Bank of Canada

Annual report of the Governor
to the Minister of Finance
and statement of accounts for the year

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Governor - Gouverneur

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26 February 1993

The Hon. Donald F. Mazankowski, P.C.
Minister of Finance
O t t a w a

Dear Mr. Mazankowski,

In accordance with the provisions of the Bank of Canada Act, I am submitting my report for the year 1992 and a statement of the Bank's accounts for this period, signed and certified in the manner prescribed in the by-laws of the Bank.

Yours sincerely,

BANK OF CANADA

REPORT OF THE GOVERNOR - 1992

GENERAL OBSERVATIONS

I want to begin these general comments by reviewing briefly what monetary policy and price stability can be expected to contribute to economic performance before surveying the thrust of inflation, economic and monetary policy developments over the past year.

Monetary policy, price stability and economic performance

Public economic policy aims to achieve a strong Canadian economy. The most solid contribution that monetary policy can make to this goal is to see to it that Canadians are provided with a money they can trust – that is, one that maintains its value as they go about their economic business. Achieving and maintaining price stability is, therefore, what guides the Bank of Canada in its monetary policy actions.

What benefits are there in having a trustworthy money? It means that investors and savers can plan with greater confidence. Stability in the value of money improves decisions about production and pricing and gets rid of the distortions in investment resulting from the perverse interaction of inflation and taxes. Savers no longer seek the kind of premium in interest rates they need in inflationary times to guard against the inevitable uncertainty about how much inflation will be permitted in the future. In short, an economy where monetary policy is committed to maintaining confidence in money will systematically generate better savings, investment and production decisions. That, of course, helps the economy to perform better than it would otherwise.

There are many aspects of the economy that are outside the influence of monetary policy – outside the scope of what the Bank of Canada can achieve through its influence on the rate of monetary expansion in Canada. So no one should suggest that aiming to provide a trustworthy money is a cure-all. However, it is a distinct advance on the alternative of financing, and therefore promoting, chronic inflation. Our understanding of basic economic relationships shows why this is so, and the experience of recent decades provides additional testimony on this matter. Inflation, and the expectations and concerns generated by an inflationary process, not only did not produce a better economy, it made our economic performance worse.

Nevertheless, there is a lingering belief that to achieve a faster expansion in the Canadian economy than we have seen in recent quarters will require an increase in inflation. In part, it is based on a view that inflation is a necessary ingredient to encourage economic growth. This view, however, depends on the odd presumption that people can persistently be fooled into believing that inflation-related increases in prices and wages make them better off. In other words, that they never learn. In fact, as I have already indicated, as inflation gets built in, it is a drag on the ability of the economy to sustain growth, not something that spurs growth.

Others appear to see inflation not as a stimulus, but as the unavoidable, if perhaps unfortunate, result of any economic pickup. They believe inflation can only remain subdued in a weak economy, and therefore inflation will be inevitable when an economy recovers from a period of cyclical weakness.

But, as we have seen in other countries and in earlier times in Canada, the economy is perfectly capable of expanding to higher rates of production without generating inflation pressures. Only if the economy is allowed to overheat will progress in reducing inflation be jeopardized. Furthermore, as experience with lower rates of inflation accumulates, underpinned of course by a consistently anti-inflationary monetary policy, public confidence increases that inflation will not re-emerge. This means that in all parts of the economy people take decisions with less concern about the threat from inflation, and this in turn also means that their decisions are less conducive to inflation.

The experience of the early 1980s is instructive in this regard. After a sharp reduction in inflation from double-digit levels, the economy and business profitability were able to expand quite rapidly without an increase in inflation pressures. It was only in the latter part of the 1980s, as spending began to run ahead of the economy's ability to produce, that such pressures began to appear.

Progress towards price stability

To provide a clearer indication of the downward path of inflation on the way to price stability, inflation-reduction targets were announced in February 1991. I believe that they have been helpful in underlining and reinforcing the commitment of monetary policy to the achievement of price stability.

When the targets were introduced, the inflation rate was very high. Some of the immediate pressure on consumer prices came from elements whose effects might have been regarded as temporary – the introduction of the goods and services tax, increases in other indirect taxes, and a sharp jump in oil prices following the invasion of Kuwait. However, even abstracting from these particular effects, inflation was still quite rapid and domestic cost pressures were strong. In these circumstances there was a real question whether the immediate additional price pressures would indeed be transitory, or whether there would be a feedback into higher wage costs and still higher prices. Such a transmission would of course only propel further the inflationary momentum. These were the immediate circumstances in which it was judged that establishing an explicit target path for reducing inflation could be helpful in backing up the fundamental monetary policy commitment to return to price stability.

There is no simple way of identifying the extent to which the inflation-reduction targets in themselves have helped in bringing inflation down. In any event, it does seem that by the latter part of 1991 there was a significant and very welcome improvement in attitudes regarding inflation. Businesses and households were coming increasingly to recognize that Canada's inflation performance really was changing for the better and were starting to act on that basis.

The lowering of price and wage inflation that was achieved through 1991 was built upon further in 1992. The underlying rate of price inflation slowed steadily through most of 1992, and with better growth in productivity the increase in labour costs per unit of output was the smallest in years.

The targets announced in early 1991 provided for a target band for consumer price inflation of 2 to 4 per cent as of the end of 1992. As it turned out the consumer price index in December 1992 was 2.1 per cent higher than a year earlier – just above the lower edge of the target band. Some of the effects on prices of the depreciation of the Canadian dollar that we have undergone in recent months are apparent in the most recent numbers and some of these effects probably have yet to be seen. This could result in some temporary upward movement in inflation over the next few months. However, the exchange rate effect should not be allowed to obscure the fundamentally favourable development that we have been doing better on inflation than forecast. As this progress is consolidated in further improvement in expectations and behaviour regarding inflation, it encourages a trend of interest rates lower than would otherwise have been possible.

The next milestone incorporated in the inflation-reduction targets announced two years ago is a range of 1½ to 3½ per cent as of mid-1994. The trend in underlying inflation appears "on track" to an outcome in the lower part of that range. To secure the improvement to our financial climate, and therefore to our economic prospects, that this better inflation outcome can deliver, monetary policy must maintain confidence that it will be oriented to preserving progress towards price stability. The Bank of Canada's actions will be geared to maintaining that confidence.

Economic developments

As described in more detail in a later chapter of this report, the expansion in economic activity that began in the spring of 1991 continued through 1992. However, the increases in economic activity over the first seven quarters of the recovery have been appreciably below the norm of previous economic cycles.

Part of this sluggishness has stemmed from external developments. Prices for raw materials have continued to be weak. And the international economy has posted mixed results over this period. In 1992 most of the overseas economies that are significant for Canadian exports – in Europe and Japan – showed a distinct tendency to weaken, the exception being Southeast Asia. But in contrast to the general situation overseas, as the year progressed there were increasing signs of a more broadly based recovery in the United States, our largest export market by far. In that economy, recovery had been held back by difficulties related to the burden of debt and speculative asset accumulation that had developed in the 1980s – for the most part more severe than here. But by late 1992 there were indications that these balance-sheet type constraints had eased sufficiently to permit a more vigorous expansion of demand.

While it is disappointing, it is hardly surprising that the Canadian economy has only gradually been able to work off the economic fallout from its earlier period of inflationary pressures, speculative activity and debt accumulation. What was less easy to foresee is the extent of the challenge to Canadian business of competing in an increasingly global economy. In many instances this has required a difficult restructuring of operations.

The decline in inflation and resulting improvement in interest rates in Canada over the past couple of years have helped to ease the financial and economic adjustments that needed to take place. Businesses have benefited from the lower interest rates as they restructured both their balance sheets and their operations to meet the reality of a global marketplace. It is noteworthy in this context that investment in machinery and equipment has stayed strong. Increased productivity and a better control of costs in a distinctly less inflationary environment have resulted in more moderate increases in unit labour costs, and substantial gains have been posted in exports, particularly in the export of manufactures.

Lower interest rates also have relieved pressure on the finances of households by reducing the share of their income needed to service debt. And the combination of lower mortgage rates and lower house prices has made housing more affordable than it has been in years.

Debt has weighed heavily on all levels of our government. The debt buildup resulted from a long period of sizable budgetary deficits that were not limited to times of slow growth in revenues and not offset adequately at times when revenues were more buoyant. The outcome has been a sharply reduced capacity on the part of governments to respond to unexpected developments, such as the pressures of the recent recession and subsequent slow recovery. Coping with the public debt burden is proving an arduous task. At the same time, it is welcome that a more disciplined approach to public finances has become more widespread. It needs to continue if Canada is to generate the increased savings to finance adequately its investment needs in the years ahead.

The Canadian economy has come through a difficult period. And plenty of challenges remain. Nonetheless, with the fundamental improvements associated with declining inflation, such as the lower rates of interest, cost containment and improved productivity growth, we have a much better basis from which to make further progress. The restructuring efforts of Canadian businesses to take advantage of these developments and become more competitive, in tandem with the better economic pickup in the United States, have put us in a strong position to make solid economic gains.

As reviewed in a later section of this report, trends in monetary aggregates are also promising for the profile of economic developments. The more rapid growth in narrow monetary aggregates and the moderate pace of expansion of the broader monetary aggregates are consistent with a stronger recovery along with a favourable inflation performance.

Interest rates and exchange rates

Through the first eight months of 1992, the pattern of declining interest rates continued in Canada. Thus by early September short-term interest rates had fallen below 5 per cent, the lowest level since the early 1970s, and long-term rates were below 8 per cent, only about one-half of a percentage point above their U.S. counterparts.

The Bank's monetary policy actions over this period were directed to helping to maintain the decline in interest rates, in line with progressive improvement in the confidence of savers and investors. When the Bank intervened, it tended to use its influence to smooth the decline in shorter-term rates. At times it needed to work to forestall unsustainably rapid drops that could come from an overenthusiastic wholesale money market, and that could generate sharp reversals when the enthusiasm petered out.

In the Bank's view, steady declines in interest rates held out a better prospect of a sustained lower level of interest rates over the medium term than did more erratic movements. Steady declines were more likely to be accepted by savers and investors as they progressively adjusted their views about appropriate interest returns in an environment of gradually increasing confidence in the future value of money.

However, in the latter part of the year short-term interest rates became very volatile and moved generally higher. In large measure this reflected the tension in domestic financial markets provoked by the downward movement in the exchange value of the Canadian dollar. The details of these financial market developments are discussed in a subsequent section of this report. The point I want to make here is that such swings in interest rates, while unusually large on this occasion, are not altogether surprising when there is heightened uncertainty about future developments in Canada. They underline once again that the various segments of financial markets – money markets, bond markets and exchange markets – are bound to react and to interact in response to disturbances affecting the outlook. The recent events also underline the fundamental importance of strong confidence among savers and investors in bringing about steady financial markets where yields stay low. Monetary policy is of course focussed on promoting and sustaining such confidence.

The weakening in the exchange value of the Canadian dollar in the final months of 1992 came from more than one source. In September, important factors were the spillover from the exchange rate turmoil in Europe and the lead-up to our constitutional referendum. In the second bout of weakness, in November, there was an increased market focus on developments in Canada, and our currency was also affected by the general strengthening of the U.S. dollar against most currencies.

The exchange rate gets a lot of attention. Strong views about the Canadian dollar and where it should or should not go are frequently expressed – from many quarters. This is therefore a good occasion to review once again how the exchange rate fits within the overall framework of Canadian monetary policy.

As I have already underlined in these remarks, monetary policy is for good reason aimed at achieving and maintaining monetary stability – that is, domestic price stability. Here I can add that given this basic purpose, it follows that the Bank does not pursue an exchange rate target.

However, the fact that Canada has a flexible, not a fixed, exchange rate regime by no means implies that in conducting monetary policy the Bank of Canada is, or should be, indifferent to what happens to the exchange rate and to the exchange rate's effect on monetary conditions overall. The exchange rate is an important price in the economy, with important effects on demand, output and inflation. And in its monetary policy actions, the Bank of Canada must of course take account of those effects, actual or potential.

Furthermore, the Bank also has to be mindful of exchange market confidence in an environment that is susceptible to cumulative movements – to bandwagon effects – stemming from increases in market uncertainty.

These are the kinds of considerations that the Bank bore in mind as it coped with the turbulence in the money, bond and exchange markets in late 1992. What was important, let me repeat, was for the Bank to be a force for confidence and for steadiness.

The Bank's primary concern was to provide reassurance that the focus of monetary policy continued to be on preserving the value of money in Canada. The Bank's actions also had to help the markets settle down and trade effectively – in ranges where there really were willing buyers and sellers.

Perhaps for anyone who still believes that the Bank of Canada can move interest rates around virtually at will, it might seem that the Bank acted arbitrarily in the period of exchange market turbulence to push interest rates up, thus preventing the Canadian dollar from finding its "natural level."

However, such a view ignores the crucial importance for savers and investors of what they expect regarding future developments as they make judgments about where to invest and what is an acceptable rate of return. Claims in Canadian dollars must provide a return consistent with these expectations if they are to be acceptable to investors – and this is true whether those investors are foreign or Canadian.

Among the most important elements in such expectations are views on the likely conduct of monetary policy. Accordingly, the Bank of Canada's influence over domestic interest rates stems more from the confidence it can bring to savers and investors regarding the basic anti-inflationary purpose of monetary policy than from any power to shift interest rates around through injections of liquidity. Indeed, such injections can have an effect that is opposite to that intended, if they raise concerns that monetary policy is becoming inflationary. The same considerations apply equally forcefully to the exchange market. This means that the notion of a "natural level" for the exchange rate, somehow divorced from expectations among savers and investors and from what policy is aiming to achieve, has little real meaning.

