestic clearing and settlement systems; conducting and publishing research; and by providing advice to various domestic and international policy-making bodies.

## Ongoing Work towards Goals and Desired Outcome

### Promoting a Stable and Efficient Financial System

The global financial system was severely tested by the repricing of risk that took place in 2007 in the wake of greater-than-expected losses on U.S. subprime mortgages. Credit spreads widened, liquidity evaporated in the market for structured financial products, bank funding became more costly and more difficult to obtain, and credit conditions tightened. Although the provision of liquidity by most major central banks has been effective in keeping overnight interest rates close to targeted levels, liquidity further out the maturity spectrum has remained more problematic, partly owing to a precautionary buildup of liquidity by financial institutions. On

balance, the global financial system has weathered the shock reasonably well, partly because of large initial capital positions in major banks around the world.

At the heart of the problem was the rapid growth of structured financial products that were so complex and opaque that even some sophisticated investors did not understand exactly what they were buying. This rapid growth led to an erosion of lending standards, particularly evident in the market for U.S. subprime mortgages, where many of the securities that underpinned structured financial products originated. In turn, these products were sold worldwide. When delinquencies rose on U.S. subprime loans, the lack of transparency of structured products caused a breakdown in that market as investors started questioning the value of the assets backing the securities they owned. The breakdown was particularly pronounced in the market for asset-backed commercial paper (ABCP), where investors had no appetite for risk. Banks were affected in various ways: from a direct exposure to these structures, from a commitment as liquidity providers, or from difficulty in securitizing loans. As concerns about counterparties rose, investors sought safety in government securities, banks began to hoard liquidity because of uncertainty about their ability to meet their future funding needs, liquidity in money markets (including the interbank market) dried up, and the cost of term funding for banks increased significantly.

Canadian financial markets experienced many of the same pressures evident globally, including (as noted in the Monetary Policy section of this report) a tightening of credit conditions. However, in Canada, the problem in the ABCP market took on a unique characteristic, since non-bank-sponsored asset-backed commercial paper had been issued with backup lines of credit that were accessible only at times of general market disruption. When non-bank-sponsored conduits could not roll over their paper, market participants agreed to a standstill under the Montréal Accord—an accord that led in late December to an agreement-in-principle for restructuring the paper into tradable term notes supported by a margin funding facility. Bank-sponsored ABCP continued to roll over but at sharply higher interest rate spreads. Canadian banks were affected by the global increase in the cost of term funding, despite a relatively small exposure to U.S. subprime mortgages and low reliance on securitization.

At the onset of market turbulence in early August, the Bank promptly issued a statement to reassure markets that it was ready to provide liquidity to support the efficient functioning of financial markets. When pressures on overnight funding emerged, the Bank used the standard tools it employs to keep the overnight interest rate near its target level: It engaged in open market buyback operations with primary dealers, and it increased the level of settlement balances in the payments system. On 15 August, the Bank temporarily expanded the range of securities that it was prepared to accept in its buyback operations. These actions allowed the Bank to meet the needs for overnight liquidity and keep the overnight interest rate close to target.

The persistence of elevated term spreads raised the question of whether a facility that would provide liquidity at terms longer than overnight, possibly against a broader range of securities, might allow the Bank of Canada to respond more effectively to some market dislocations. The Bank took two steps in this direction in December. First, as part of a coordinated effort by a number of central banks, the Bank expanded the list of securities that it was prepared to accept as it entered into term purchase and resale agreements that extended over the year-end. Second, the Bank announced that it would

broaden the range of securities acceptable as collateral under its Standing Liquidity Facility to include certain types of bank-sponsored ABCP by the end of March 2008 and, later, U.S. Treasury bills. Work continues on this issue. In particular, the Bank is assessing whether amendments to the Bank of Canada Act may be needed to expand the range of securities that the Bank may buy or sell in various situations. This work will benefit from parallel work going on in other central banks coordinated by the Committee on the Global Financial System at the Bank for International Settlements (BIS).

*The international dimension.* The Bank participated actively in international groups such as the G-7 and G-20, the Financial Stability Forum, and several committees of the BIS, which provided forums for sharing information, monitoring financial developments, and discussing appropriate policy responses. Of particular interest, the Financial Stability Forum, composed of national authorities and international financial institutions, began an extensive study of the turbulence at the request of the G-7 finance ministers and central bank governors. A final report, including recommendations, is expected in April 2008.

### Assessing the Financial Sector

In 2006, Canada invited the International Monetary Fund to examine the health of the country's financial system under its Financial Sector Assessment Program (FSAP). The exercise was conducted in 2007 in partnership with Canadian public agencies and financial institutions, and was an update of the first Canadian FSAP exercise, conducted in 1999. The Bank of Canada was involved in two main components: a general assessment of Canada's financial system against international standards, codes, and best practices, and a stress-testing exercise to assess the ability of Canadian banks to withstand adverse shocks such as a disorderly resolution to global imbalances. The Bank designed the scenario for the macroeconomic stress-testing exercise and assessed individual banks' results in collaboration with the IMF. The Bank also played an important role in providing information and comments for the assessment of Canada's securities settlement system. The IMF's FSAP report is expected to be published in early 2008.



*Konstantinos Tsatsaronis of the BIS and Deputy Governor Pierre Duguay at the Bank's annual economic conference. The 2007 conference focused on developing a framework for the assessment of financial stability.*

In 2007, the Bank hosted or co-hosted a number of workshops to assess the state of knowledge on financial system issues, including portfolio theory and management, fixed-income markets, and the effects of complex financial products on the transmission of monetary policy. Some of the research presented at these workshops was published as working papers.

### Containing Systemic Risk in Clearing and Settlement Systems

Under the Payment Clearing and Settlement Act, the Bank is responsible for the oversight of systemically important clearing and settlement systems. In 2007, the Bank assessed a number of significant changes to CLS Bank, an international bank that provides for simultaneous settlement of foreign exchange transactions, and to CDSX, the system that settles debt and equity trades in Canada.

The Bank also continued to work with the Canadian Depository for Securities, which operates CDSX, and the Canadian Payments Association, which operates the LVTS, the system that handles large-value or time-sensitive Canadian-dollar payments, to examine possible improvements in business-continuity plans. Specifically, the Bank invited systems participants to discuss the implications of possible disruptions at a major participant.

The Bank regularly tests its own systems and periodically conducts operations from its backup facilities. In 2007, the Bank's services to systemically important clearing and settlement systems were available 99.98 per cent of the time, a slight improvement from 2006.

### Priorities for 2007 and the medium term

- Develop a framework to assess financial system stability
- Analyze the operations of large, complex financial institutions with a view to their implications for the financial system
- Carry out further research on the cross-border linkages among clearing and settlement systems for payments and securities
- Pursue efforts to reform the IMF by enhancing the IMF's role in surveillance
- Examine the efficiency of the Canadian financial sector
- Improve the collection and use of financial data
- Develop a new business application for banking services, and strengthen the resiliency of the systems that support banking operations
- Enhance emergency preparedness

### Progress on Priorities

#### Financial System Stability

##### *Develop a framework to assess financial system stability*

In 2007, the Bank laid more of the groundwork for a framework to assess financial stability, which will help to identify and evaluate sources of systemic risk to Canada's financial system. A more systematic approach to identifying and evaluating potential international risks was developed, and work progressed on improving the Bank's capacity to assess the vulnerability of the financial system to various risks, including advances in the Bank of Canada's capabilities to conduct stress tests

of the Canadian financial system. This work benefited from the stress-testing exercise conducted with the IMF in the context of FSAP. The Bank's annual economic conference brought together experts from around the world to review progress made on these issues, and to identify the most promising avenues of research.

### *Analyze the operations of large, complex financial institutions with a view to their implications for the financial system*

Work in 2007 on large, complex financial institutions (LCFIs) found that, while Canada does not have any global LCFIs, our largest domestic banks share many of their characteristics. A review of the key risk issues raised by LCFIs was conducted, and an assessment of their significance for Canada was started.

