Report on the Management of Canada's Official International Reserves

2004

Canada

Report on the Management of Canada's Official International Reserves

2004

Department of Finance Canada
Ministère des Finances Canada

Available from the

Distribution Centre
Department of Finance Canada
Room P-135, West Tower
300 Laurier Avenue West
Ottawa, Ontario K1A 0G5
Tel: (613) 995-2855
Fax: (613) 996-0518

This document is available on the Internet at
www.fin.gc.ca

Cette publication est également disponible en français.

Cat. No.: F1-31/2004E
ISBN 0-662-40265-0

Table of Contents

Purpose of the Report

The 2004 *Report on the Management of Canada's Official International Reserves* provides a detailed overview of the Government's official international reserves management operations, primarily the operations of the Exchange Fund Account (EFA), for the 2004 calendar year.

The EFA, which represents the largest component of the official international reserves, is an actively managed portfolio of liquid foreign currency assets, maintained to provide foreign currency liquidity for the Government of Canada and to provide the funds needed to help promote orderly conditions for the Canadian dollar in foreign exchange markets. The EFA is funded by liabilities of the Government of Canada denominated in, or converted to, foreign currency. Assets and liabilities are matched as closely as possible in currency and duration to minimize the Government's exposure to currency and interest rate risks.

The EFA is governed by the provisions of the *Currency Act*, which requires the Minister of Finance to report to Parliament on the operations of the EFA for each calendar year within five months after the end of that year. As such, the report provides a comprehensive account of the framework within which the EFA is managed, its composition and changes during the year, and strategic policy initiatives. The accompanying financial statements, audited by the Auditor General of Canada, provide information on the year-end position in the EFA portfolio.

Canada's total official international reserves stood at US$34,467 million as of December 31, 2004 (Table 1). The official international reserves consist of the EFA (US$31,030 million), the reserve position in the International Monetary Fund (IMF) (US$3,327 million), and foreign currency accounts held by the Bank of Canada (US$105 million) and the Receiver General (US$5 million).

Table 1

The EFA and Official International Reserves

	2003	2004	Change
	(market value in millions of US dollars, as at December 31)		
Securities[1]	29,111	27,834	-1,277
Deposits	2,315	2,223	-92
Gold	45	48	3
Special drawing rights (SDRs)	838	925	87
Total EFA	32,309	31,030	-1,279
IMF reserve position	3,848	3,327	-521
Bank of Canada account	106	105	-1
Receiver General account	5	5	0
Total official international reserves	36,268	34,467	-1,801

[1] Includes securities issued by sovereigns, agencies and supranationals (international financial organizations).

Highlights of 2004

During 2004 notable developments were:

- *Change in the level of the official international reserves:* As of December 31, 2004, the official international reserves declined to US$34.5 billion from US$36.3 billion as at December 31, 2003. This reflects a US$1.3-billion decrease in EFA assets and a US$0.5-billion decrease in the IMF reserve position.
- *Change in the level of the EFA:* The decline in the EFA from US$32.3 billion to US$31.0 billion was largely due to foreign currency debt maturities, which were met through sales and maturities of assets. The reduction was partly offset by an increase in the value of the EFA, primarily due to the appreciation of the euro against the US dollar.
- *Funding sources:* The program of cross-currency swaps of domestic obligations was the Government's primary source of foreign currency funding. The Government raised US$3.1 billion at an average cost of 3-month US$ LIBOR (London Inter-Bank Offered Rate) less 44 basis points, a slightly more cost-effective funding level than in recent years.
- *Investment policy:* EFA investment policy was reviewed with the aim of assessing the range of assets eligible for investment and ensuring that the Government's policies are in line with leading practices of other comparable sovereign asset managers. As part of this process, the principles and objectives governing the management of the EFA were restated.
- *Reporting framework:* Internal reporting was strengthened with the implementation of a new performance and risk reporting framework. The new framework combines the formerly separate monthly and quarterly investment and risk reports and emphasizes an integrated approach, which improves awareness and understanding of risk/return trade-offs.
- *Portfolio performance:* The EFA is managed on an asset-liability portfolio basis that aims to optimize return and to minimize any cost of carry (interest paid on liabilities less interest earned on assets, plus realized gains) on the portfolio. During 2004, the Government earned net revenues on the EFA of US$91 million, or 25 basis points (27 basis points when the IMF reserve position is included), which reflects US$160 million in realized gains on US-dollar and euro asset sales, partially offset by net interest costs of US$69 million (US$64 million when the IMF reserve position is included).