None of this should suggest that the Bank has no ability to act as a countervailing influence to market disturbances. But, let me reiterate, we can only do so effectively by being very clear in our actions that Canadian monetary policy continues to pursue the fundamental objective of domestic price stability. A policy that pursues this objective is the only sure way to achieve sustained low interest rates. It also provides an essential underpinning to the exchange rate.

Over time the markets did find new trading ranges, and following a period of stability, interest rates in late 1992 and early 1993 improved from the peaks registered in the period of turbulence in the autumn. I cannot overemphasize the importance, for such improvement, of confidence in continued good inflation performance.

ECONOMIC AND FINANCIAL DEVELOPMENTS

International environment

The year 1992 saw a further moderation in inflation in the major industrial countries and divergent movements in output growth between North America and the overseas economies. While the United States, Canada's most important trading partner, showed stronger signs of recovery, economic activity in major overseas countries softened towards year-end. As a consequence, world commodity prices remained close to the cyclical troughs recorded in 1991, contributing to the weakness in Canada's terms of trade and the lower external value of the Canadian dollar.

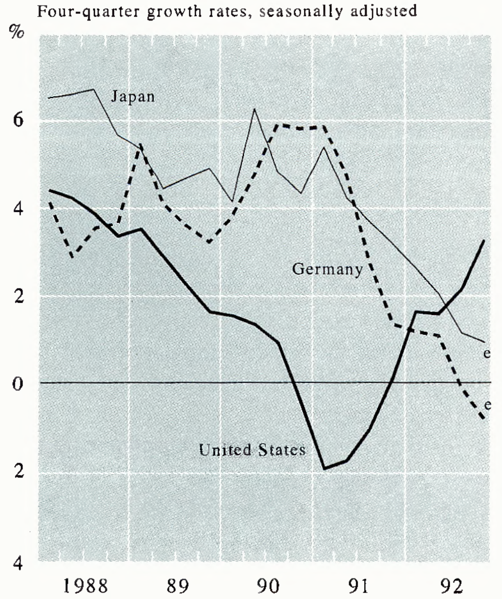
International capital and foreign exchange markets became increasingly volatile as the year progressed, reflecting the differing cyclical positions of the major world economies, as well as other factors of both a political and an economic nature. Tensions within the European Monetary System led to dramatic exchange rate and interest rate movements in Europe that spilled over into financial markets elsewhere, adding to the uncertainty and financial pressures affecting Canada through the latter part of the year.

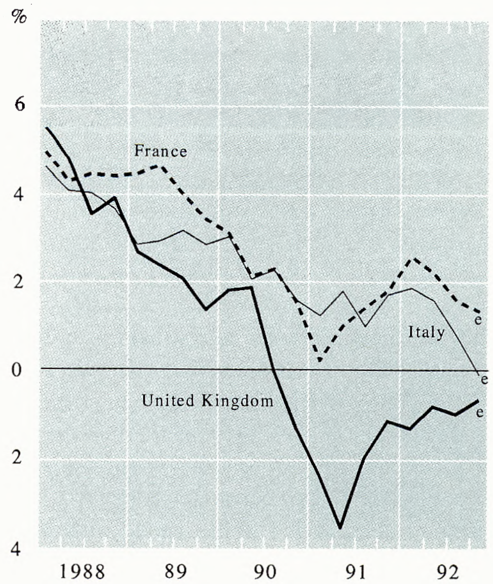
Economic developments

The pace of aggregate economic activity in the major overseas countries slowed in 1992, continuing a trend that began in 1990. In Japan, asset price deflation and a saturated market for consumer durables contributed to a sharp decline in domestic demand. Government measures aimed at supporting the Japanese financial system and stimulating the domestic economy are still working their way through the system and have yet to reverse the slowing trend in output growth.

Output in selected major industrial countries

Four-quarter growth rates, seasonally adjusted





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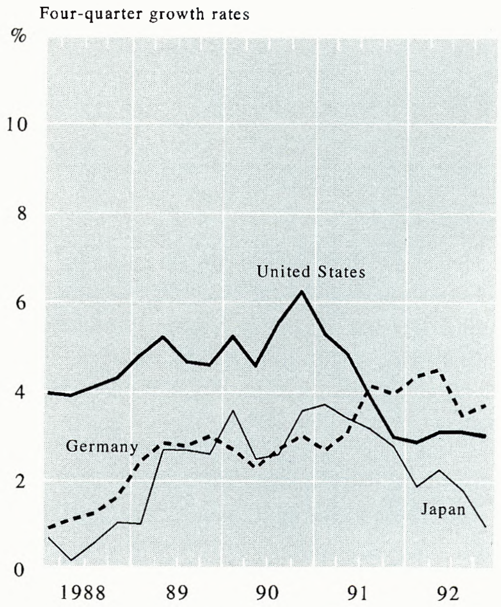
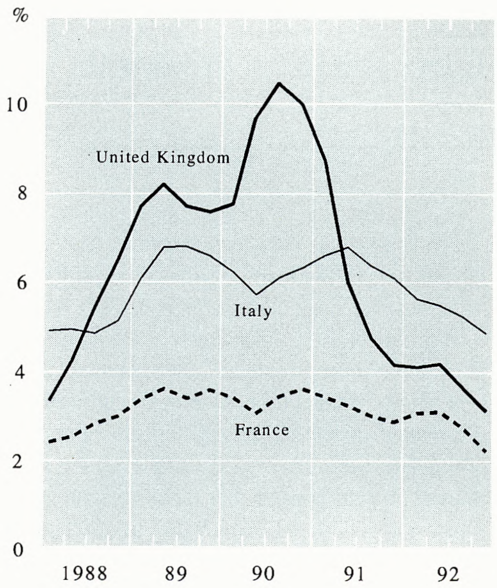
Consumer prices





Economic activity in Germany, France and Italy had continued to expand in the early part of 1992, but weakened towards year-end. The German economy, which until recently had been boosted by increased government spending associated with unification, slowed in response to tighter monetary conditions, resulting from persistent inflationary pressures. The United Kingdom, which had moved to tighten policy earlier than its European partners because of more extreme demand pressures in the late 1980s, experienced a further contraction in economic activity in 1992, although with some indications of a turnaround in the second half of the year. Any stimulative effect provided by larger government expenditures was largely offset by sagging private demand as households and businesses worked to restructure balance sheets and to reduce large debt overhangs.

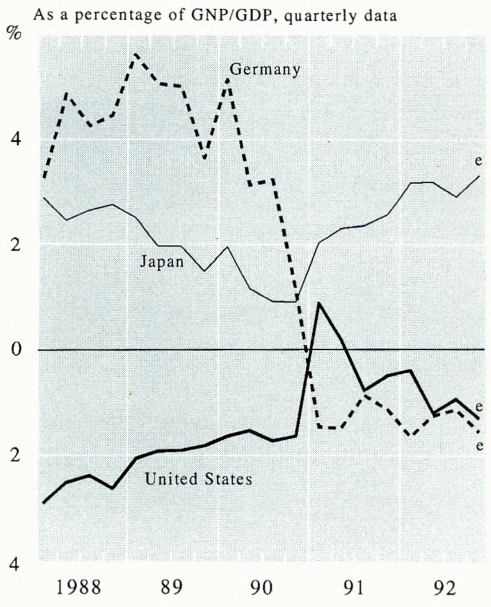
In these circumstances, many overseas countries experienced downward pressure on inflation throughout the year. Though Japan recorded the lowest consumer price inflation in 1992, France, Italy and the United Kingdom all reported significant declines in their rates of inflation. The one notable exception was Germany, where inflation remained relatively high.

The United States, in contrast to the overseas countries, showed increased signs of recovery in 1992, with output growing faster in the third and fourth quarters and the economy expanding by just over 3 per cent on average through the year. However, despite a significant easing in monetary conditions, the recent rebound has been relatively slow by historical standards.

High levels of household and corporate indebtedness in the United States, overbuilding in the commercial real estate market and balance sheet restructuring in the financial sector appear to have muted the positive impact of past monetary easing on economic activity. Large U.S. government deficits have also limited the room for manoeuvre on the fiscal policy side. However, interest-sensitive consumer expenditures have recently started to rebound, and key financial indicators such as the ratio of corporate debt to equity and household interest payments as a proportion of disposable income have also shown improvement. Although consumer prices rose at about the same rate as in 1991, the underlying trend of inflation remained downward.

The current account balances of the major industrial countries were affected in 1992 by their differing cyclical positions, but the resulting deficits and surpluses remained much smaller as a percentage of GDP/GNP than in the mid-1980s. In 1992, the U.S. current account deficit increased by approximately U.S.$60 billion, reflecting growing import demand in the strengthening U.S. economy and the absence of special factors that had helped support the current account in 1991 (most notably, the transfer payments received from other countries after the Gulf War). The Japanese surplus widened from U.S.$73 billion in 1991 to U.S.$118 billion, as the value of imports declined in response to slowing domestic demand and low world prices for many imported raw materials.

Current account balances



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Interest rates and exchange rates

Lower inflation rates and sustained excess capacity provided scope for lower interest rates in most industrial countries in 1992. In the United States, for example, short-term commercial paper rates fell to a low near 3 per cent. Interest rates in Japan also fell to their lowest levels in recent years.

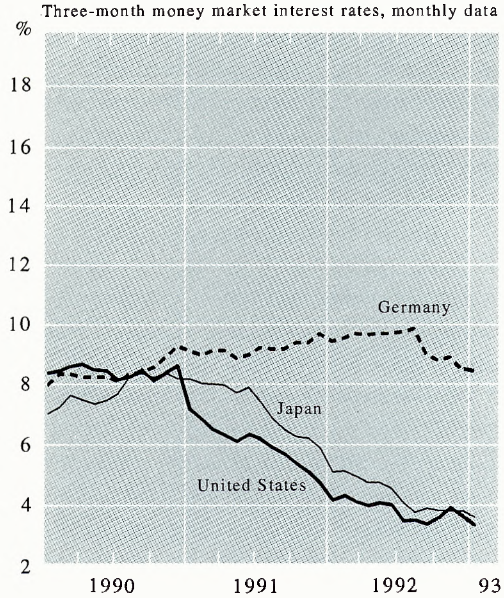
In Germany, however, short-term interest rates were generally firmer over the year in the face of continuing inflationary pressures, although they declined somewhat in the latter part of the year as the domestic economy slowed. These differential movements in interest rates between the United States and Germany, along with political and economic uncertainty in Europe and the former Soviet Union, caused exchange rates to display considerable volatility throughout the year. The German mark reached a postwar high against the U.S. dollar in the third quarter of 1992 but later weakened sharply in response to mounting evidence of a strengthening U.S. recovery and market expectations of further declines in German interest rates.

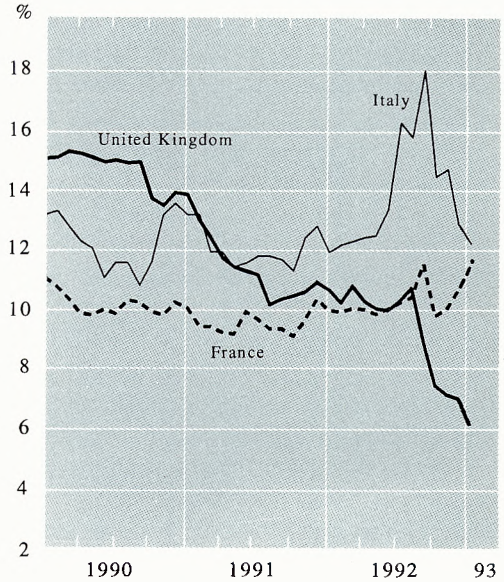
Tensions within the European Monetary System (EMS) escalated during the year as monetary conditions became increasingly incompatible with domestic economic conditions in a number of member countries, and uncertainty grew over the future of the Maastricht treaty and the proposed European economic and monetary union. The pound and the lira were eventually forced to break their link with the exchange rate mechanism and to float, depreciating to levels that were more than 15 per cent below their previous values against the mark. Three other countries had to devalue within the EMS, while currencies of some other countries previously linked to EMS currencies also were floated.

While short-term interest rates in the United Kingdom declined significantly after the pound left the EMS, those in most other member countries showed only modest declines, as monetary conditions remained tight in Germany in the presence of sustained domestic inflationary pressures.