### *Carry out further research on the cross-border linkages among clearing and settlement systems for payments and securities*

The Bank has been active in an international working group on system interdependencies established by the Committee for Payment and Settlement Systems (CPSS). This group is analyzing the sources of such cross-border linkages and their implications for risk management. The Bank assessed and approved a proposed link between Canada's securities settlement system, CDSX, and the U.K. securities clearing and settlement system.

### *Pursue efforts to reform the IMF*

The Bank has been a leading advocate of changes to make the International Monetary Fund's surveillance function more effective. Economic surveillance is the Fund's main crisis-prevention tool. The Bank has extensively researched the Fund's governance and its surveillance function. In June, a significant step forward was taken when the IMF's Executive Board adopted new guidelines that will focus surveillance on the policies of member countries that most affect external stability. The Board agreed to introduce a "statement of priorities," likely to take effect in 2008, that will set priorities for surveillance and update them regularly. These steps will strengthen the IMF's contribution to the stability of the international financial system, mitigating international risks to the Canadian economy.

## Financial System Efficiency

### *Examine the efficiency of the Canadian financial sector*

To promote the efficiency of the financial system, the Bank conducts and publishes research and provides advice to Canadian and international policy-making bodies. In 2007, research in this area focused on market structure and regulatory developments, in particular: stock exchange consolidation and competition; price formation and liquidity in fixed-income markets; the impact of alternative trading systems on the interdealer market for government bonds; and the cost of capital for Canadian firms versus U.S. firms. The Bank also examined issues related to the efficiency of clearing and settlement systems, including the factors driving tiering in payments systems, the use and distribution of liquidity in these systems, and the provision of liquidity by the central bank. Much of this research was published in the Bank's *Financial System Review*.

## Building IT and Data Infrastructure

### *Implement a strategy to improve the collection and use of financial data*

In 2005, the bank initiated a multi-year project to improve its collection of financial data and to broaden its research on financial system issues. In 2007, the Bank determined its financial-data requirements and evaluated potential



*Participants in a workshop on debt strategy modelling hosted by the Financial Markets Department in June.*

suppliers. A major focus was the household microdata required to improve the analysis of vulnerabilities related to household indebtedness.

*Develop a new business application for banking services, and strengthen the resiliency of the systems that support banking operations*

As the sole provider of unique services that support Canada's critical clearing and settlement systems, the Bank made considerable progress on its High-Availability Program, a multi-year initiative to enhance the IT environment for time-critical applications. After delays encountered in 2006, an important milestone was achieved in 2007 when the first application to be deployed in this program, the High-Availability Banking System, was successfully tested. The new system will improve the reliability and efficiency of operations and is expected to become operational in the autumn of 2008.

## Priorities for 2008

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

# Funds Management

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

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

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

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

## Ongoing Work towards Goal and Desired Outcome

### Fiscal Agent Responsibilities

As part of its fiscal agent responsibilities, the Bank provides banking services to the federal government. These include making and receiving payments, settling and paying entitlements on domestic debt, and providing information to facilitate cash-management and reconciliation activities. To prepare for the 2008 implementation of the Canadian Payments Association's cheque-imaging project—an initiative to modernize the clearing system—the Bank continued to work with the government to make the necessary changes to systems and procedures.

The Bank's treasury-management operations aim to ensure that funds are available to meet the government's daily operating requirements, while minimizing the cost of maintaining cash balances. Average cash balances of

the Receiver General in 2007 were \$8.2 billion, up from the 2006 average of \$6.6 billion. Contributing to the increase were higher balances at the government's fiscal year-end and higher balances prior to a large bond maturity.

Canada's official international reserves, held mainly in the Exchange Fund Account (EFA), are managed to provide foreign currency liquidity to the government and to promote orderly conditions for the Canadian dollar in foreign exchange markets if required. At year-end, official international reserves totalled US\$41.1 billion, an increase of US\$6 billion over the previous year. As in 2006, the assets of the EFA were hedged against movements in interest rates and exchange rates, principally through an ongoing program of cross-currency swaps of domestic obligations. The EFA met strategic objectives and earned a positive underlying return net of liabilities.



*The Bank's Trading Room*

During the credit-related stresses in international capital markets in late summer and autumn, the EFA's conservative investment policy and asset-liability management policy resulted in strong performance in terms of return and the mitigation of risk.

In 2007, the Bank explored opportunities to further reduce the cost of administrative services for the retail debt program. These services were outsourced to EDS Canada in 2001. Arrangements with EDS were renegotiated in 2007 to improve business processes and streamline technical infrastructure, and the contract was extended to 2021. The federal government will realize an estimated saving of approximately \$107 million over the life of the amended contract.

### Other Funds-Management Responsibilities

In 2007, the Bank continued to review the investment-management framework of its pension fund, and several changes were made. With the aim of generating higher risk-adjusted returns, further emphasis was put on an active style of investment, and several new external managers were engaged for the actively managed portion of equities held in the fund. The review process for the fund's investment managers was strengthened.

The Bank undertakes transactions with chartered banks and federally chartered trust and loan companies arising from the requirement that these institutions transfer to the Bank all unclaimed balances in Canada that are in Canadian currency and have been inactive for 10 years. The owners of these accounts can have their money returned if they can provide proof of ownership. In 2007, financial institutions transferred \$39.5 million in unclaimed balances to the Bank. There were approximately 28,000 general enquiries, and the Bank paid out or returned a total of \$12.3 million to satisfy 7,000 claims.

The Bank provides services to foreign central banks and to international financial organizations, including the provision of Canadian-dollar operating accounts, the provision of a securities account for the settlement and custody of securities, and the safekeeping of gold. While volumes in 2007 decreased somewhat owing to diminished activity by several key clients, changes were made to the Bank's systems and procedures to comply with a cap of \$50 million on the size of individual trades eligible to settle in CDSX and with new anti-money-laundering legislation.

## Priorities for 2007 and the medium term

- Continue to support liquidity in the market for Government of Canada securities
- Improve the measurement and reporting of performance and risks of the Exchange Fund Account
- Complete the transition of sales and marketing for retail debt from Canada Investment and Savings into the Bank
- Enhance analytic capabilities
- Renew systems and improve processes
- Enhance risk management

## Progress on Priorities

### *Continue to support liquidity in the market for Government of Canada securities*

The objective of the federal government's wholesale domestic debt and cash-management activities is to raise stable, low-cost funding to meet operational needs. This is facilitated by maintaining a well-functioning market in Government of Canada securities. As indicated in the federal government's 2007–08 Debt Management Strategy, there were no major changes to debt programs or operations in 2007. Debt issuance continued at key benchmark maturities along the interest yield curve. Increased recognition by market participants of the degree of substitutability between newly issued 2-year and 5-year benchmark bonds and existing bond issues that carry the same maturity date led to some increase in the issuance of bonds with longer maturities.

Average turnaround times for regular auctions and for buyback and switch operations—which the Bank undertakes on behalf of the government—remained within the targets of less than 3 and 5 minutes, respectively. The average turnaround time for regular auctions was 2.20 minutes and 3.02 minutes for buyback and switch operations. For one 3-day auction of cash-management bills, turnaround time exceeded the 5-minute maximum, but the market impact was negligible.

Several times in 2007, the Bank lent securities from its balance sheet on a fully collateralized basis under its securities-lending program. Under this program, established in 2002, the Bank supports the liquidity of the market for Government of Canada securities by providing a secondary and temporary source of securities for a specific maturity when there is a strong demand.

### *Improve the measurement and reporting of performance and risks of the Exchange Fund Account*

The Bank's risk-management activities involve monitoring and reporting risks that arise from its operations as fiscal agent, including the management of the Exchange Fund Account. The Bank uses market-based, risk-measurement tools that are consistent with best practices in the central banking community and the financial sector. In 2007, the policy framework for credit risk in the EFA was reviewed to assess changes in the methods used by rating agencies to rate banks. Risk-management tools were enhanced to improve the measurement and reporting of the account's performance and risks. Risk-management practices were reviewed by an external expert under the government's Treasury Evaluation Program and were found to be working well.