- *New measure of performance:* A new methodology called total return was introduced to measure performance. Total return is a measure based on the market value of both the EFA assets and liabilities and captures three key variables: realized gains/losses on sales of assets, unrealized gains/losses on existing portfolio assets and liabilities, and net interest income. The Government earned a total return of 20 basis points on the EFA portfolio in 2004. When the IMF reserve position is included, the total return increases to 59 basis points.
- *Annual audit:* The Office of the Auditor General conducted its annual audit of the EFA as an investment portfolio. The audited financial statements and a clean audit opinion are included at the end of this report.

Overview of the Exchange Fund Account

This section describes the EFA management framework, including the purpose, objectives and guiding principles; the governance structure of the EFA; and the policies governing investment, asset-liability management, risk management and performance assessment.

Management Framework

Purpose

The purpose of the EFA is to provide a source of funds needed to help promote orderly conditions for the Canadian dollar in the foreign exchange market, and to provide foreign currency liquidity for the Government of Canada.

Key Objectives

- *Maintain a high standard of liquidity:* Hold reserves in assets that mature or can be sold on very short notice with minimal market impact and therefore loss of value.
- *Preserve capital value:* Minimize risk of loss of market value by holding a diversified portfolio of high-quality assets (in terms of credit rating and type of issuer), managing assets and liabilities on a matched basis (in terms of currency and duration) and using appropriate practices to mitigate risks.
- *Optimize return:* Achieve the highest possible level of return, while respecting the liquidity and capital preservation objectives.

Guiding Principles of Funds Management

Government funds management, which encompasses a wide range of activities related to the issuance of debt and the management of liquid financial assets, including the EFA, follows three general principles:

- *Governance:* The governance framework should ensure that debt and asset management activities are conducted in line with clearly established operational and risk guidelines and that risk monitoring and oversight are independent of treasury management operations.
- *Transparency:* Information on the management and performance should be disclosed in a timely manner so as to ensure public understanding and accountability.
- *Leading practices:* Operational frameworks and practices should be in line with leading practices of other comparable sovereigns. Regular evaluations should be conducted on the effectiveness of the governance framework, policy initiatives and operations.

Additional Reserves Management Principles

- *Prudence:* Borrowing and investment activities should be managed to limit exposure to risk and protect the value of the Government's assets.
- *Cost-effectiveness:* The carrying cost of reserves, taking into account the return on assets and the cost of liabilities, should be kept as low as possible.

Governance of the EFA

The EFA is governed by Part II of the *Currency Act*, which requires the Minister of Finance to report to Parliament on the operations of the EFA each calendar year within five months after the end of that year. The legislative mandate of the EFA is to aid in the control and protection of the external value of the Canadian dollar. The Minister of Finance can acquire, sell or lend for the Account those assets that are deemed appropriate for the legislated purpose. The Minister of Finance approves the general policies and strategy related to the investment and risk management of the EFA and, in particular, establishes the target level of reserves.

Responsibility for strategic planning and the operational management of the EFA is jointly borne by the Department of Finance Canada and the Bank of Canada. The Bank of Canada, acting as fiscal agent for the Minister of Finance, executes transactions for the Account.

The oversight of activity is through the Funds Management Committee (FMC), which comprises senior management from the Department of Finance Canada and the Bank of Canada. The FMC advises the Minister of Finance on policy and strategy, oversees the implementation of approved policy and plans, and reviews performance outcome reports.

The FMC is supported by a Risk Committee (RC), whose mandate is to oversee and advise on the risk management policy and to report to the FMC on financial risk positions and exposures. The Financial Risk Office at the Bank of Canada provides analytical support to the RC in this role and is responsible for monitoring and regularly reporting on the financial performance and position of the EFA, including market, credit, operational, liquidity and legal risks.

EFA Management Policy

Management of the EFA follows a set of policies that apply to investment, asset-liability management, risk management and performance assessment.