Short-term interest rates in selected major industrial countries

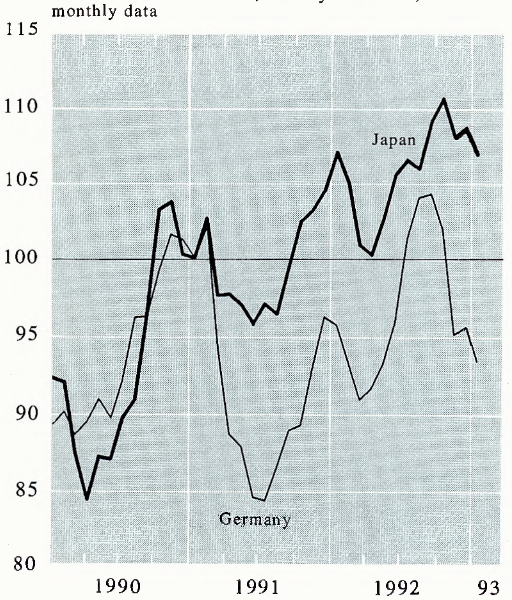
Three-month money market interest rates, monthly data



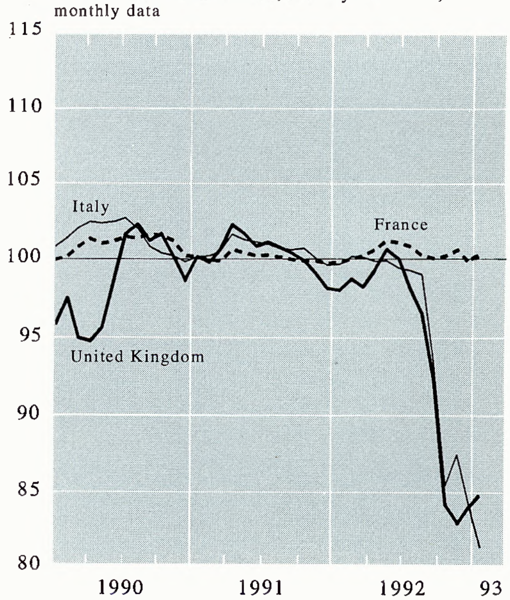


Selected exchange rates

Vis-à-vis the U.S. dollar, January 1991=100, monthly data



Vis-à-vis the German mark, January 1991=100, monthly data

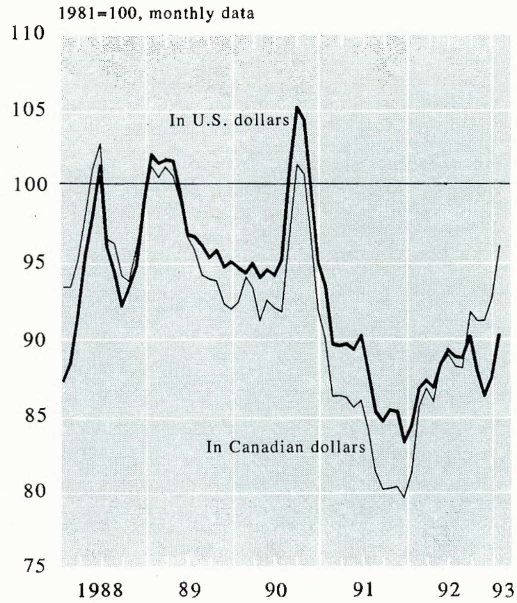


World commodity prices

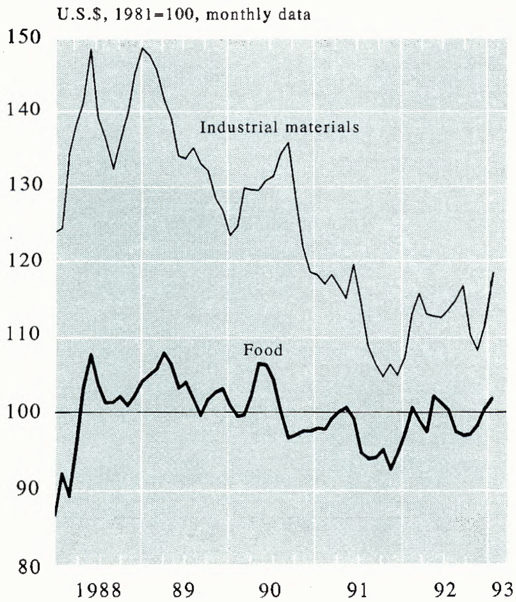
Sluggish world demand coupled with additions to productive capacity resulted in the continued weakness of international prices of many commodities. However, the Bank of Canada commodity price index in Canadian dollar terms strengthened throughout the year, reflecting the depreciation of the Canadian dollar.

Prices of industrial materials in U.S. dollar terms rebounded at the beginning of 1992 from four-year lows. Lumber prices climbed in response to expectations of a pickup in demand, low inventories and restricted supply from the northwestern United States. Additional support was provided by metals prices, which rose gradually through the first half of the year. This was followed by a reversal in the latter half of the year, however, when metals prices dropped to their lowest level since 1987 in reaction to high and rising inventories and increasing evidence of weakening overseas economies. In contrast, lumber prices surged further at year-end and in early 1993 in anticipation of tight supplies during the upcoming building season. While wheat prices dropped slightly in 1992 from the high levels recorded at the end of 1991, owing to a bumper U.S. crop, support was provided by growing demand from China and the former Soviet Union, and a shortage of high-quality grain. Crude oil prices in U.S. dollar terms were little changed on balance in 1992.

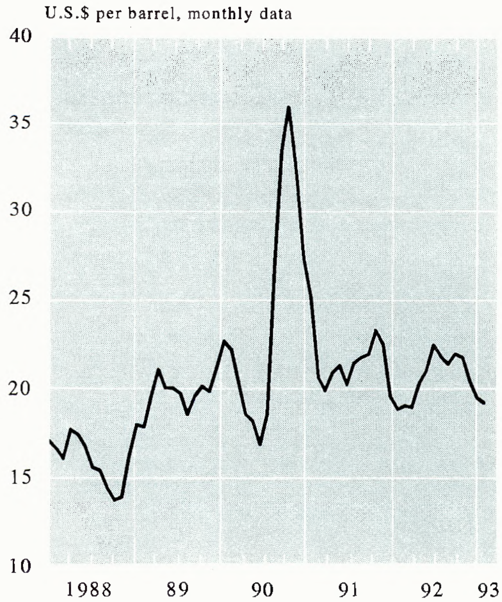
Bank of Canada commodity price index



Food and industrial materials prices



World oil prices



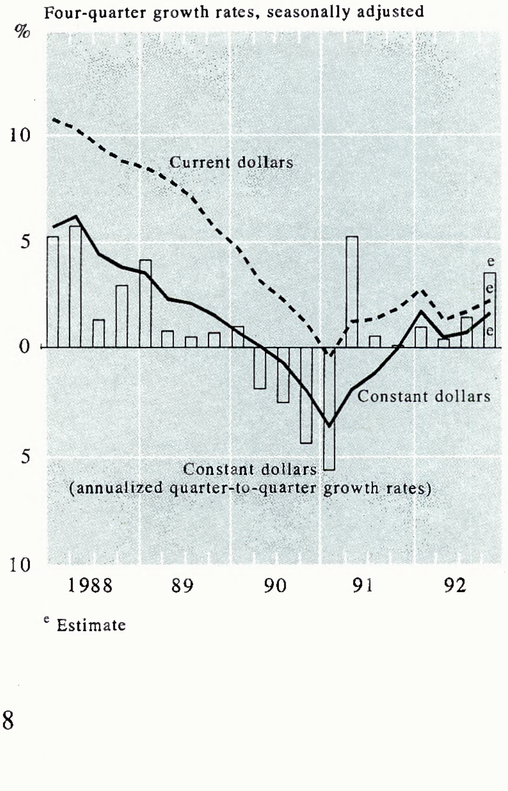
Domestic economic activity and inflation

Economic expansion in Canada continued through 1992 while underlying inflation declined further. However, the pace of activity remained modest overall as a number of factors continued to exert a restraining influence on domestic demand. Activity did pick up noticeably in the second half of the year, although this was more evident in some sectors and regions than in others. While a temporary rise in measured inflation is possible over the next few months in response to the recent depreciation of the Canadian dollar, the prospects are for continued moderation in underlying inflation.

Aggregate demand and output

Although the economy responded more noticeably in 1992 to the previous easing in monetary conditions, growth in aggregate demand remained subdued and unemployment rose further, especially during the first half of the year. The recovery has been affected by a variety of factors. These include a persistent surplus of commercial real estate, the continued necessity for governments to contain their budget deficits, and lacklustre economic activity in a number of other countries. But perhaps the most important in this regard has been the need to adjust to the rising pressures of global competition, which has prompted widespread restructuring efforts on the part of Canadian firms. This has involved increased spending on new machinery and equipment and more efficient processes, as well as tighter inventory management, all of which should contribute to gains for the Canadian economy as time goes on. Indeed, there were indications as the year

Gross domestic product



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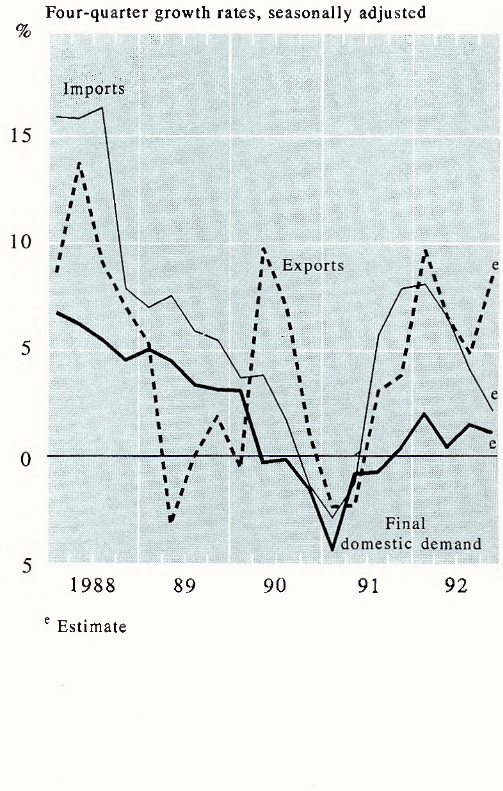
Final domestic demand, exports and imports, constant dollars



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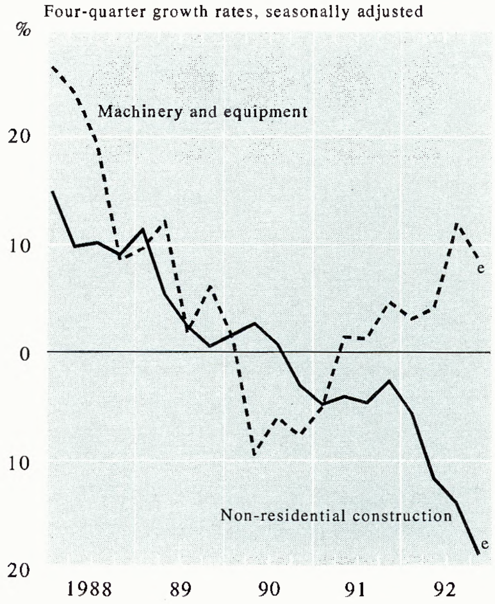
progressed that these investments were beginning to pay off in terms of improved cost control, higher productivity and better export performance. Yet, in the first instance, restructuring often means accomplishing more with less labour, and the associated layoffs and the gradual movement of resources into new or expanding sectors have meant that overall growth in income and aggregate demand has remained modest. Moreover, the additional investment spending itself had relatively little immediate impact on domestic activity, since most capital equipment is imported.

Another important reason for the moderate economic recovery is that the Canadian consumer has remained cautious. Although in 1992 spending was boosted by higher income tax refunds and by reduced household debt-service costs, restructuring efforts by firms gave rise to uncertainty regarding employment prospects, and this weighed on consumer demand throughout the year. There also seemed to be a tendency early in the year to delay major purchases in anticipation of further declines in interest rates, and high debt levels probably continued to constrain the spending of some households. Finally, the financial market turbulence that dominated the autumn scene caused some postponement of planned spending.

Despite these various restraining elements, the economy gained momentum as the year progressed. One positive factor was residential construction, which was spurred by a combination of increased affordability and new government initiatives to make home ownership more accessible. However, the most important source of strength in 1992 was exports, which rose significantly as the U.S. recovery began to take hold and Canadian competitiveness improved. The increase in exports was particularly marked in the manufacturing sector, where restructuring efforts were most intense and where the benefits of tax reform and trade liberalization were expected to be concentrated.