### *Complete the transition of sales and marketing for retail debt from Canada Investment and Savings into the Bank*

The federal government's retail debt instruments are Canada Savings Bonds, which can be redeemed at any time, and Canada Premium Bonds, which typically carry a higher rate of interest but can be redeemed only once a year. In April 2007, marketing and sales responsibilities for retail debt were transferred to the Bank, following the winding up of the Canada Investment and Savings agency. The transfer took place with no interruption of service to bondholders, and investors continued to purchase retail debt instruments and access information as they had in the past.

Associated with the consolidation of all operational aspects of the retail debt program at the Bank, the Memorandum of Understanding between the Bank of Canada and the Department of Finance to guide governance of the program was updated. As part of this agreement, the Bank, beginning in 2008, will no longer charge back to the Department of Finance expenses related to retail debt. These expenses will be reflected in the Bank of Canada's financial statements.



*Bill Beauchamp, Banking Services Representative, Department of Banking Operations*

### *Enhance analytic capabilities*

During 2007, the Bank completed work that significantly improved its domestic debt simulation model. The enhanced model offers various approaches to modelling the interest rate yield curve and macroeconomic factors, including inflation and output. It will help inform analysis of policy issues related to the distribution of government debt, both in terms of maturity and the balance between nominal and Real Return bonds.

To support its management of foreign reserves, the Bank began research in 2007 to develop a model that will help analyze issues related to the optimal distribution of the government's foreign reserve assets and the liabilities that finance them.

## Priorities for 2008

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

# Corporate Administration

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

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

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

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



*Anne LeClair and Jane Boyko, Archival Services, Knowledge and Information Management*

## Ongoing Work towards Goal and Desired Outcome

To strengthen governance and clarify accountability, the information technology area within the Corporate Services Department was made a separate department in 2007, and its chief is a member of the Bank's Executive Management Committee. This development recognized the growing importance and complexity of information technology (IT) and IT linkages across Bank functions.

### Priorities for 2007 and the medium term

- Develop recruitment and compensation strategies that address changing business needs, demographics, and labour market conditions
- Expand the leadership-development program for management
- Improve capacity to access and retain knowledge
- Renew infrastructure
- Maintain clear and open internal communication

## Progress on Priorities

### *Develop recruitment and compensation strategies that address changing business needs, demographics, and labour market conditions*

A major challenge in coming years will be managing the transition from a workforce dominated by the baby-boom generation to one drawn from a smaller and younger cohort of workers. Demographic realities suggest that attracting and retaining talented staff will require greater effort. With this in mind, the Bank is enhancing various aspects of both its work environment and its human resource management over the medium term, thus increasing its capacity to attract, engage, and retain talented staff. In 2007, particular focus was placed on recruitment and staff-development initiatives, as well as on building a better understanding of the Bank's total compensation package.

### *Expand the leadership-development program for management*

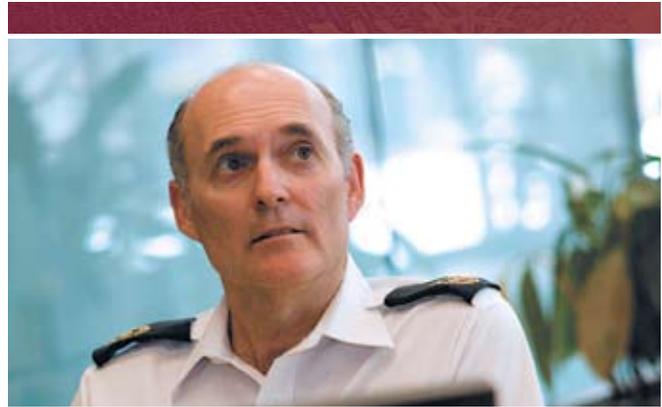
Strong management skills are key to the Bank's success. In 2007, the Bank launched a leadership-development program aimed at reinforcing the importance of good management and strong leadership, and developing management and leadership capabilities. The program includes formal training, development opportunities, and on-the-job coaching. In 2007, 330 participants attended 25 training sessions.

### *Improve capacity to access and retain knowledge*

Access to and retention of knowledge and information is an important aspect of corporate management. The looming demographic changes in the Bank's workforce make the capture and sharing of knowledge a priority. In 2007, the focus was on knowledge transfer, building awareness, and on expanding the use of available tools.

### *Renew infrastructure*

Renewing the Bank's IT infrastructure is a priority for the 2007–09 planning period. In addition to continuing delivery of reliable computing services in several locations, the Bank aims to significantly enhance its



*Gaston Carbonneau, Security and Facilities Services*

computing environment. Two initiatives will improve the performance of hardware, software, and IT services.

The High-Availability Program is designed to ensure that the Bank's critical banking and funds-management applications continue to operate in a highly reliable manner, while being able to meet changing business needs. One application tested in 2007 is described in the Financial System section of this report.

The Analytic Environment (AE) Program is a long-term initiative to improve the computing environment and the business processes that support the Bank's analysis of economic and financial developments. The program will involve significant upgrades to the computing platform and tools used by the Bank's economists and analysts, as well as more effective business processes and work practices. Three outcomes are projected: more efficient use of resources and reduced run costs; enhanced knowledge management; and a higher and more consistent quality of analytic products. In 2007, relevant business processes were defined, and system architecture was developed. Exercises to test continuity of operations for all key systems were successfully conducted in 2007.

Finally, the Bank strives to invest wisely in its security and physical facilities. An ongoing program of analysis and investment ensures that Bank facilities operate efficiently and safely. In 2007, the focus was on facilities related to the Bank's IT infrastructure, as well as planning for the longer term.

### *Maintain clear and open internal communication*

Clear and open internal communication continues to be a priority at the Bank. The Bank aims to ensure that all staff understand the organization's priorities and desired outcomes, and are able to place their own work in this larger context. In 2007, efforts focused on helping staff to understand the Bank's "total compensation" package and its new IT initiatives.



*Economist Michael Bonazza reviews a recent acquisition in the Bank's Information Resource Centre.*

## Priorities for 2008

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

# Financial Discussion

This section of the Annual Report presents management's discussion of the financial aspects of our operations, including financial operating highlights and risk management.

To evaluate the Bank's financial statements, it is important to understand that the finances of the Bank are shaped by its mandate, which is to promote Canada's economic well-being. General information about how the Bank's balance sheet supports its functions can be found on our website at <<http://www.bankofcanada.ca/en/about/corp.html>>. The information presented there explains how the Bank uses its assets and liabilities towards these functions. The Bank's assets provide it with the independence from government necessary to undertake its policy decisions. The annual net income earned on the Bank's assets, after operating expenses and allocations to its reserves, is paid each year to the Receiver General for Canada. The Bank's operating budget is approved by the Bank's Board of Directors.

Unlike most central banks, the Bank does not report foreign exchange reserves on its balance sheet. Canada's official international reserves are held in a separate entity, the Exchange Fund Account, which the Bank manages on behalf of the federal government.

## Financial Highlights for the Year

### The Bank's Balance Sheet

The Bank's assets and liabilities, along with changes to these balances as displayed in the Statement of Cash Flows, support one or more of the Bank's functions. The largest single balance sheet item is the *Bank notes in circulation* liability created through the issuance of Canadian bank notes. As a counterpart to this bank note liability, the Bank holds financial assets. As at 31 December 2007, *Bank notes in circulation* were valued at \$50.6 billion, an increase of 4 per cent over 31 December 2006. This increase reflects the growing demand for notes by the Canadian public.

Aside from providing a counterpart to the Bank's currency liabilities, the Bank's asset base supports its ability to implement monetary policy. This is primarily through the use of assets as collateral to support open market operations. Market intervention to reinforce the target overnight rate is conducted using either sale and repurchase agreements (SRAs), or purchase and resale agreements (PRAs).