Imports also grew strongly during 1992, especially imports of machinery and equipment. However, towards the end of the year, better domestic cost performance, along with the depreciation of the Canadian dollar, were beginning to moderate spending on imported consumer goods. The combination of this

Indicators of business fixed investment, constant dollars



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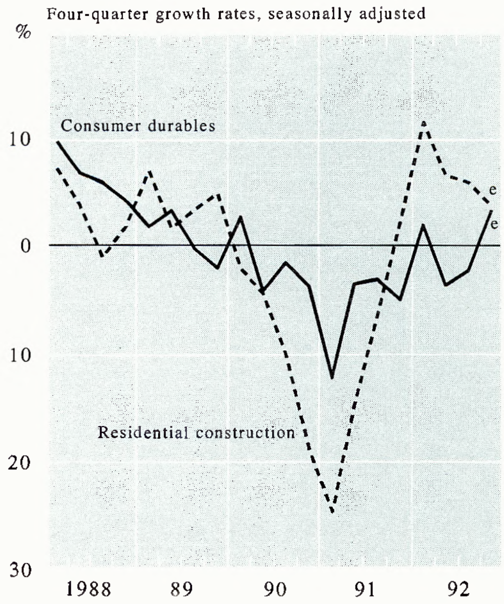
Indicators of household demand, constant dollars



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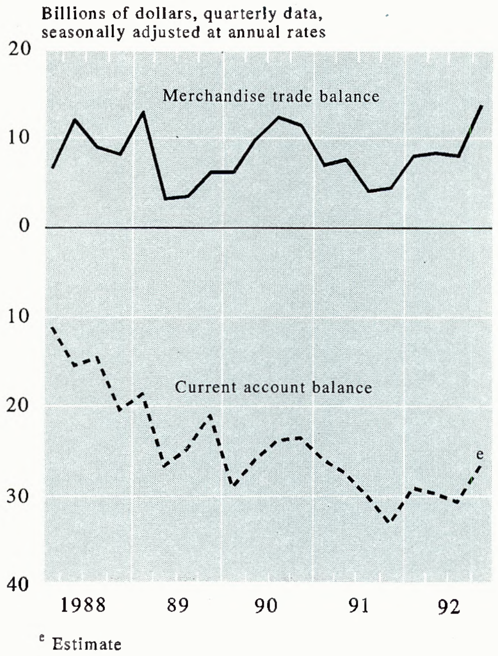
Balance of payments



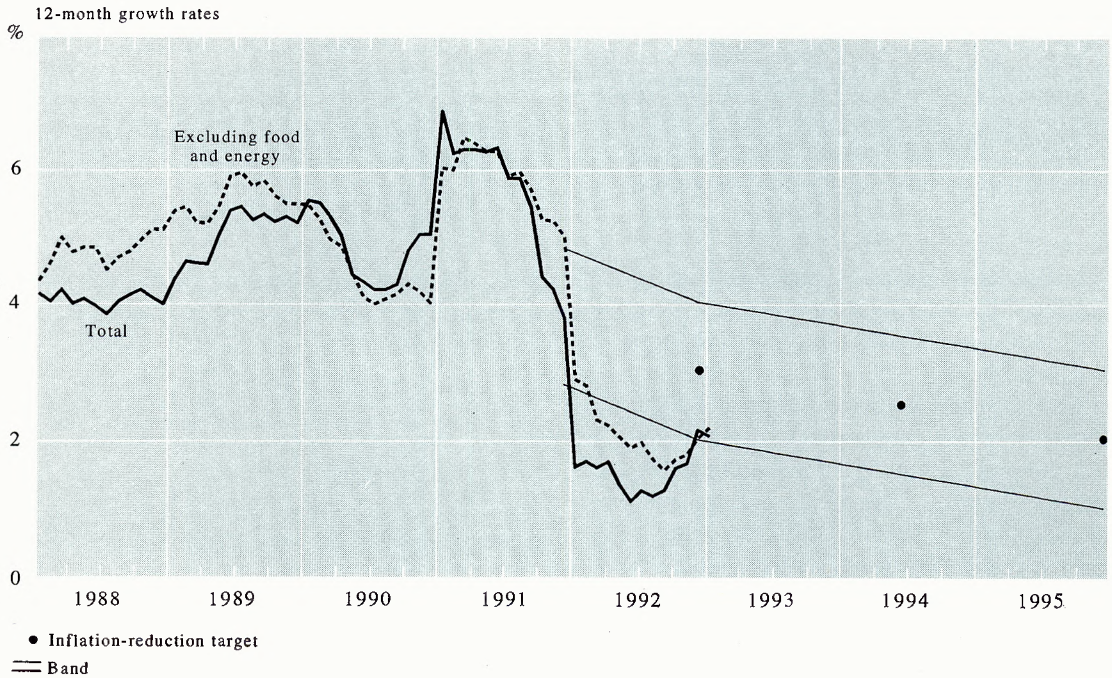
moderation and the growth in exports generated an increase in the merchandise trade surplus, resulting in a narrowing of the current account deficit.

The gathering momentum in the economy was also reflected in the labour market, which saw modest, though steady, increases in employment during the second half of the year. At the same time there was renewed growth in the labour force, suggesting increasing optimism regarding employment prospects. These two developments tended to be offsetting in terms of the unemployment rate itself, as is typical of economies in the early stages of recovery.

Prices and costs

With the moderate pace of increase in economic activity in 1992, a significant degree of slack in goods and labour markets remained, and there was a further easing in price and cost inflation. The underlying rate of inflation, as measured by the 12-month increase in the consumer price index excluding the volatile food

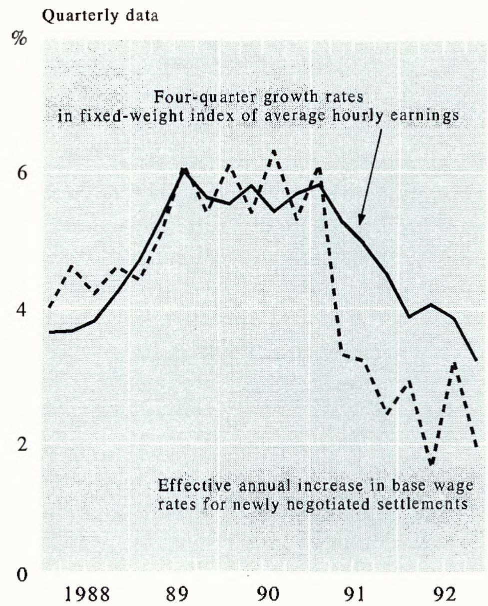
Consumer price index



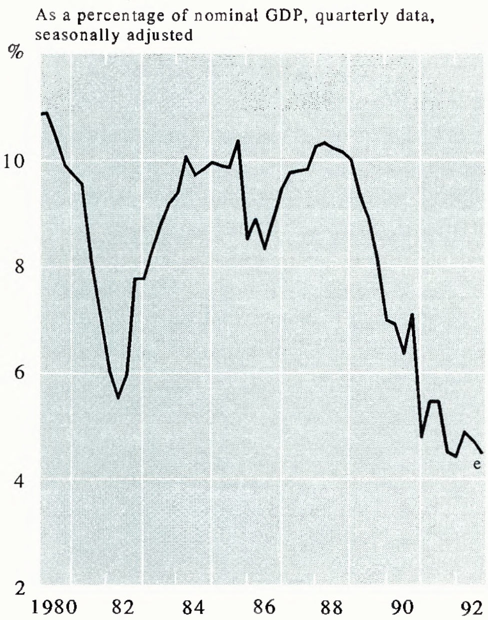
and energy components, declined from 2.9 per cent in January to 2.0 per cent in December, at the bottom end of the inflation-reduction targets. The sizable depreciation of the Canadian dollar that took place in 1992 can be expected to raise measured inflation temporarily above its underlying trend during 1993. Early signs of this are evident in recent data.

Regulated prices continued to rise more quickly than non-regulated prices in 1992. Relatively high rates of increase were seen in such items as property taxes, water, electricity, public transportation and tuition fees. The gap between regulated and non-regulated price increases has widened considerably over the past two years as the underlying rate of inflation has declined. This is consistent with previous experience, as regulated prices tend to respond more slowly than non-regulated prices to changes in aggregate demand conditions. However, measures by various levels of government to increase their revenues and by some utilities to improve their profitability also had an impact.

Measures of wages and earnings

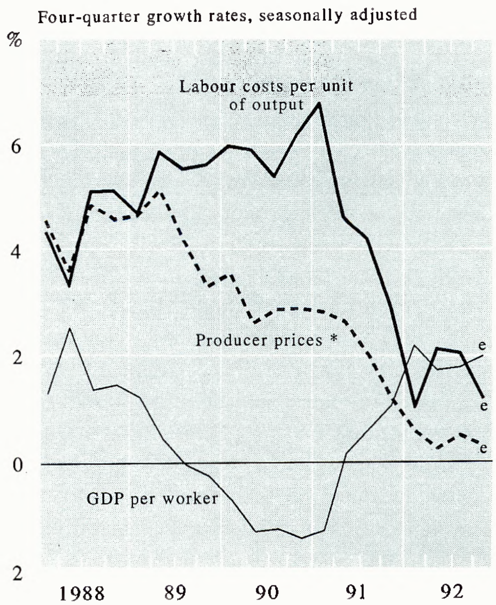


Corporate profits



[e] Estimate

Unit labour costs, producer prices and labour productivity

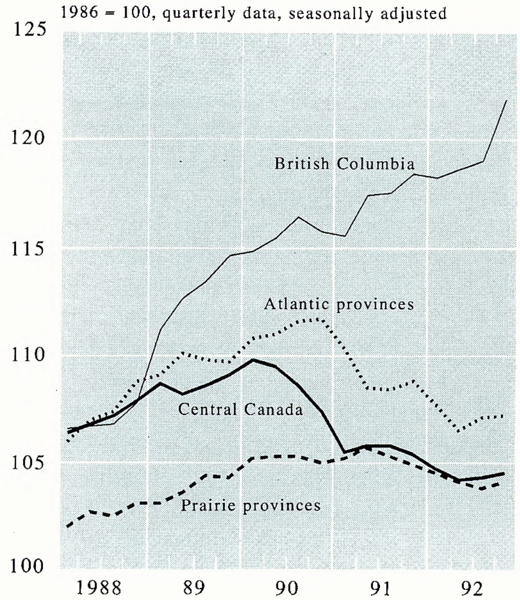


* GDP deflator at factor cost excluding federal sales tax rebate on inventories in the fourth quarter of 1990

[e] Estimate

Developments on the cost side point to continued moderation in the trend of inflation. Wage and salary inereases slowed further in 1992, as the fixed-weight index for average hourly earnings increased by 3.7 per cent in the year as a whole, compared to 5.1 per cent in 1991. Negotiated wage settlements, which are more forward-looking, indicate that there has been a significant downward adjustment in inflation expectations. Settlements averaged about 2 per cent in 1992, suggesting that broader measures of costs should slow even further in 1993. The lower growth in money wages, along with the significant rise in productivity gains associated with industrial restructuring, generated a further decline in the growth of unit labour costs in 1992. These costs nevertheless continued to rise more quickly than producer prices. Therefore, and despite the benefits of lower debt-servicing costs, corporate profits remained very weak by historical standards.

Employment



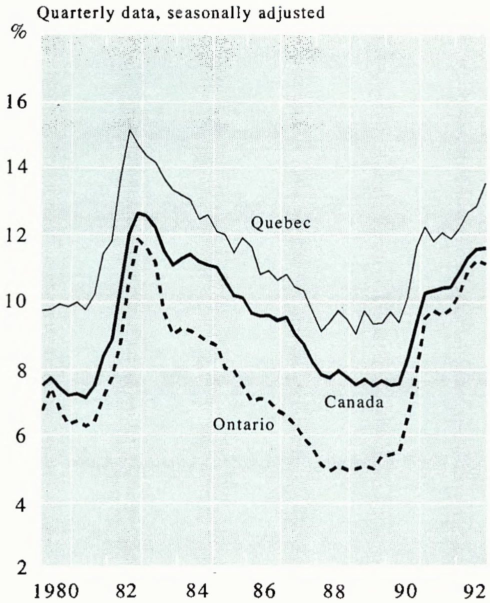
Regional developments

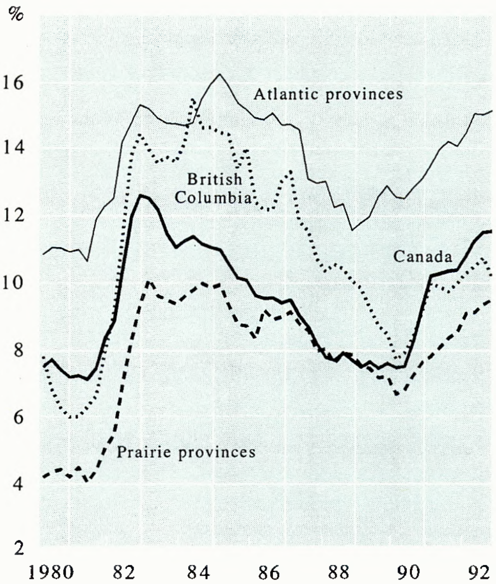
While the national picture improved in 1992, the paee of economic activity remained uneven among the regions. Although these regional differences in the main reflected varying local conditions, broader forces also played a role. In particular, the process of industrial restructuring was concentrated in the manufacturing sector, and therefore had more of an effect in Ontario and Quebec than in the rest of the country. At the same time, these provinces more than others felt the positive effects of strong growth in exports of manufactured goods. As well, the depreciation of the Canadian dollar began to strengthen the profitability of resource-exporting firms in the latter part of the year, particularly in British Columbia, New Brunswick, Alberta and Quebec.

In the Atlantic provinces, economic activity was dampened by a number of adverse local developments, including the moratorium on cod fishing, a slowdown in spending on the Hibernia project, weak prices for pulp and paper, layoffs in mining and declining iron ore production. However, during the second half of the year, the compensation plan for those affected by the moratorium on cod fishing helped boost incomes, and the benefits of higher lumber prices began to be felt. Furthermore, income from lobster catches increased significantly as a result of higher prices.

Economic activity was generally sluggish in Central Canada in 1992, although a firming was apparent in the second half of the year. In Quebec, local factors that restrained demand included the expiry in late 1991 of a provincial government program designed to stimulate new housing construction, which probably had caused some home construction to be moved from 1992 to 1991, and the broadening of the provincial sales tax to include services. Low international prices for metals and for pulp and paper also had a negative impact. In both Quebec and Ontario, consumer confidence remained fragile owing to concerns about job losses. Non-residential construction continued to decline in Ontario, reflecting a glut of commercial real estate and low capacity utilization rates in manufacturing. Nevertheless, robust growth in exports of manufactured products stimulated activity, particularly for industries producing electrical, rubber, plastic and automotive products.

Unemployment rate





A lack of economic vigour also characterized the Prairie provinces, although there were a number of bright spots. While investment in the energy sector declined significantly, energy production rose substantially, led by strong growth in exports of natural gas and, to a lesser extent, crude oil. A large rise in the price and exports of cattle raised farm receipts, and the impact on farm cash income of lower grain prices was more than offset by increased government farm program payments. Both uranium and potash production rose significantly.

Economic activity was strongest in British Columbia, where continued immigration from the rest of the country and abroad and steady employment growth stimulated consumption and housing expenditures. Although the picture was clouded by continuing difficulties in the coal industry and low prices for metals and for pulp and paper, substantial rises in lumber output and prices were important sources of strength.

Domestic monetary and financial developments

Monetary aggregates and credit market developments

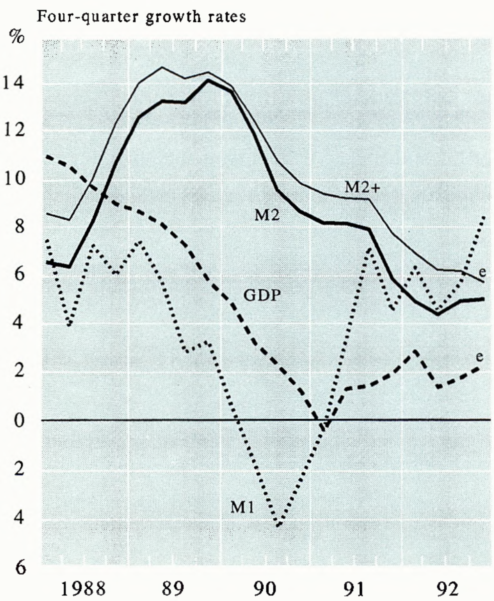
The downward trend in the growth of the broad measures of money, M2 and M2+, continued in 1992, boding well for an ongoing favourable inflation performance since these aggregates tend to move in advance of price changes. As well, there was a significant pickup in the rate of growth of the narrow aggregate M1, the best monetary indicator of future developments in economic activity, providing additional evidence of a strengthening economic recovery.

Growth in M2+ slowed from 7½ per cent in 1991 to 5½ per cent in 1992. Within M2+, there was a smaller deceleration in the pace of M2 growth, as the banks' share of deposits increased at the expense of trust and mortgage loan companies.

Growth of the narrow monetary aggregate M1 picked up in 1992, largely in response to the declines in interest rates in 1991 and 1992. Nonetheless, the pickup was somewhat less than might have been expected on the basis of historical relationships, in part because businesses made greater use of money market mutual funds for cash management purposes. These funds are included in M2+ but not in M1.

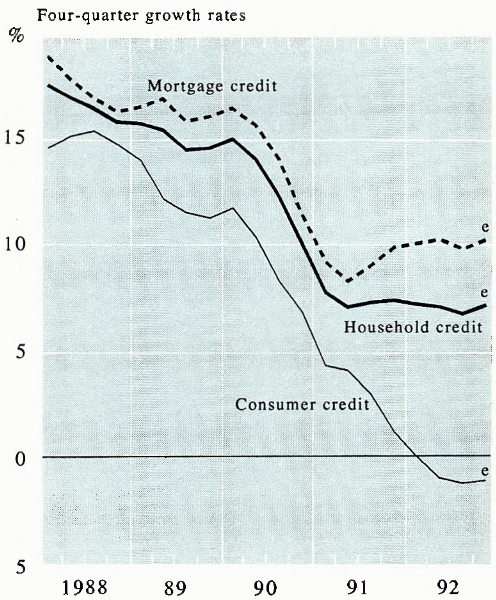
In 1992, the growth of total household credit continued to exceed that of disposable income, leading to a rise in the ratio of household debt to disposable income. With a sluggish economy, some borrowers must have

Monetary aggregates and nominal GDP



ᵉ Estimate

Total household credit



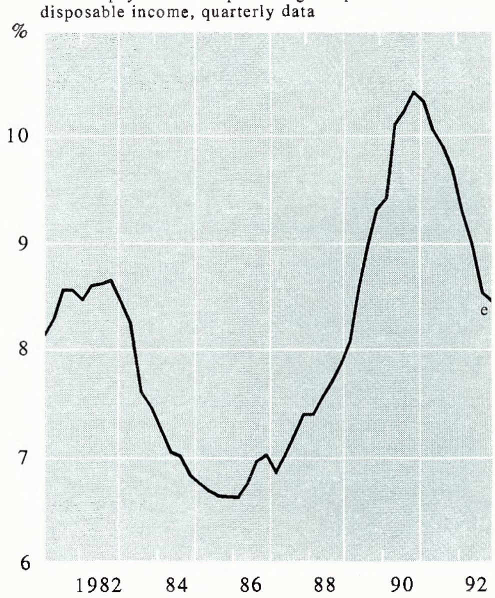
ᵉ Estimate

found their debt loads more difficult to carry. Nonetheless, many households were evidently willing to borrow and lenders were quite prepared to lend, especially in the form of mortgages.

There are a number of factors behind the continued strength of household borrowing. First, the declines in interest rates led to a significant reduction in the debt-service ratio and to an improvement in the affordability of housing, thus encouraging home buying. Second, the estimated market value of total household assets increased at almost the same rate as debt. Third, although housing prices are lower than at their peak, selling prices in most instances are still substantially higher than those at which the houses were last mortgaged. Therefore, the typical size of new mortgages on existing houses is also likely to be significantly higher. Indeed, the ratio of mortgage debt outstanding to the estimated market value of the housing stock is only now returning to its previous peak, reached in 1979. Fourth, an increase in the maximum loan-to-value ratio on mortgage loans insured by the Canada Mortgage and Housing Corporation has tended to increase somewhat the average loan-to-value ratio.

Estimated household debt service ratio

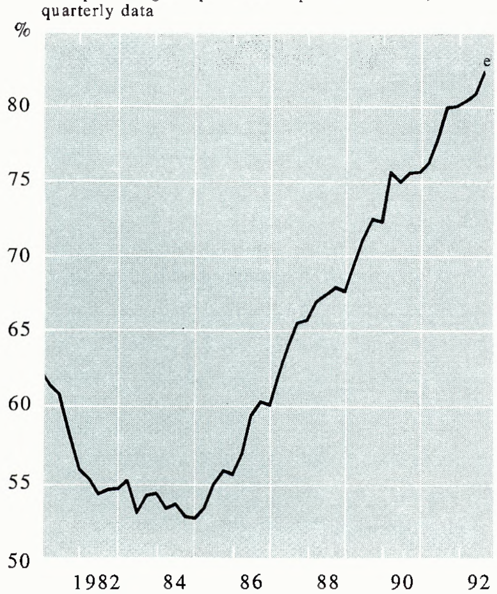
Interest payments as a percentage of personal disposable income, quarterly data



[e] Estimate

Total household credit

As a percentage of personal disposable income, quarterly data



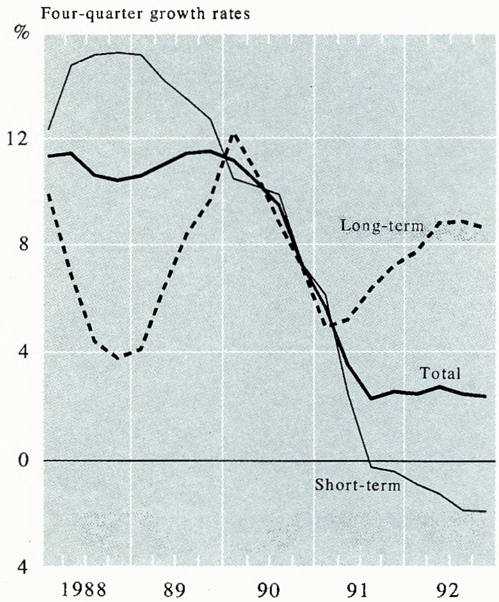
[e] Estimate

Within household credit, the strong growth in mortgage credit more than offset the decline in consumer credit over the past year, a pattern that was particularly evident at banks. This suggests that households were borrowing against the equity in their houses, taking out larger mortgages in part to reduce other types of household loans. These loans tend to bear higher interest rates and to have shorter repayment periods than mortgage debt.

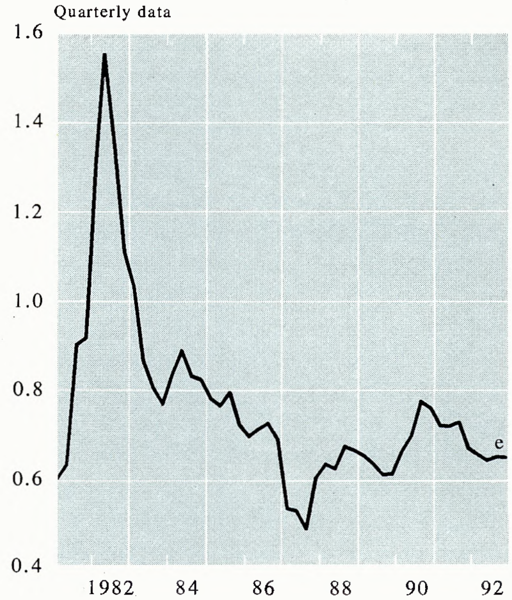
Total business credit continued to grow at about 2½ per cent in 1992, reflecting weak overall investment spending, in turn largely related to declines in non-residential construction.

Even though short-term borrowing costs were well below long-term borrowing costs for most of the year, businesses continued to substitute into long-term sources in order to lessen the risk of interrupted access to funds. The overall ratio of non-financial enterprise debt to equity (whether on a market value or book value basis) was essentially unchanged from 1991.

Business credit

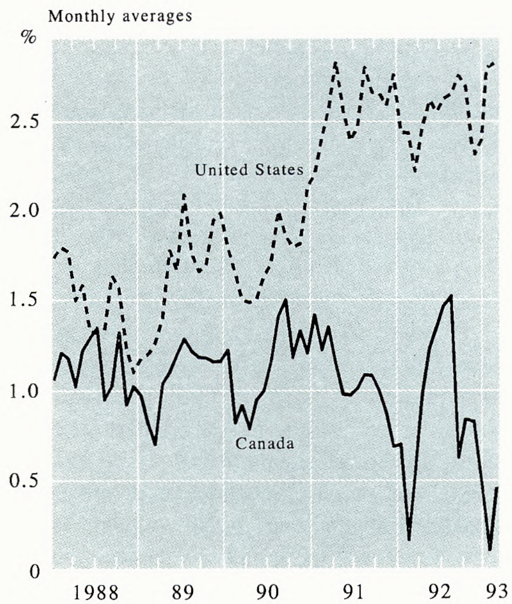


Non-financial debt-to-equity ratio (market value)



Credit-market debt only (excludes loans with affiliated corporations, accrued tax liabilities and other liabilities)
e Estimate

Differential between prime rate and 90-day commercial paper



In response to the commercial real estate slump, the supply of credit to firms seeking loans using commercial real estate as collateral has tightened significantly. Furthermore, a number of financial institutions have had to take substantial loan loss provisions against real estate related loans.

Nevertheless, spreads between the prime business loan rate and commercial paper rates were within or below their normal historical range. In fact, at the end of 1992 and in early 1993 these spreads were pushed well below that range as financial institutions competed vigorously for business loans.

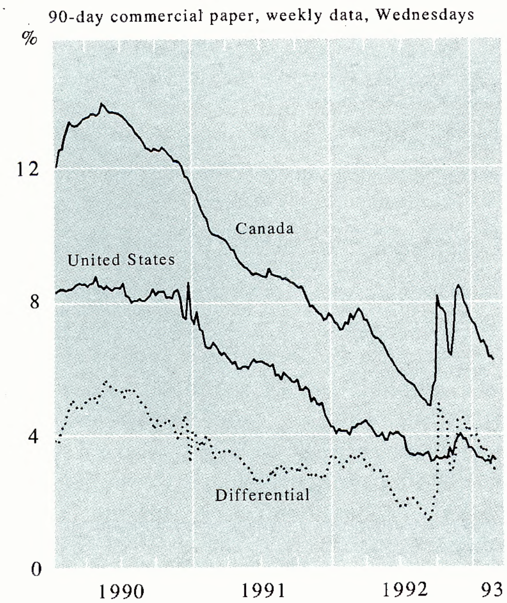
Monetary conditions

In response to lower inflation and the continued restrained pace of economic expansion, monetary conditions eased substantially during 1992. Short-term interest rates on average were much lower than in 1991 and the exchange value of the Canadian dollar fell significantly during the year.

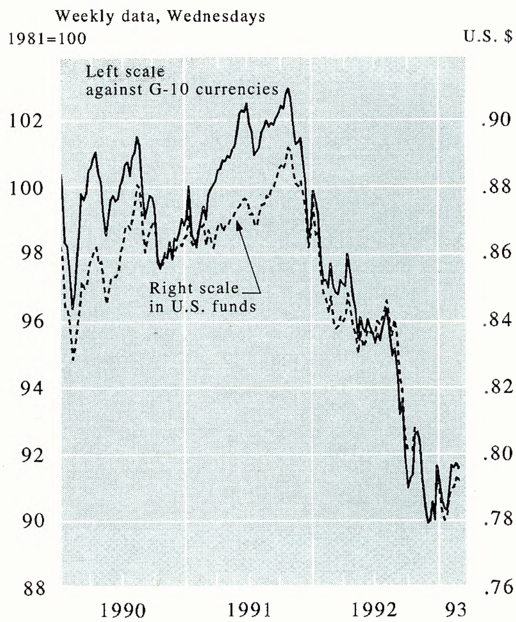
Continuing the downward trend that has been evident since mid-1990, short-term interest rates declined from 7½ per cent at the beginning of the year to 4¾ per cent in early September. In the autumn, markets were subjected to the extreme volatility discussed in the first section of this report. Short-term interest rates backed up sharply to 9 per cent when the exchange value of the dollar came under marked downward pressure. Rates subsequently declined, falling by year-end to 7¼ per cent and by the end of February to about 6 per cent.