The Bank's balance sheet also supports its financial system function. Generally, relatively small advances are routinely made to, or deposits are taken from, members of the Canadian Payments Association (CPA) under the Bank's standing facilities. The sizes of these advances and deposits are influenced by the management of settlement balances within the Large Value Transfer System (LVTS). In the second half of 2007, the Bank injected additional liquidity into the payments system through the provision of extra settlement balances in the LVTS and through the issuance of term purchase and resale agreements. Net deposit positions of members of the CPA peaked during the year on 9 August 2007, with a net deposit balance of \$1.8 billion. At 31 December 2007, the Bank held \$501.5 million in deposits from and had advances outstanding of \$1.5 million to members of the CPA.

At 31 December 2007, there was \$4.0 billion outstanding in term PRAs, serving partially as a counterpart to the seasonal increase in demand for bank notes and partially to support the efficient functioning of financial markets through the provision of liquidity.

Until 2007, the Bank's capital structure had not changed since it opened for business in 1935. In 2007, two new components were introduced into the Bank's capital structure in response to the new accounting standards for financial instruments adopted on 1 January 2007. Unlike most organizations, the Bank cannot hold retained earnings, and, as a result, in early 2007, the Bank of Canada Act was amended to provide the Bank

with the ability to establish a *Special reserve* to absorb potential negative valuation swings on the part of its investment portfolio that is available for sale. The *Special reserve* is reviewed regularly for appropriateness and may be amended, pursuant to a resolution passed by the Board of Directors. This reserve is subject to a ceiling of \$400 million; an initial amount of \$100 million was established in September 2007.

*Accumulated other comprehensive income* (AOCI) tracks unrealized gains and losses resulting from the change in fair value of assets classified as available for sale. When an asset so classified is sold, the difference between market value and amortized cost is taken to income and removed from AOCI. As at 31 December 2007, the Bank's AOCI had a balance of \$24.7 million. This is due to the market value of the treasury bill portfolio being in excess of its cost.

## Statement of Revenue and Expense

### Revenue from Investments

Total revenue from investments in 2007 was \$2.3 billion, an increase of 7 per cent over 2006, primarily as a result of a larger investment portfolio. The main source of revenue is interest earned on holdings of federal government securities. After expenses and allocations to the *Special reserve*, the net income transferred to the Receiver General for Canada in 2007 was \$2.0 billion, approximately \$55 million more than the amount transferred in 2006.

### Operating Expenses

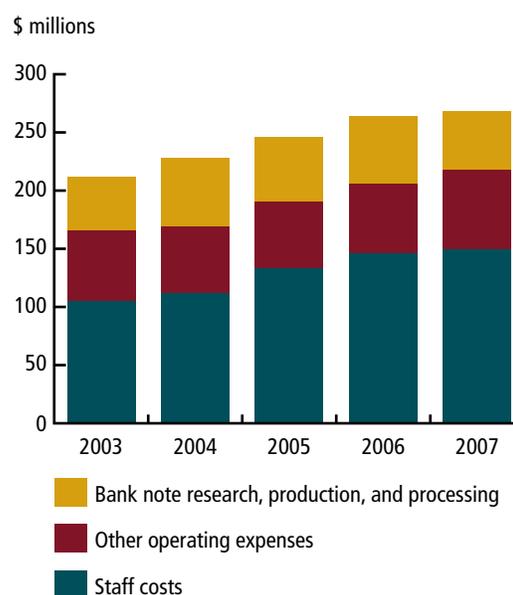
Operating expenses support the Bank in undertaking its four main functions: monetary policy, currency, financial system, and funds management. Included as part of the funds-management function are expenses for retail debt operations. These expenses are fully recovered from the Government of Canada's Department of Finance. Operating expenses, net of recoveries, for the Bank's main functions in 2007 were \$268 million, an increase of \$4 million from 2006.

The largest components of expenses relate to bank notes and staff (see note 3 of the Financial Statements). Bank note expenses decreased by approximately \$8 million in 2007, mainly reflecting a reduction in the volume of notes received due to production delays. *Staff costs*, which comprise salaries, current and deferred benefits, and other staff-related expenses, increased by \$3 million in 2007, mainly reflecting pressures on compensation rates in a tight labour market. Expenditures on technology and premises accounted for \$4 million of additional spending. The remaining increase in expenses was due to a restructuring charge of \$5 million that was recorded in support of reorganizing information technology services. This initiative will enable the Bank to operate more efficiently and to increase investments in innovative business systems to keep pace with the demands of rapidly evolving technology.

In April 2007, marketing and sales responsibilities for the retail debt program were consolidated within the Bank of Canada, following the windup by the Government of Canada of the Canada Investment and Savings agency.

### Operating Expenses

Net of retail debt recovery



Costs of \$9 million for the months April to December, associated with these additional responsibilities, are partially offset by reduced costs in other areas of the retail debt program. The net increase of \$6 million is included in *Other operating expenses*. Starting in 2008, the full amount of expenses incurred by the Bank for the retail debt program will no longer be recovered from the Department of Finance.

## Financial Risk

Financial risk is the risk associated with the Bank's management of its financial assets and liabilities. The Bank is exposed to two underlying financial risks—interest rate risk and credit risk—both of which are inherently low.

*Credit Risk*—Credit risk is the risk that a counterparty to a financial contract will fail to discharge its obligations in accordance with agreed-upon terms. The Bank's portfolio is essentially free of credit risk, since the securities held are direct obligations of the Government of Canada. Advances to members of the Canadian

Payments Association and securities purchased under resale agreements do not pose material credit risk for the Bank because they are fully collateralized transactions backed by high-quality securities denominated in Canadian dollars.

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

Fluctuations in the fair value of the treasury bills of Canada portfolio resulting from interest rate movements are reflected in *Other comprehensive income*, since these investments are classified as available for sale.

Exposure to fluctuations in future cash flows of financial instruments arises from fluctuations in interest rates on newly acquired treasury bills and bonds issued by the Government of Canada. Since the Bank's interest revenues greatly exceed its expenses, changes in underlying interest rates are unlikely to affect the ability of the Bank to fulfill its financial obligations.

## The Bank's Medium-Term Plan 2007-09

The year 2007 was the first of the Bank's new medium-term plan (MTP): Moving Forward—Building the Future Together. The plan focuses on three strategic priorities: renewing the Bank's infrastructure, creating a superior work environment, and staying at the forefront of good governance.

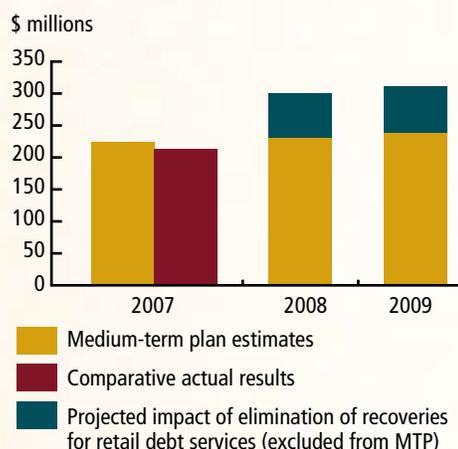
The MTP financial plan excludes expenses associated with both non-current deferred employee benefits and the procurement of bank notes because of their volatility. Deferred employee benefits are susceptible to changes in year-end discount rates used to value financial obligations. Bank note costs are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

In 2007, financial results as they relate to the MTP fell within the established projections, despite additional costs incurred as a result of continued efforts to establish a robust high-availability IT environment for critical banking systems, an initiative expected to have been completed by 2007. A reprioritization and rebalancing of business activities and spending took place in 2007 to accommodate this important project, allowing the Bank to come in under the planned spending for 2007.

Investments in the High-Availability Banking System and in the new Analytic Environment (AE) Program will continue in 2008. The AE Program entails renewal of the infrastructure and business processes for data management, research, and analysis supporting the monetary policy, financial system, and funds-management functions. Expenses to complete the IT transformation initiatives aimed at strengthening technology infrastructure and services will also be incurred in 2008.

Commencing 1 January 2008, retail debt expenses will no longer be recovered from the Department of Finance. This change was not anticipated in the MTP and will render the Bank's actual expenses in 2008 and beyond significantly higher than in prior years.

Medium-Term Plan Financial Profile: Expenses



# FINANCIAL STATEMENTS

As at 31 December 2007



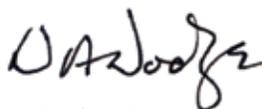
FINANCIAL REPORTING RESPONSIBILITY

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

In support of its responsibility for the integrity and reliability of these financial statements and for the accounting system from which they are derived, management has developed and maintains a system of internal controls to provide reasonable assurance that transactions are properly authorized and recorded, that financial information is reliable, that the assets are safeguarded and liabilities recognized, and that the operations are carried out effectively. The Bank has an Internal Audit Department, whose functions include reviewing internal controls, including accounting and financial controls and their application.

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

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



D. A. Dodge, Governor



S. Vokey, CA, Chief Accountant

Ottawa, Canada

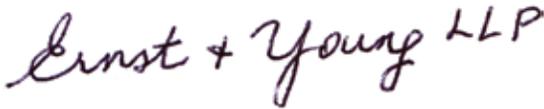
AUDITORS' REPORT

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

We have audited the balance sheet of the Bank of Canada as at 31 December 2007 and the statements of revenue and expense, comprehensive income, changes in capital and accumulated other comprehensive income, and cash flows for the year then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Bank as at 31 December 2007 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.



ERNST & YOUNG LLP  
Chartered Accountants  
Licensed Public Accountants



PRICEWATERHOUSECOOPERS LLP  
Chartered Accountants  
Licensed Public Accountants

Ottawa, Canada  
18 January 2008

# BANK OF CANADA

## BALANCE SHEET

As at 31 December  
(Millions of dollars)

	2007	2006
<b>ASSETS</b>		
<b>Deposits in foreign currencies</b>	3.3	3.1
<b>Loans and receivables</b>		
Advances to members of the Canadian Payments Association	1.5	12.1
Securities purchased under resale agreements	3,963.4	2,853.8
Other receivables	37.3	17.3
	4,002.2	2,883.2
<b>Investments</b> (note 4)		
Treasury bills of Canada	20,280.9	18,120.7
Government of Canada bonds	29,359.8	30,358.8
Other investments	38.0	38.0
	49,678.7	48,517.5
<b>Bank premises</b> (note 5)	133.7	133.8
<b>Other assets</b> (note 6)	78.9	87.9
	53,896.8	51,625.5
<b>LIABILITIES AND CAPITAL</b>		
<b>Bank notes in circulation</b> (note 7)	50,565.2	48,762.2
<b>Deposits</b>		
Government of Canada	1,970.4	2,228.1
Members of the Canadian Payments Association	501.5	11.8
Other deposits	509.2	443.9
	2,981.1	2,683.8
<b>Other liabilities</b> (note 8)	195.8	149.5
	53,742.1	51,595.5
<b>Capital</b> (note 9)	154.7	30.0
	53,896.8	51,625.5
Commitments, contingencies and guarantees (note 11)		



D. A. Dodge, Governor



S. Vokey, CA, Chief Accountant



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

On behalf of the Board



J.-G. Desjardins, LScCom, CFA,  
Chair, Planning and Budget Committee,  
and Lead Director

See accompanying notes to the financial statements.

## BANK OF CANADA

### STATEMENT OF REVENUE AND EXPENSE

Year ended 31 December  
(Millions of dollars)

	2007	2006
<b>REVENUE</b>		
Revenue from investments, net of interest paid on deposits of \$90.4 million (\$71.5 million in 2006)	2,292.1	2,159.6
<b>EXPENSE by function</b> (notes 1 and 3)		
Monetary policy	67.9	65.6
Currency	120.7	122.9
Financial system	38.8	35.5
Funds management, net of the recovery of retail debt services costs of \$58.6 million (\$53.1 million in 2006)	40.3	39.5
	267.7	263.5
<b>NET INCOME</b>	2,024.4	1,896.1

### STATEMENT OF COMPREHENSIVE INCOME

Year ended 31 December  
(Millions of dollars)

	2007
<b>NET INCOME</b>	2,024.4
<b>OTHER COMPREHENSIVE INCOME</b>	
Net unrealized gains on available-for-sale financial assets	22.7
<b>COMPREHENSIVE INCOME</b>	2,047.1

See accompanying notes to the financial statements.

## STATEMENT OF CHANGES IN CAPITAL AND ACCUMULATED OTHER COMPREHENSIVE INCOME

Year ended 31 December  
(Millions of dollars)

	2007	2006
<b>SHARE CAPITAL</b>	5.0	5.0
<b>STATUTORY RESERVE</b>	25.0	25.0
<b>SPECIAL RESERVE</b>		
Balance, beginning of year	–	–
Allocation from net income	100.0	–
Balance, end of year	100.0	–
<b>RETAINED EARNINGS</b>		
Balance, beginning of year	–	–
Transition adjustment - Financial instruments (note 2n)	26.6	–
Net income	2,024.4	1,896.1
Allocation to special reserve	(100.0)	–
Transfer to Receiver General for Canada	(1,951.0)	(1,896.1)
Balance, end of year	–	–
<b>ACCUMULATED OTHER COMPREHENSIVE INCOME</b>		
Balance, beginning of year	–	–
Transition adjustment - Financial instruments (note 2n)	2.0	–
Other comprehensive income	22.7	–
Balance, end of year	24.7	–
<b>CAPITAL (note 9)</b>	154.7	30.0

See accompanying notes to the financial statements.

## STATEMENT OF CASH FLOWS

Year ended 31 December  
(Millions of dollars)

	2007	2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Interest received	2,351.2	2,121.2
Dividends received	3.9	3.7
Other income received	48.8	62.9
Interest paid	(91.9)	(76.7)
Payments to suppliers and employees	(280.0)	(288.7)
Net (increase) decrease in <i>Advances to members of the Canadian Payments Association</i>	10.6	(12.0)
Net increase in <i>Deposits</i>	297.6	1,308.8
Decrease in securities purchased under resale agreements	41,221.2	14,764.3
Increase in securities purchased under resale agreements	(42,327.8)	(16,318.7)
Decrease in securities sold under repurchase agreements	(10,121.3)	(35,969.0)
Increase in securities sold under repurchase agreements	10,121.3	35,284.8
Net cash provided by operating activities	1,233.6	880.6
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Net increase in <i>Treasury bills of Canada</i>	(2,087.4)	(1,648.5)
Purchases of <i>Government of Canada bonds</i>	(2,939.4)	(3,272.2)
Proceeds from maturity of <i>Government of Canada bonds</i>	3,943.0	3,191.9
Proceeds from maturity of BIS term deposits	–	83.6
Purchases of Bank premises	(15.8)	(15.0)
Net cash used in investing activities	(1,099.6)	(1,660.2)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in <i>Bank notes in circulation</i>	1,803.0	2,684.3
Amount paid to Receiver General for Canada	(1,936.1)	(1,902.4)
Net cash provided by (used in) financing activities	(133.1)	781.9
<b>EFFECT OF EXCHANGE RATE CHANGES ON FOREIGN CURRENCY</b>	(0.7)	(3.7)
<b>INCREASE (DECREASE) IN CASH</b>	0.2	(1.4)
<b>CASH, BEGINNING OF YEAR</b>	3.1	4.5
<b>CASH, END OF YEAR</b>	3.3	3.1

See accompanying notes to the financial statements.

## NOTES TO THE FINANCIAL STATEMENTS

As at 31 December 2007

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

### 1. The business of the Bank

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

#### Monetary policy

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

#### Currency

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

#### Financial system

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

#### Funds management

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

### 2. Significant accounting policies

The financial statements of the Bank are in accordance with Canadian generally accepted accounting principles (GAAP) and conform to the disclosure and accounting requirements of the Bank of Canada Act and the Bank's bylaws.