In the context of narrowing interest rate differentials vis-à-vis U.S. instruments through much of the year, weak commodity prices and the slow pace of economic activity, the Canadian dollar fell 9 per cent through 1992 against its U.S. counterpart and 8 per cent against G-10 currencies on a trade-weighted basis. The fall in the value of the Canadian dollar was concentrated in the January-March and September-November periods; in the latter period concerns about the constitutional referendum as well as about budgetary and current account deficits were apparently elements in the dollar's decline. The dollar stabilized in December and traded between 77½ cents U.S. and 80 cents U.S. in early 1993.

Canada-U.S. short-term interest rates



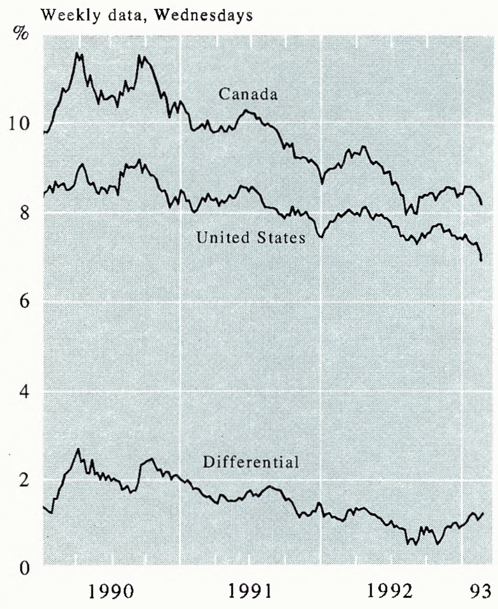
Canadian dollar exchange rate



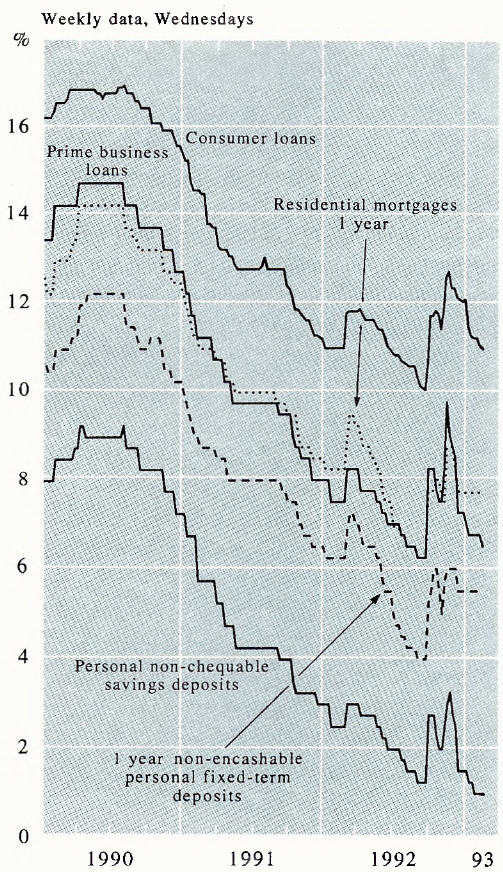
Canadian long-term bond yields, which had come down over 2½ percentage points from their peak in 1990, fell a further ½ of a percentage point in 1992. The differential with respect to U.S. yields also came down by about ½ of a percentage point during the year to stand at about 1 percentage point at the end of the year. Increased confidence in monetary stability contributed to the downward trend in bond yields and to the fact that they were less affected than short-term interest rates by the turbulence in financial markets in the autumn.

Administered rates in 1992 on average were below those in 1991. Through the year they generally followed the movement of market rates for similar maturities. Thus, although there was a spike in the autumn, administered rates generally finished 1992 below their end-1991 levels. Mortgage rates were down by about ¾ of a percentage point to just under 7¾ per cent at the one-year term and by almost ½ of a percentage point to 9½ per cent at five years. The prime rate on business loans at chartered banks dropped ¾ of a percentage point to 7¼ per cent at year-end and by a further ¾ of a percentage point to 6½ per cent at the end of February, in part because of heightened competition among banks.

Yields on long-term Canadian and U.S. government bonds



Selected bank interest rates



Monetary policy operations

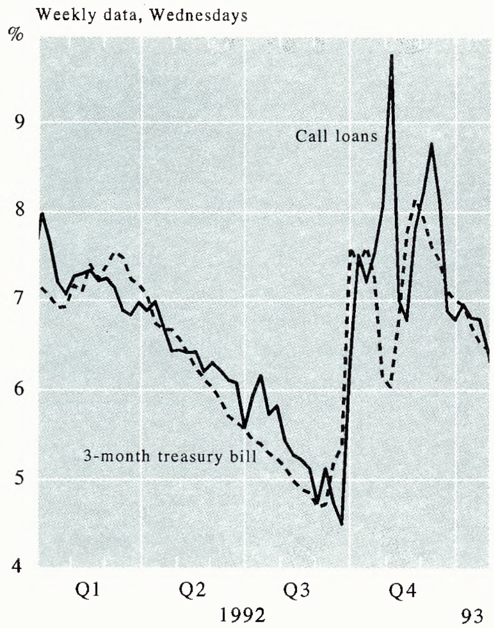
The Bank of Canada's monetary policy operations have their most direct effect on the overnight financing rate. While decisions about the Bank's day-to-day actions are focussed on bringing about particular levels for that rate, these decisions are taken with a view to influencing overall monetary conditions in a direction consistent with the broad anti-inflationary thrust of policy. At times of unusual volatility in financial markets, with uncertainty in the exchange markets feeding through to the money markets, the Bank's actions are designed to encourage greater steadiness by helping the markets to find viable trading ranges.

Over the period to the beginning of September, with the exception of an interval during February and March, market expectations of declining short-term interest rates were prevalent. These expectations were sufficiently strongly held at times that the Bank acted on a number of occasions to temper the pace of decline and thus to contribute to the sustainability of the reductions in short-term interest rates. This often resulted in the call loan and other overnight interest rates being above the 3-month treasury bill rate.

The main way in which the Bank achieved the relative tightening in call loan financing was by limiting the supply of settlement balances held by directly clearing members of the Canadian Payments Association (CPA) at the Bank of Canada, relative to the amount they wished to hold. This in turn reduced the willingness of the direct clearers to provide overnight financing to investment dealers and thus led to an increase in the call loan rate. When undue downward pressure on short-term rates persisted, the Bank sold treasury bills into the market. On occasion, it also moved to tighten overnight financing directly through sale and repurchase agreements (SRA) – offering to sell bills to chartered banks and to buy them back the next business day – at a rate of the Bank's choosing.

During February and March 1992, persistent downward pressure on the Canadian dollar in the foreign exchange market led to upward pressure on short-term interest rates on Canadian dollar-denominated securities. In this period the Bank provided the financial system with settlement balances sufficient to keep the call loan rate below the 3-month treasury bill

Call loan and 3-month treasury bill rates



rate, in order to avoid adding pressure to money market rates generally. When rates were higher than intended, the Bank bought bills outright in the market or, more usually, eased the cost of financing directly through special purchase and resale agreements (SPRA) – offering to buy treasury bills from designated investment dealers and banks and to sell them back the next business day – at a rate of the Bank's choosing.

In the autumn, domestic financial markets experienced a period of extreme volatility. Bouts of weakness of the Canadian dollar in the currency markets during September and again in November prompted abrupt swings in short-term interest rates. As market rates initially adjusted sharply upwards, the Bank acted to ratify the higher levels. At times, however, the extremely unsettled nature of the market meant that the interaction between the Bank's actions and the market was less smooth than normal. To encourage steadiness and help the market find viable trading ranges, the Bank adjusted the supply of settlement balances, adding temporary liquidity when necessary. To provide further guidance for overnight rates, the Bank through this period also made limited use of SRA and SPRA offerings.

Late in the year, financial markets responded to a more stable Canadian dollar by aggressively pushing for lower interest rates. The Bank acted to moderate this downward movement in interest rates, by raising the overnight rate above the 3-month treasury bill rate and, at times, by selling treasury bills into the market. These operations were designed to ensure that the declines in interest rates would be measured and thus sustainable. Details of the Bank's open market operations throughout the year are provided in Table 1.

In 1992 the Bank made purchases, net of maturities, of $32.7 billion of newly issued treasury bills. Its purchases were used primarily in subsequent open market sales, although it also sold over $5.0 billion to clients (central banks, Government of Canada accounts and international agencies). After account is taken of net sales in the market for monetary policy purposes, the Bank's holdings of bills increased by more than $1.5 billion during the year. These assets were acquired in the main as the counterpart to the increase in the Bank's liabilities for bank notes.

In June 1992 the proclamation of the new financial legislation led to minor modifications of the monetary policy operating framework that had been set up in November 1991. The primary reserve requirements of the chartered banks, which are being phased out over a period of two years, must now be satisfied over the same month-long period used for calculating settlement balances. Direct clearers usually meet cumulative end-of-period deficiencies by taking the option of paying a fee rather than by taking an advance. Information on the operation of the settlement balance system is provided in Table 2.

Table 1
Bank of Canada transactions

Millions of dollars unless otherwise indicated

	Sale and repurchase agreements (SRA)		Special purchase and resale agreements (SPRA)		Purchase and resale agreements (PRA)[1]		Treasury bills[2]		
	Number of days offered	Average amount outstanding[3]	Number of days offered	Average amount outstanding[3]	Number of days	Average amount outstanding[3]	Market sales[4]	Market purchases[4]	Purchases at tender net of maturities and of transactions with clients
1992									
January	1	11.4	3	45.5	14	153.6	2,363.0	321.0	2,328.2
February	2	17.8	1	21.0	5	29.2	0.0	0.0	429.9
March	5	29.5	4	61.6	2	8.7	764.0	409.0	996.6
April	4	109.5	4	92.6	3	26.9	2,555.0	385.0	863.2
May	3	71.3	0	0.0	4	42.8	2,960.0	0.0	2,695.1
June	0	0.0	0	0.0	11	107.0	3,595.0	0.0	4,164.6
July	0	0.0	3	29.5	21	224.5	2,597.0	1,176.5	3,529.6
August	1	1.2	2	75.0	13	110.7	2,417.0	882.0	1,335.5
September	2	0.0	3	80.2	5	68.7	516.0	0.0	2,044.0
October	1	0.0	1	50.5	13	170.7	4,607.0	0.0	1,427.4
November	4	74.5	1	38.0	9	126.2	2,490.0	0.0	3,135.7
December	3	14.3	2	10.7	10	91.8	4,712.0	294.0	4,699.7
1993									
January	2	10.0	0	0.0	7	87.5	3,956.4	52.4	2,856.2

1. PRA is a form of financing available to investment dealer jobbers at their initiative at Bank Rate and up to a predetermined limit.
2. Par value.
3. Average based on the number of clearing days.
4. Exclude purchases at tender and transactions with clients. Include portfolio-related switches of bills with money market participants.

Table 2
Settlement balances, advances and overdrafts

Millions of dollars unless otherwise indicated

		End-of-period computed settlement balances[1]		Average overdraft loans to direct clearers[5]	Reserve advances to chartered banks[2]	
		Excess cumulative[3]	Cumulative deficiency[4]		I	II
1991 1992	Dec. 16 – Jan. 15	625	118	135	715	650
	Jan. 16 – Feb. 16	465	521	141	553	483
	Feb. 17 – Mar. 15	2,367	216	79	286	201
	Mar. 16 – Apr. 15	1,945	174	123	108	0
	Apr. 16 – May 18	2,270	504	102	611	773
	May 19 – June 15	−435	635	135	560	992
	June 16 – July 15	−1,175	1,344	216		
	July 16 – Aug. 19	−1,228	1,344	139		
	Aug. 20 – Sept. 16	360	718	176		
	Sept. 17 – Oct. 21	−394	1,349	172		
	Oct. 22 – Nov. 18	1,950	350	202		
	Nov. 19 – Dec. 16	1,234	101	151		
1993	Dec. 17 – Jan. 20	−1,964	2,297	238		
	Jan. 21 – Feb. 17	−421	1,821	262		

1. Before the effective date of the new Bank Act changes, the calculation period spanned two reserve-averaging periods. Beginning with the 16 June period, the calculation period became four or five weeks ending the third Wednesday of the calendar month.
2. Until 15 June, reserve requirements continued to be met over two half-monthly averaging periods and advances taken to meet reserve requirements counted towards calculation period requirements. Beginning 16 June, reserve requirements are automatically met when calculation period requirements are satisfied.
3. The cumulative amount by which the direct clearers in total exceed their required deposits at the Bank of Canada (for banks) or zero (for non-banks) over the calculation period.
4. The total of the amount by which those direct clearers with negative excess cumulatives fell short of their required deposits at the Bank of Canada (for banks) or zero (for non-banks) over the calculation period. The deficiency must be covered with either an advance or payment of a fee in lieu of an advance.
5. Average based on the number of clearing days.

BANK OF CANADA ACTIVITIES

The Bank of Canada operates under the management of a Board of Directors. The Board approves the objectives, plans and budget for the Bank and in general seeks to ensure that the Bank's functions are carried out effectively and economically.

The Bank of Canada Act prescribes four major functions for the Bank: monetary policy, banking activities, bank note issue, and management of Government of Canada debt. To fulfil adequately these functions the Bank has to operate with a medium-term orientation. Consequently, the Bank's planning has a medium-term focus.