The significant accounting policies of the Bank are:

#### a) Accounting estimates

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

#### b) Revenues and expenses

Revenues and expenses are accounted for on an accrual basis.

### c) Employee benefit plans

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

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

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

On 1 January 2000, the Bank adopted the new accounting standard on employee future benefits using the prospective application method. The initial transitional balances are amortized on a straight-line basis over the EARSL, as at the date of adoption. The EARSL has been determined to be 11 years (12 years for the period 2002–04) for the pension plans and for the long-service benefit program, 14 years for the post-retirement health-care plan, and 7 years for post-employment benefits plans.

### d) Translation of foreign currencies

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

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

### e) Advances

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

### f) Investments

Securities, consisting mainly of *Treasury bills of Canada* and *Government of Canada bonds*, are held for investment purposes. In 2006, these investments were recorded at cost and adjusted for the amortization of purchase discounts and premiums using the constant-yield method for treasury bills and the straight-line method for bonds. In 2007, the new financial instruments accounting standards issued by the Canadian Institute of Chartered Accountants (CICA) were adopted. *Treasury bills of Canada* are classified as available-for-sale and are measured at fair value, with unrealized changes in fair value recognized in *Other comprehensive income*. *Government of Canada bonds* are classified as held-to-maturity and are recorded at amortized cost using the effective interest method of amortization. *Other investments* are classified as available-for-sale and are comprised of Bank for International Settlements (BIS) shares, which are carried at cost since they do not have a quoted market value in an active market. Transaction costs are expensed as incurred for all classes of financial instruments. Amortization, as well as gains and losses on disposition, are included in revenue.

### **g) Securities Lending Program**

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

### **h) Bank premises**

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

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

Projects in progress are not amortized until the asset is put into service.

### **i) Securities purchased under resale agreements**

Securities purchased under resale agreements are reverse repo-type transactions in which the Bank purchases securities from designated counterparties with an agreement to sell them back at a predetermined price on an agreed transaction date. For accounting purposes, these agreements are treated as collateralized lending transactions and are recorded on the balance sheet at the amounts at which the securities were originally acquired plus accrued interest.

### **j) Deposits**

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

### **k) Securities sold under repurchase agreements**

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

### **l) Insurance**

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

### **m) Cash**

For the purpose of the cash flow statement, cash comprises cash on hand as well as demand deposits with other central banks or international institutions.

### **n) Change in accounting policy**

On 1 January 2007, the Bank adopted two new accounting standards that were issued by the CICA: Handbook Section 1530, *Comprehensive Income*; and Section 3855, *Financial Instruments – Recognition and*

*Measurement.* These standards have been adopted retroactively with prospective presentation; accordingly, comparative amounts for prior periods have not been restated.

### **Comprehensive income**

Section 1530 introduces *Comprehensive income*, which consists of *Net income* and *Other comprehensive income* (OCI). OCI represents changes in equity arising from unrealized gains and losses resulting from the change in fair value of financial assets classified as available for sale. Included in the Bank's financial statements is a *Statement of comprehensive income* for the changes in these items during the year. The cumulative changes in OCI are included in *Accumulated other comprehensive income* (AOCI), which is a new component of *Capital* on the *Balance sheet*.

### **Financial Instruments – Recognition and Measurement**

Section 3855 establishes standards for recognizing and measuring financial assets and liabilities. All financial instruments are required to be measured at fair value on initial recognition. Upon initial adoption of Section 3855, the Bank was required to classify its financial assets as held-for-trading (HFT), available-for-sale (AFS), held-to-maturity (HTM), or loans and receivables (L&R) and to identify any financial liabilities HFT.

The Bank has either classified its financial assets as AFS, HTM, or L&R and has not classified any of its financial assets as HFT. The principal categories of the Bank's financial assets designated as AFS are the *Treasury bills of Canada* and *Other investments* portfolios. The *Government of Canada bonds* portfolio is classified as HTM.

Subsequent to initial recognition, financial assets classified as AFS are measured at fair value using quoted market prices from a pricing service provider, with the exception of BIS shares in *Other investments*, which are carried at cost since they do not have a quoted market value in an active market. Unrealized changes in fair values of AFS financial assets are recognized in OCI. All other financial assets are measured at amortized cost using the effective interest method of amortization. Transaction costs are expensed as incurred for all classes of financial instruments.

The Bank has not classified any of its financial liabilities as HFT. Financial liabilities are comprised of *Bank notes in circulation*, *Deposits* (from the Government of Canada, Members of the CPA, and other financial institutions), and *Securities sold under repurchase agreements*. Subsequent to initial recognition, financial liabilities are measured at amortized cost using the effective interest method, with the exception of *Bank notes in circulation*, which are measured at face value.

### **Impact upon adoption of Sections 1530 and 3855**

The transition adjustment attributable to the adoption of the effective interest method resulted in an increase to the amortized cost of investments of \$26.6 million as at 1 January 2007. This amount was recognized in *Retained Earnings* as of that date. Had the Bank not adopted the effective interest method, interest revenue recognized in 2007 would have been \$2.9 million lower, and the amortized cost of investments as at 31 December 2007 would have been \$29.5 million lower.

Adjustments arising from the remeasurement of financial assets classified as AFS to fair value on 1 January 2007 totalled \$2.0 million. These amounts were recognized in opening AOCI as at that date.

### **o) Future accounting changes**

On 1 December 2006, the CICA issued three new accounting standards: Handbook Section 1535, *Capital Disclosures*, Handbook Section 3862, *Financial Instruments – Disclosures* and Handbook Section 3863, *Financial Instruments – Presentation*. These new standards will be effective for the Bank of Canada on 1 January 2008.

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

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

### 3. Expense by class of expenditure

	2007	2006
Staff costs	149.3	146.1
Bank note research, production and processing	49.9	57.6
Premises maintenance	25.7	23.3
Amortization	15.9	16.3
Other operating expenses	91.4	82.8
	332.2	326.1
Recoveries		
Retail debt services	(58.6)	(53.1)
Other	(11.0)	(9.5)
	(69.6)	(62.6)
Restructuring and related costs	5.1	–
	267.7	263.5

The cost of retail debt services is recovered from the Government of Canada's Department of Finance; these recoveries will be discontinued 1 January 2008. Other recoveries represent the fees charged by the Bank for a variety of services.

In 2007, the Bank began restructuring its information technology (IT) organization in order to optimize processes and enhance the delivery of services. This restructuring initiative commenced in late 2007 with the reduction of some IT management positions and will be completed in 2008 with further reviews of the IT operational areas. An expense of \$5.1 million has been recognized for the special termination benefits associated with this re-organization.

### 4. Investments

The Bank invests in treasury bills and bonds issued by the Government of Canada. These holdings are distributed to broadly resemble the structure of the Government of Canada domestic debt outstanding and are typically not sold prior to maturity.

There were no securities loaned under the Securities Lending Program as at 31 December 2007.

The Bank also holds 9,441 shares in the BIS in order to participate in the BIS and in international initiatives generally.

#### Credit risk

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

The portfolio is essentially free of credit risk because the securities held are direct obligations of the Government of Canada, the Bank's shareholder. Advances to Members of the CPA and securities purchased under resale agreements do not pose material credit risk for the Bank because they are collateralized transactions fully backed by high-quality Canadian-dollar-denominated securities. The credit quality of collateral is managed through a set of exposure limits tied to credit ratings of the collateral and term to maturity.

### Interest rate risk

Interest rate risk is the risk that the value or future cash flows of a financial instrument will fluctuate due to changes in market interest rates. Exposures to both kinds of interest rate risk arise in the course of the Bank's activities.