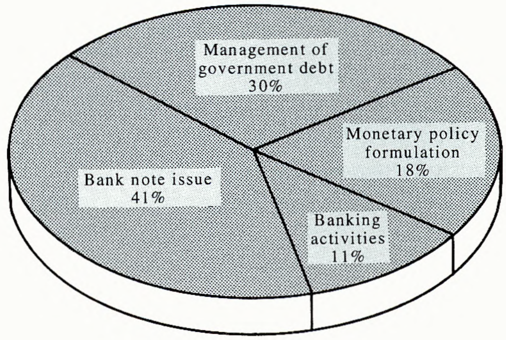
In the area of monetary policy, targets for the reduction of inflation over the 1991 to 1995 period were jointly announced by the Bank of Canada and the Government of Canada in February 1991. Progress towards this objective is discussed in the General Observations section of this report and in the section dealing with economic activity and inflation.

As regards bank notes, the Bank is in the midst of an investment program to replace outdated equipment and to construct automated note-processing centres in Montreal and Toronto. This will improve the efficiency of bank note handling. The extensive commitments to the research and development associated with the new series of bank notes first introduced in 1986 will be completed with the introduction in 1993 of a $20 note incorporating the Optical Security Device.

The Bank's medium-term plan involves the gradual replacement of the automated systems supporting its banking and government debt operations in order to take advantage of the greater efficiency and flexibility of new technology.

The activities in 1992 relating to each of the Bank's major functions are reviewed in more detail below. The functional allocation of the Bank's net operating costs for 1992 of $202 million is illustrated in the following chart.

Operating costs by function



Monetary policy formulation

Monetary policy formulation involves seeing to it that monetary expansion is consistent with achieving price stability over time. In making judgments about the associated monetary conditions, the Bank assesses financial and economic developments in Canada and abroad. This process involves the examination of economic and financial statistics along with meetings with industry associations and individual companies, liaison with financial market participants, and a wide range of other contacts across the country.

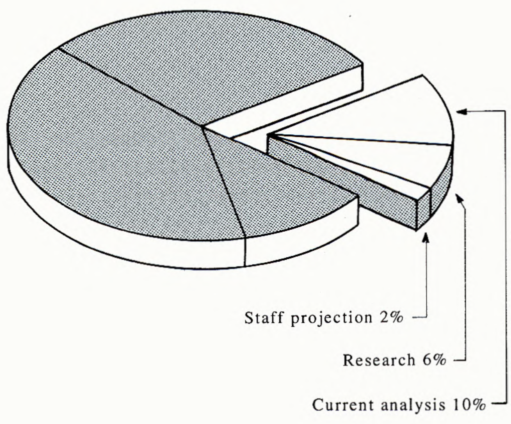
As part of its involvement in international financial matters the Bank participates in international meetings, including those of the finance ministers and central bank governors of the Group of Seven countries (the G-7), the Organisation for Economic Co-operation and Development, the Bank for International Settlements and the International Monetary Fund (IMF).

On the basis of information gathered from both domestic and international sources, supplemented by studies on how the economy works, economists at the Bank prepare analyses and projections of economic and financial developments. These are used in making decisions about the conduct of monetary policy.

Senior staff also discuss policy issues and progress in meeting objectives with a variety of groups in Canada. In 1992, officers of the Bank met frequently with academics, interest groups, industry and financial groups, and provincial officials across the country, exchanging information on the state of the national and regional economies. The directors of the Bank were active in organizing meetings in the various regions of the country. The Governor participated in meetings across the country, gave a number of public speeches and appeared on three occasions before parliamentary committees.

The Bank provides technical assistance, typically under the auspices of the IMF, to central banks in developing countries, Eastern Europe and the republics of the former Soviet Union. In 1992 Bank staff provided such assistance in nine countries.

Allocation of operating costs related to monetary policy formulation



Banking activities

The Bank undertakes a number of banking activities relating to the implementation of monetary policy and the provision of financial services to the Government of Canada and other clients.

Market operations

Market operations related to the conduct of monetary policy have been described in detail in an earlier section of this report.

Using the resources of the Exchange Fund Account (EFA) and acting on behalf of the Minister of Finance, the Bank of Canada intervenes in the foreign exchange market to help maintain orderly conditions in the market and to mitigate fluctuations in the value of the Canadian dollar. Intervention generally involves purchases or sales of U.S. dollars in exchange for Canadian dollars, but can also take place in German marks or Japanese yen.

During 1992, Canada's official reserves declined from U.S.$16.9 billion to U.S.$11.9 billion. The impact on these reserves of the foreign exchange operations undertaken to moderate the movements in the external value of the Canadian dollar over the year was partially offset by U.S.$2.0 billion of maturing EFA cash management swaps, a net increase in reserves of U.S.$0.9 billion attributable to the sale of 3 million ounces of gold and the addition of U.S.$0.7 billion resulting from the reactivation of the Canada Bills program in the U.S. market.

In addition to undertaking foreign exchange and gold transactions, the Bank of Canada manages the portfolio of reserve assets held by the Exchange Fund Account. To enhance the efficiency of these activities, the Bank plans to replace some of the automated and manual systems used in the execution, recording and management of currency and gold operations.

Administration of accounts

In conjunction with the Department of Finance, the Bank actively manages the government's cash balances in order to minimize the cost of the government's liquidity and debt-service requirements. The regular weekly treasury bill tender varied in 1992 between $5.1 billion and $7.8 billion, depending on cash needs.[1] In addition, there were 21 issues of cash management treasury bills (with original terms

[1] In late November 1992, the normal day for the treasury bill tender was changed from Thursday to Tuesday. This initiative was taken, after discussions with the investment community, to improve the efficiency of the market for treasury bills.

ranging from 17 to 46 days), totalling $28.0 billion, compared with 11 issues totalling $13.5 billion in 1991. Moreover, in 1992 the Exchange Fund Account swapped some of its foreign currency assets with Canadian banks for Canadian dollars for terms of 3 to 92 days.

In order to limit the government's demand deposit balances to the minimum cushion necessary for implementing monetary policy and for government payments, cash balances in excess of daily requirements were auctioned to direct clearers for specific terms of one to ten days; the daily amount outstanding of such term balances averaged $2.0 billion in 1992, and ranged up to $6.8 billion. Shares of demand deposits were auctioned to the direct clearers twice a month until August, and then once a week following changes to the government's banking arrangements with the directly clearing members of the Canadian Payments Association.

The Bank of Canada also maintains deposit accounts for 57 foreign central banks, thereby facilitating the official transactions that these banks or their governments may have in Canadian dollars. In 1991, the Bank of Canada entered into an agreement with the central bank of Mexico that provided for establishment of a reciprocal stand-by currency facility and for regular consultations on financial and economic matters. The first of these consultations took place in Ottawa in September 1992. There have been no drawings on the facility. A similar facility has been in place with the U.S. Federal Reserve Bank of New York since 1962.

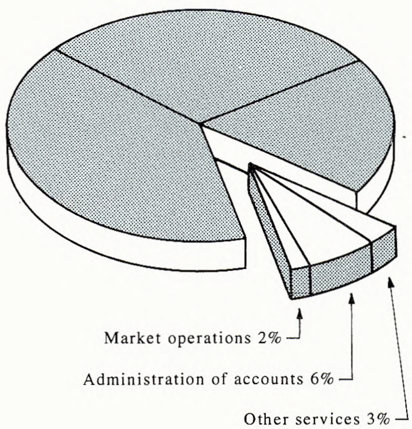
Other banking activities

The Bank of Canada acts as registrar of Notices of Intention by the chartered banks to take security for loans, in the form of certain classes of equipment and inventory, under the Bank Act. In order to recover associated costs, the fees charged by the Bank for these services were increased at the beginning of June 1992, with proclamation of the new Bank Act. As well, unclaimed balances at chartered banks are transferred to the Bank for custody after being inactive for ten years. The records of these balances may be reviewed by the public free of charge at any Bank of Canada Agency.

The Bank plays an advisory role with respect to the regulation and supervision of financial institutions. To ensure close co-ordination between the Bank's lender of last resort responsibility and the supervisory activities of the Office of the Superintendent of Financial Institutions, the Governor is an ex officio member of the Financial Institutions Supervisory Committee, chaired by the Superintendent. The Governor is also an ex officio member of the Board of Directors of the Canada Deposit Insurance Corporation.

To improve the soundness and efficiency of Canada's clearing and settlement systems and to meet its own operating requirements, the Bank is involved in a number of areas. It is working with other members of the Canadian Payments Association in an examination of proposals for a large-value transfer system and with the Canadian Depository for Securities (CDS) in the development of the Debt Clearing Service (DCS) to handle the clearing and settlement of bond and money market securities transactions. With the conclusion of an agreement in principle on the risk-proofing of the government bonds segment of the DCS, preparations for the implementation of this first phase of the DCS were recently announced by CDS. Subject to successful completion of the implementation arrangements, the new system for clearing and settling Government of Canada marketable bonds is expected to begin operation in the autumn of 1993. The Bank is also a member of committees working to implement in

Allocation of operating costs related to banking activities



Canada the recommendations of the report of the Group of Thirty on internationally consistent standards for clearing and settling securities transactions. As well, it is involved in discussions with financial institutions concerning a multilateral foreign exchange netting mechanism.

Bank note issue

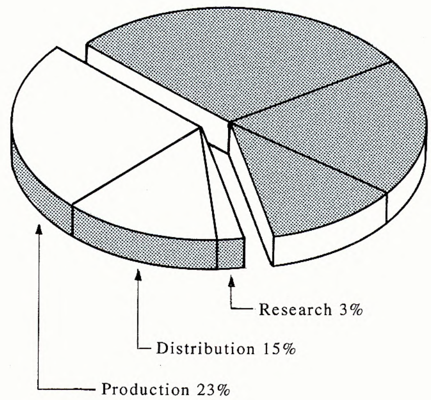
Notes are issued by the Bank to meet the public's demand for additional notes and to replace worn notes taken out of circulation. Besides issuing new notes, the Bank reissues used notes still fit for circulation that have been returned by financial institutions finding themselves with excess holdings. At the end of 1992, the value of notes in circulation amounted to $25.6 billion, over 90 per cent of the Bank of Canada's total liabilities.

Over 4.6 billion notes were processed by the Bank in 1992 at its Agencies across the country, a slight increase from the previous year. This volume reflects withdrawals of notes by financial institutions and the return of used notes to the Bank by those institutions.

Note processing is heaviest at the Montreal and Toronto Agencies, each of which has accounted for over one-quarter of the total in recent years. Since the present facilities were built, in 1950 in Montreal and in 1958 in Toronto, the volume of bank notes processed in each of these centres has increased about tenfold. In order to handle work volumes more efficiently, the Bank is constructing new cash-processing centres outside the financial district in both Montreal and Toronto. These centres will use newer technology that will improve productivity. The Montreal facility is nearing completion. It is scheduled to start operations in the spring of 1993 and to become fully operational later in the year. The Toronto facility, now under construction, is scheduled to be fully operational in the summer of 1994.

As part of its program to deter counterfeiting, the Bank has acquired additional equipment to produce its Optical Security Device (OSD) and to apply it to bank notes. This equipment is required to incorporate the OSD on the new $20 note, the last in the new series of notes. The $20 note is the most heavily used Canadian note, and the number of new $20 notes withdrawn by financial institutions each year is more than three times that of all of the higher-denomination notes to which the OSD is already applied. New $50 and $100 notes incorporating the OSD were introduced in 1989 and 1990, and a new $1,000 note with the OSD was first issued in May 1992.

Allocation of operating costs related to bank note issue

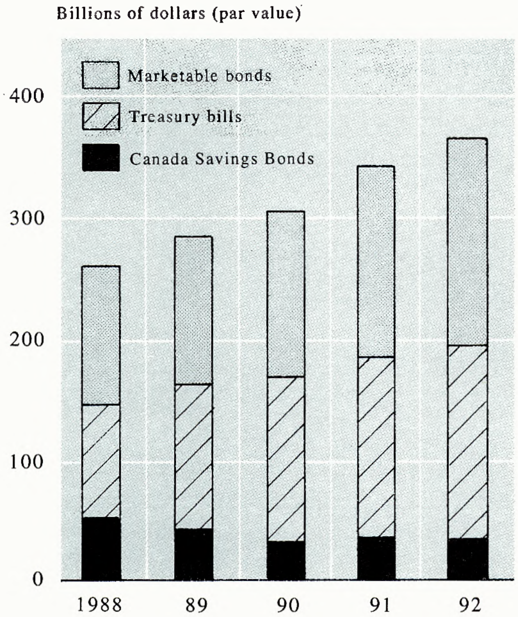


Management of Government of Canada debt

As statutory fiscal agent for the government, the Bank of Canada acts as adviser and administrator for new debt issues and is responsible for servicing and eventually redeeming outstanding debt. In 1992, the government's Canadian dollar market debt outstanding – marketable bonds, treasury bills and Canada Savings Bonds (CSBs) – increased by $25.8 billion to $366.5 billion.[2] The government's foreign currency debt in Canadian dollar terms increased to $3.8 billion from $3.6 billion. The increase in the Canadian dollar value of this debt, resulting from the decline in the external value of the Canadian dollar and the reactivation in December of the government's program of

[2] The government's total debt in Canadian dollars includes non-market debt held by Government of Canada accounts, almost all of it by superannuation accounts.

Outstanding stock of Canadian dollar market debt



short-term borrowings denominated in U.S. dollars, more than offset the paydown of maturing bond issues.

Over one-half of the increase in outstanding Canadian dollar market debt was in the form of marketable bonds, which rose to 47 per cent of the total. In April the government advised the market that all regular issues of marketable bonds would in future be sold at auction, completing a process begun in 1983. A second issue of Real Return Bonds, whose nominal return is linked to the consumer price index, was also placed in 1992. This $500 million issue brought the amount outstanding of such bonds to $1.2 billion.

The proportion of outstanding domestic market debt in the form of treasury bills increased slightly in 1992, to 43.5 per cent. The average term of the marketable portion of the outstanding domestic debt (bonds and treasury bills) remained unchanged at 4 years and 5 months. The proportion of the Canadian dollar market debt on which interest rates are adjusted within a year (including $7.1 billion of Canadian dollar interest rate swaps outstanding at the end of 1992) increased slightly during the year to 60 per cent.

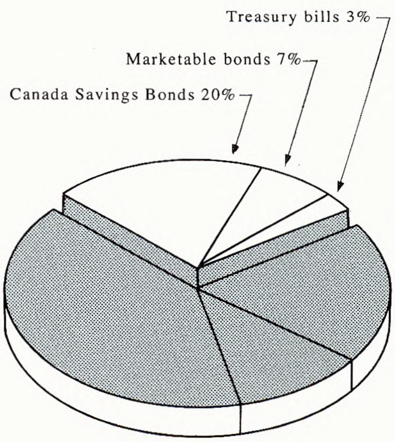
The amount of Canada Savings Bonds outstanding declined by $0.9 billion in 1992. Gross sales of the new issue of CSBs were $9.2 billion compared with $9.6 billion in 1991. The proportion of outstanding domestic market debt in the form of CSBs decreased for the fifth consecutive year, to 9.5 per cent from 23.4 per cent in 1987.

The Bank is responsible for the integrity of the domestic public debt records and for the accuracy and efficiency of the payments it makes on behalf of the government for interest and debt redemption. The volume of processing involved in administering the debt increased in 1992, following two years of decline, as a result of activity related to servicing CSBs.

CSBs account for about three-quarters of the total processing volume each year. The increase in servicing activity in 1992 mainly reflected the first full-year effect of a requirement, starting with the 1990 series, that the Bank begin reporting to CSB holders accrued interest income each year on compound interest bonds. Most of the reports for 1991 were not processed until early 1992. Activity related to the issue of new CSBs declined, reflecting lower sales in 1992.

Processing related to marketable bonds has been decreasing for the past three years, mainly reflecting the inclusion of these bonds in the computerized clearing and settlement

Allocation of operating costs related to management of government debt



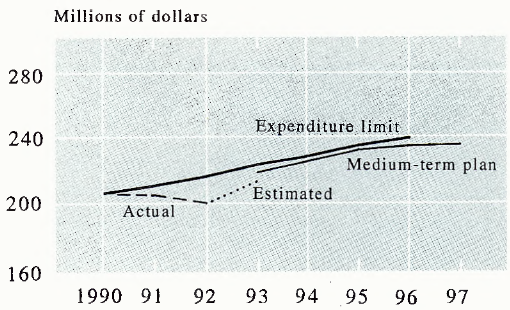
systems of the Canadian Depository for Securities. As a result of this initiative, there has been a substantial reduction in the number of certificates processed and a consolidation of interest payments.

The Bank has developed an automated register for marketable bonds to replace the former paper-based system. This change provides a more effective and secure processing environment than is possible with a manual system. The Bank is also considering options to redevelop the automated CSB systems so as to provide for increased flexibility and better service to bondholders.

Operating expenses

The medium-term plan, updated and approved each year by the Board of Directors of the Bank, sets the framework for the Bank's activities and annual operating expenses. In the period to 1996 the plan incorporates an expenditure limit that restricts the average growth in operating expenses to no more than the average rate of inflation contained in the inflation-reduction targets. A reduction in the Bank's expenditures from 1990 to 1992 provides some room within this expenditure limit to accommodate the major planned initiatives, mentioned earlier, that are required for the Bank to fulfil its responsibilities in the period ahead.

Net operating expenses



1992 expenses

The Bank's operating expenses, net of costs recovered, were less in 1992 than in 1991. The composition of these expenses is shown in the following table.

Net operating expenses
(Millions of dollars)

	1992	1991
Staff expenses	$97.6	$97.5
Bank note costs	35.8	41.7
Other expenses	48.4	49.2
Depreciation	19.8	17.2
	$201.6	$205.6

Staff expenses were little changed in 1992. Salary expenditures declined as pay scales were held unchanged and staff years employed were reduced by 3 per cent. However, the cost of pension and insurance plans rose.

Bank note costs declined by 14 per cent in 1992, mostly reflecting a decrease in production of new notes. The savings were associated in part with enhancements to automated note-processing equipment and steps to reduce the average inventory of notes on hand. A partial offset to these savings came from the additional depreciation associated with the purchase of equipment for the production of the new $20 note.

1993 estimated expenses

While the Bank's pay scales for 1993 remain unchanged, provision has been made for introducing a new job evaluation system designed to ensure equal pay for work of equal value, in line with the Canadian Human Rights Act. Bank note costs are expected to be held close to the 1992 level. Other expenses, however, will increase, mainly as a result of the start-up of operations at the new Montreal operations centre. Completing the facility in Montreal will mean a substantial increase in depreciation expense.

FINANCIAL STATEMENTS

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

C.P. 813, SUCCURSALE B

OTTAWA, CANADA
K1P 5P9

P.O. BOX 813, STATION B

RAYMOND, CHABOT, MARTIN, PARÉ

PEAT MARWICK THORNE

AUDITORS' REPORT

We have audited the statement of assets and liabilities of the Bank of Canada as at December 31, 1992 and the statement of revenue and expense for the year then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Bank as at December 31, 1992 and the results of its operations for the year then ended in accordance with the accompanying summary of significant accounting policies applied on a basis consistent with the preceding year.

Raymond, Chabot, Martin, Paré

Peat Marwick Thorne

Chartered Accountants

Ottawa, Canada

January 22, 1993

Bank of Canada
Statement of revenue and expense

Year ended 31 December 1992
(with comparative figures for 1991)

	1992	1991
	Millions of dollars	
REVENUE:		
Revenue from investments, net of interest paid on deposits of $26.7 ($39.0 in 1991)	**$2,007.5**	$2,324.4
OPERATING EXPENSES:		
Staff expenses (note 2):		
Salaries	**$ 78.3**	$ 80.2
Contributions to pension and insurance funds	**13.7**	11.8
Travel and staff transfers	**2.7**	2.7
Other staff expenses	**2.9**	2.8
	97.6	97.5
Bank note costs	**35.8**	41.7
Other expenses:		
Premises maintenance – net of rental income	**19.9**	21.2
Taxes – municipal and business	**11.5**	10.9
Directors' fees	**0.1**	0.1
Auditors' fees and expenses	**0.6**	0.6
Data processing and computer costs	**8.3**	7.5
Printing of publications	**0.7**	0.7
Other printing and stationery	**1.8**	2.0
Postage and express	**1.5**	1.7
Telecommunications	**1.8**	1.9
Other expenses – net (note 3)	**2.2**	2.6
	48.4	49.2
Depreciation on buildings and equipment	**19.8**	17.2
	201.6	205.6
NET REVENUE PAID TO RECEIVER GENERAL FOR CANADA	**$1,805.9**	$2,118.8

(See accompanying notes to the financial statements)

Bank of Canada
Statement of assets and liabilities

As at 31 December 1992
(with comparative figures for 1991)

ASSETS	1992	1991
	Millions of dollars	
Deposits payable in foreign currencies:		
U.S.A. dollars	$ 163.2	$ 230.7
Other currencies	9.6	6.2
	172.8	236.9
Advances to members of the Canadian Payments Association (note 8)	224.5	1,173.9
Investments — at amortized values:		
Treasury bills of Canada	14,393.6	12,819.1
Other securities issued or guaranteed by Canada maturing within three years	3,210.1	3,920.1
Other securities issued or guaranteed by Canada not maturing within three years	4,763.3	5,356.6
Other investments	4,177.7	3,002.9
	26,544.7	25,098.7
Bank premises (note 4)	233.4	196.6
Other assets	266.2	339.0
	$27,441.6	$27,045.1

(See accompanying notes to the financial statements)

LIABILITIES	1992	1991
	Millions of dollars	
Capital paid up (note 5)	**$ 5.0**	$ 5.0
Rest fund (note 6)	**25.0**	25.0
Notes in circulation	**25,609.2**	24,481.4
Deposits:		
Government of Canada	**20.1**	21.0
Chartered banks	**1,116.8**	1,617.9
Other members of the Canadian Payments Association	**88.8**	133.6
Other deposits	**512.9**	559.4
	1,738.6	2,331.9
Liabilities payable in foreign currencies:		
Government of Canada	**28.1**	95.6
Other liabilities	**35.7**	106.2
	$27,441.6	$27,045.1

Governor, **J. W. CROW**

Chief Accountant, **J.-P. AUBRY**

Bank of Canada
Notes to the financial statements
Year ended 31 December 1992

1. Significant accounting policies:

The financial statements of the Bank conform to the disclosure and accounting requirements of the Bank of Canada Act and the Bank's by-laws. The significant accounting policies of the Bank are:

a) Revenues and expenses:

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

b) Investments:

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

c) Translation of foreign currencies:

Assets and liabilities in foreign currencies are translated to Canadian dollars at the rates of exchange prevailing at the year-end. Gains and losses from translation of, and transactions in, foreign currencies are included in revenue.

d) Bank premises:

Bank premises, consisting of land, buildings and equipment, are recorded at cost less accumulated depreciation. Depreciation is calculated on the declining balance method using the following annual rates:

Asset	Rate
Buildings	5%
Computer equipment	35%
Other equipment	20%

A full-year of depreciation is charged against assets in the year of acquisition, except for projects in progress which are depreciated from the point of substantial completion. No depreciation is taken on assets in the year of disposal.

e) Pension plan:

Pension plan expense is recorded on the basis of the Bank's contributions. Actuarial surpluses or deficiencies, if any, are amortized over periods not exceeding those provided for by the Pension Benefits Standards Act, 1985, and the regular contributions are adjusted accordingly.

f) Insurance:

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

2. Staff expenses:

Wages and benefits of Bank staff engaged in premises maintenance are not included in this category but rather as part of the Premises maintenance expenses.

3. Other expenses - net:

Other expenses - net includes expenses recovered through fees for a variety of services provided by the Bank ($1.3 million in 1992 and $.7 million in 1991).

4. Bank premises:

	1992			1991		
	Millions of dollars					
	Cost	Accumulated depreciation	Net book value	Cost	Accumulated depreciation	Net book value
Land and buildings	**$210.6**	**$ 82.1**	**$128.5**	$174.6	$ 79.2	$ 95.4
Computer equipment	**40.4**	**29.8**	**10.6**	43.4	31.7	11.7
Other equipment	**95.8**	**50.3**	**45.5**	68.6	44.2	24.4
	346.8	**162.2**	**184.6**	286.6	155.1	131.5
Projects in progress	**48.8**	**–**	**48.8**	65.1	–	65.1
	$395.6	**$162.2**	**$233.4**	$351.7	$155.1	$196.6

5. Capital:

The authorized capital of the Bank is $5.0 million divided into 100,000 shares of the par values of $50.00 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 Canada.

6. Rest fund:

The rest fund was established by the Bank of Canada Act and represents the general reserve of the Bank. In accordance with the Act, the rest fund was accumulated out of net revenue until it reached the stipulated maximum amount of $25.0 million in 1955. Subsequently all net revenues have been paid to the Receiver General for Canada.

7. Commitments:

As at 31 December 1992, outstanding commitments under contracts for new buildings and equipment totalled $29.2 million. These contracts call for payments over the next two years.

8. Legal matters:

Advances include a total of $29.5 million, unchanged from 1991, provided to the Canadian Commercial Bank and the Northland Bank for which winding-up orders have been issued by the courts. On the basis of the available information, it is the opinion of the Bank of Canada that this amount will be fully repaid from the proceeds of the liquidations.

The Bank of Canada's security for these advances includes the loan portfolios of those institutions. In the case of the Canadian Commercial Bank, the liquidator's conclusion that loans made by the Canadian Commerical Bank in California form part of the Bank of Canada's security has been challenged and this issue is before the courts. In the event of a final legal determination that part of the California loan portfolio is not included in the security, it could result in some adjustment to amounts which have been recorded in income. The information available at the present time is not sufficient to estimate the potential magnitude of such an adjustment.

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Gordon G. Thiessen	Senior Deputy Governor *Member of the Executive Committee*
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John T. Douglas	NEW GLASGOW, NOVA SCOTIA
William A. Graham	LONDON, ONTARIO
Frederick E. Hyndman	CHARLOTTETOWN, PRINCE EDWARD ISLAND *Member of the Executive Committee*
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Nancy Orr-Gaucher	WESTMOUNT, QUEBEC *Member of the Executive Committee*
Charles Pelletier, FCA	CHARLESBOURG, QUEBEC

Ex officio

David A. Dodge	Deputy Minister of Finance *Member of the Executive Committee*

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Donald R. Stephenson

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Frank J. Mahoney, *Deputy Comptroller*

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Janet Cosier, *Auditor*
Peter Koppe, *Deputy Auditor*

1. Also Chairman of the Board of Directors of the Canadian Payments Association
2. Also Deputy Chairman of the Board of Directors of the Canadian Payments Association

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Vancouver
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Department of Banking Operations

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