Fluctuations in the fair value of the *Treasury bills of Canada* portfolio resulting from changes in interest rates are reflected in *Other comprehensive income* since these investments are classified as available-for-sale. Exposure to fluctuations in future cash flows of financial instruments arise from fluctuations in interest rates on newly acquired treasury bills and bonds issued by the Government of Canada. Since the Bank's revenues greatly exceed expenses, changes in interest rates would not affect the ability of the Bank to fulfill its obligations. The Bank does not use derivative instruments to reduce its exposure to interest rate risk.

### Fair values

The fair values of the securities are based on quoted market prices. The amortized cost of all other financial instruments held by the Bank (assets or liabilities including *Other receivables*, *Securities purchased under resale agreements*, *Deposits*, and *Other liabilities* other than accrued post-retirement and post-employment benefits liabilities) approximates the fair value, given their short-term nature.

Ownership of the BIS shares is limited to central banks and new shares can only be acquired following an invitation to subscribe extended by the BIS Board of Directors. Since the price of these shares is not quoted in an active market, fair value is based on recent share issues for the purpose of these financial statements, and is estimated as being 70 per cent of the Bank's interest in the BIS shareholders' equity.

	2007			2006		
	Carrying amount	Fair value	Average yield per cent	Carrying amount	Fair value	Average yield per cent
Treasury bills of Canada	20,280.9	20,280.9	4.2	18,120.7	18,122.7	4.2
Government of Canada bonds maturing:						
- within 3 years	11,091.1	11,267.3	5.0	11,067.3	11,203.9	5.0
- after 3 years but not over 5 years	6,130.5	6,429.7	5.3	6,697.0	7,040.0	5.4
- after 5 years but not over 10 years	5,650.8	5,914.7	4.8	6,467.4	6,803.3	5.0
- after 10 years	6,487.4	7,939.3	5.7	6,127.1	7,593.8	5.8
	29,359.8	31,551.0		30,358.8	32,641.0	
Shares in the Bank for International Settlements	38.0	240.6		38.0	254.4	
	49,678.7	52,072.5		48,517.5	51,018.1	

## 5. Bank premises

	2007			2006		
	Cost	Accumulated amortization	Net book value	Cost	Accumulated amortization	Net book value
Land and buildings	183.5	98.6	84.9	183.5	94.0	89.5
Computer hardware/software	58.3	50.2	8.1	61.7	47.6	14.1
Other equipment	118.9	98.9	20.0	139.0	114.5	24.5
	360.7	247.7	113.0	384.2	256.1	128.1
Projects in progress	20.7	–	20.7	5.7	–	5.7
	381.4	247.7	133.7	389.9	256.1	133.8

Projects in progress in 2007 consist primarily of investments in the High Availability project (\$14.6 million; \$5.3 million in 2006), the CPA's cheque-imaging project (\$2.3 million; \$0 in 2006), and upgrades to bank note processing equipment (\$1.8 million; \$0 in 2006).

The net carrying amount of Bank premises is reviewed when events or changes in circumstances indicate that future benefits may no longer be reasonably assured, and adjusted if required. No adjustments were recorded during the years ended 31 December 2007 and 31 December 2006.

## 6. Other assets

Other assets include the pension accrued benefit asset of \$59.1 million (\$70.6 million in 2006).

## 7. Bank notes in circulation

In accordance with the Bank of Canada Act, the Bank has the sole authority to issue bank notes for circulation in Canada.

A breakdown by denomination is presented below.

	2007	2006
\$5	940.9	994.3
\$10	1,079.1	1,060.8
\$20	15,659.3	15,027.7
\$50	7,133.2	6,924.1
\$100	24,095.0	23,005.2
Other bank notes	1,657.7	1,750.1
	50,565.2	48,762.2

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

## 8. Other liabilities

This category primarily includes accrued post-retirement and post-employment benefits liabilities of \$110.5 million (\$98.0 million in 2006), an accrued transfer payment to the Receiver General for Canada of \$36.0 million (\$21.1 million in 2006), accounts payable and accrued liabilities of \$34.5 million (\$19.4 million in 2006), and payroll liabilities of \$11.0 million (\$10.3 million in 2006).

## 9. Capital

Capital is composed of share capital, a statutory reserve, a special reserve, and accumulated other comprehensive income.

### Share capital

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

### Statutory reserve

The statutory reserve was established in accordance with the Bank of Canada Act. Its balance was accumulated out of net income until it reached the stipulated maximum amount of \$25.0 million in 1955.

### Special reserve

The special reserve was created in 2007 further to an amendment to the Bank of Canada Act to offset potential unrealized valuation losses due to changes in fair value of the Bank's AFS portfolio. The special reserve is reviewed regularly for appropriateness and may be amended, pursuant to a resolution passed by the Board of Directors. This reserve is subject to a ceiling of \$400 million; an initial amount of \$100 million was established in September 2007.

### Retained earnings

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

### Accumulated other comprehensive income

The accumulated other comprehensive income records and tracks unrealized valuation gains and losses on the Bank's AFS portfolio, with the exception of the BIS shares which are recorded at cost.

## 10. Employee benefit plans

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

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

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

The Bank measures its accrued benefits obligations and fair value of plan assets for accounting purposes as at 31 December of each year. The most recent actuarial valuation for funding purposes of the Registered Pension Plan was done as of 1 January 2005 and the next required valuation will be as of 1 January 2008.

The total cash payment for employee future benefits for 2007 was \$10.7 million (\$10.4 million in 2006), consisting of \$4.4 million (\$4.7 million in 2006) in cash contributed by the Bank to its funded pension plans and \$6.3 million (\$5.7 million in 2006) in cash payments directly to beneficiaries for its unfunded other benefits plans.

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

### Plan assets, benefit obligation, and plan status

	Pension benefit plans <sup>1</sup>		Other benefit plans	
	2007	2006	2007	2006
<b>Plan assets</b>				
Fair value of plan assets at beginning of year	984.9	893.5	–	–
Bank's contribution	4.4	4.7	–	–
Employees' contributions	8.0	6.3	–	–
Benefits payments and transfers	(31.7)	(30.3)	–	–
Actual return on plan assets	31.9	110.7	–	–
<i>Fair value of plan assets at year-end<sup>2</sup></i>	997.5	984.9	–	–
<b>Benefit obligation</b>				
Benefit obligation at beginning of year	923.8	887.2	160.1	151.1
Current service cost	33.6	28.7	6.4	6.1
Interest cost	39.8	38.1	6.9	6.4
Benefits payments and transfers	(31.7)	(30.3)	(6.3)	(5.7)
Actuarial loss	–	0.1	0.5	2.2
<i>Benefit obligation at year-end</i>	965.5	923.8	167.6	160.1
<b>Plan status</b>				
Excess (deficiency) of fair value of plan assets over benefit obligation at year-end	32.0	61.1	(167.6)	(160.1)
Unamortized net transitional obligation (asset)	(51.7)	(64.6)	16.3	18.8
Unamortized cost of amendments	15.0	17.2	1.0	2.0
Unamortized net actuarial loss	63.8	56.9	39.8	41.3
<i>Accrued benefit asset (liability)</i>	59.1	70.6	(110.5)	(98.0)

1. For the Supplementary Pension Arrangement, in which the accrued benefit obligation exceeds plan assets, the accrued benefit obligation and fair value of plan assets totalled \$54.1 million (\$51.0 million in 2006) and \$37.5 million (\$32.5 million in 2006), respectively.

2. The assets of the pension benefit plans were composed as follows: 55 per cent equities; 28 per cent bonds; 8 per cent real return investments; 5 per cent real estate assets; and 4 per cent short-term securities and cash (59 per cent, 26 per cent, 9 per cent, 3 per cent, and 3 per cent, respectively, in 2006).

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

## Benefit plan expense

	Pension benefit plans		Other benefit plans	
	2007	2006	2007	2006
Current service cost, net of employees' contributions	25.6	22.4	6.4	6.1
Interest cost	39.8	38.1	6.9	6.4
Actual return on plan assets	(31.9)	(110.7)	–	–
Actuarial loss	–	0.1	0.5	2.2
<i>Benefit plan expense (income), before adjustments to recognize the long-term nature of employee future benefit costs</i>	33.5	(50.1)	13.8	14.7
Adjustments				
Difference between expected return and actual return on plan assets for the year	(14.4)	67.7	–	–
Difference between amortization of past service costs for the year and actual cost of plan amendments for the year	2.3	2.3	1.0	1.0
Difference between amortization of actuarial loss for the year and actuarial loss on accrued benefit obligation for the year	7.4	8.3	1.5	(0.1)
Amortization of transitional obligation (asset)	(12.9)	(12.9)	2.5	3.5
<i>Benefit plan expense recognized in the year</i>	15.9	15.3	18.8	19.1

## Significant assumptions

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

	Pension benefit plans		Other benefit plans	
	2007	2006	2007	2006
<b>Accrued benefit obligation as at 31 December</b>				
Discount rate	4.25%	4.25%	4.20%	4.25%
Rate of compensation increase	3.50%	3.50%	3.50%	3.50%
	+ merit	+ merit	+ merit	+ merit
<b>Benefit plan expense for year ended 31 December</b>				
Discount rate	4.25%	4.25%	4.25%	4.20%
Expected rate of return on assets	5.50%	5.50%	–	–
Rate of compensation increase	3.50%	3.50%	3.50%	3.50%
	+ merit	+ merit	+ merit	+ merit
<b>Assumed health-care cost trend</b>				
Initial health care cost trend rate			7.70%	8.20%
Health care cost trend rate declines to			4.70%	4.75%
Year that the rate reaches the ultimate trend rate			2016	2016

## 2007 sensitivity of key assumptions

	Change in obligation	Change in expense
<b>Impact of 0.25 per cent increase/decrease in assumptions</b>		
<b>Pension benefit plans</b>		
Change in discount rate	(41.4) / 44.3	(4.9) / 5.2
Change in long-term return on plan assets	0.0 / 0.0	(2.1) / 2.1
<b>Other benefit plans</b>		
Change in discount rate	(6.8) / 7.2	(0.2) / 0.2
<b>Impact of 1.00 per cent increase/decrease in assumptions</b>		
<b>Other benefit plans</b>		
Change in the assumed health-care cost trend rates	24.6 / (18.4)	2.1 / (1.5)

## 11. Commitments, contingencies, and guarantees

### a) Operations

The Bank has a long-term contract with an outside service provider for retail debt services, expiring in 2021. At 31 December 2007, fixed payments totalling \$265.6 million remained, plus a variable component based on the volume of transactions.

The Bank occupies leased premises in Halifax, Montréal, Toronto, Calgary, and Vancouver. At 31 December 2007, the future minimum payments are \$5.3 million for rent, real estate taxes and building operations. The expiry dates vary for each lease, from September 2008 to August 2014.

#### Minimum annual payments for long-term commitments

	Outsourced services	Leased space	Total
2008	17.5	1.4	18.9
2009	19.5	1.1	20.6
2010	20.3	1.0	21.3
2011	20.3	0.6	20.9
2012	20.3	0.6	20.9
Thereafter	167.7	0.6	168.3
	265.6	5.3	270.9

#### b) Foreign currency contracts

The Bank is a participant in foreign currency swap facilities with the U.S. Federal Reserve for US\$2 billion, the Banco de México for Can\$1 billion, and with the Exchange Fund Account of the Government of Canada. There were no drawings under any of those facilities in 2007 or 2006 and, therefore, there were no commitments outstanding at 31 December 2007.

#### c) Investment contracts

Sale investment contracts outstanding at 31 December 2007, of \$3,963.4 million, at an interest rate of 4.31 per cent under purchase and resale agreements, were settled by 10 January 2008 (\$2,853.8 million at the end of 2006 at an interest rate of 4.23 per cent).

No purchase investment contracts were outstanding as at 31 December 2007 (\$0 at the end of 2006).

#### d) Contingency

The 9,441 shares in the BIS have a nominal value of 5,000 special drawing rights (SDRs) per share of which 25 per cent, i.e., SDR1,250, is paid up. The balance of SDR3,750 is callable at three months' notice by decision of the BIS Board of Directors. The Canadian equivalent of this contingent liability was \$55.3 million at 31 December 2007, based on prevailing exchange rates.

#### e) Legal proceedings

In 2004, legal proceedings were initiated against the Bank relating to the Bank of Canada Registered Pension Plan. Since the Bank's legal counsel is of the view that the plaintiff's claims for compensation do not have a sound legal basis, management does not expect the outcome of the proceedings to have a material effect on the financial position or operations of the Bank.

#### f) Guarantees

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

##### Large Value Transfer System (LVTS) Guarantee

The LVTS is a large-value payment system, owned and operated by the CPA. The system's risk-control features, which include caps on net debit positions and collateral to secure the use of overdraft credit, are

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

### **Other indemnification agreements**

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

## **12. Comparative figures**

Certain of the 2006 comparative figures have been reclassified to conform to the current year's presentation.

# Senior Officers

## Governing Council

David A. Dodge, *Governor*,\* W. Paul Jenkins, *Senior Deputy Governor*\*

## Deputy Governors

Pierre Duguay,\* Sheryl Kennedy,\* David J. Longworth,\* John D. Murray\*

Marcus L. Jewett, QC, *General Counsel and Corporate Secretary*\*

## Advisers

Mark Carney, Janet Cosier,\*<sup>1</sup> Paul Masson,<sup>2</sup> George Pickering, John G. Selody

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Carolyn Wilkins, *Deputy Chief*  
Ross MacKinnon, *Director, Toronto Division*  
Miville Tremblay, *Director, Montréal Division*  
Scott Hendry, *Research Director*  
Paul Chilcott, *Director*

### Financial Risk Office

Mark Zelmer, *Director*<sup>3</sup>

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Paul Fenton, *Deputy Chief*  
Robert Amano, *Research Director*  
Sharon Kozicki, *Research Director*  
Stephen Murchison, *Research Director*

### Monetary and Financial Analysis

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Dinah Maclean, *Deputy Chief*  
Walter N. Engert, *Research Director*  
Pierre St-Amant, *Research Director*  
Ron Morrow, *Research Director*

### International

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Graydon Paulin, *Deputy Chief*  
Donald Coletti, *Research Director*  
Robert Lafrance, *Research Director*

### Banking Operations

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Lorna Thomas, *Deputy Chief*  
Louise Hyland, *Director, Financial System and Funds Management Operations*  
Nicole Poirier, *Director, Currency Communication and Compliance*  
Charles Spencer, *Director, Strategic Leadership Team*  
Richard Wall, *Director, Currency Operations*

### Executive and Legal Services

Marcus L. Jewett, *General Counsel and Corporate Secretary*\*  
Colleen Leighton, *Deputy Corporate Secretary*  
Robert Turnbull, *Assistant General Counsel*

### Communications

Denis Schuthe, *Chief*

### Corporate Services

Sheila Niven, *Chief*\*  
Janice Gabie, *Deputy Chief*  
Frances Boire-Carrière, *Director, Human Resources Services*  
John Reinburg, *Director, Security and Facilities Services*

### Information Technology Services

Carole Briard, *Chief*\*  
Dale M. Fleck, *Associate Chief*  
Daniel Lamoureux, *Director, Operations*  
Steve Little, *Director, Enterprise Portfolio Management and Business Solutions*

### Financial Services

Sheila Vokey, *Chief and Chief Accountant*\*  
Rudy Wytenburg, *Deputy Chief*

### Audit

David Sullivan, *Chief Internal Auditor*

\* Member of Executive Management Committee

<sup>1</sup> Also Chair of the Board of Directors of the Canadian Payments Association

<sup>2</sup> Visiting Special Adviser

<sup>3</sup> Also Deputy Chair of the Board of Directors of the Canadian Payments Association

Note: Positions as of 31 January 2008

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Lori Rennison, *Senior Regional  
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Trevor Frers, *Senior Regional Representative  
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Zahir Lalani, *Consul and Senior  
Representative for the Bank  
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