Investment Policy

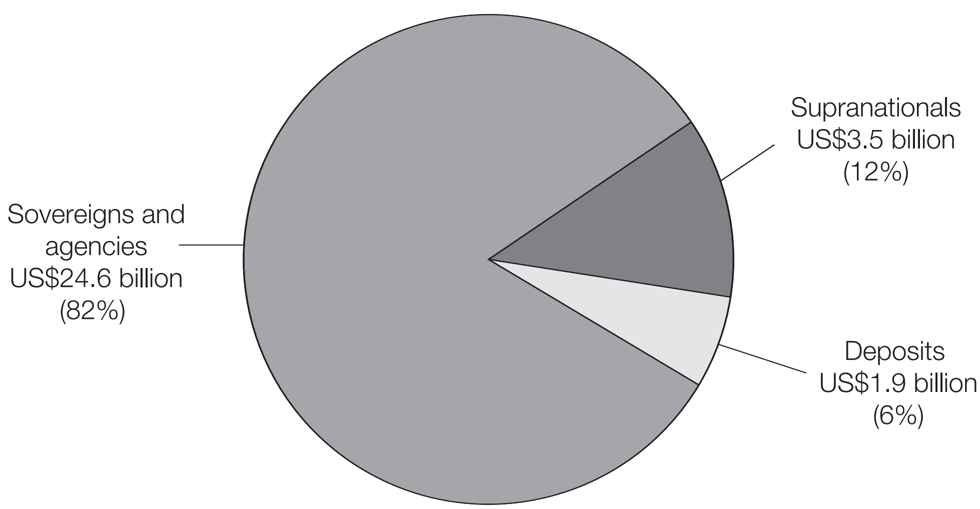
EFA investment policy strives to optimize return, subject to liquidity and capital preservation objectives. To achieve this, the Government's policy is to invest primarily in securities (bonds and bills) issued by sovereigns, agencies or supranationals denominated in US dollars, euro and yen. Reserves can also be invested in cash deposits with financial institutions and in US-dollar tri-party repurchase agreements (repos).

Furthermore, the investment policy splits investments into two tiers: the Liquidity Tier and the Investment Tier. The Liquidity Tier serves to meet the Government's core liquidity requirements in foreign currencies. It consists of highly rated US-dollar-denominated assets, such as Treasuries, discount notes and overnight bank deposits. The Investment Tier consists of a diversified mix of high credit quality securities denominated in US dollars, euro and yen.

To support the investment policy, the investment of reserves is governed by the ministerially approved investment and credit guidelines (see Annex 2), which include limits pertaining to issuers and counterparties across all lines of business and require diversification of assets and counterparties. In addition, high liquidity standards are defined in the guidelines. There are also rules governing the maximum maturity of reserve assets.

In practice, the EFA portfolio is mainly invested in sovereign and agency securities (82 per cent), as these securities enhance both liquidity and capital preservation (Chart 1).[1] This composition has stayed relatively stable over the last five years. The share of deposits is relatively small because money market securities offer lower returns than other investment options. The liquidity tier is composed mainly of US Treasuries, unchanged from previous years, given that they are the most liquid securities in the market.

Chart 1
EFA Investments by Issuer
as at December 31, 2004
(market value)

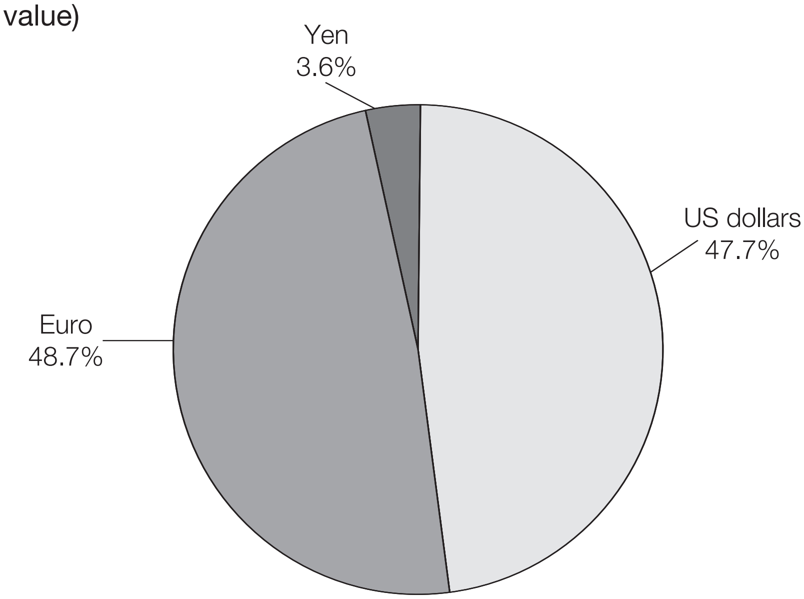


As for the currency mix, the Government's practice is to hold about US$15 billion, subject to an operating range, in US dollars. This reflects the fact that foreign currency needs are mostly in US dollars and that, historically, foreign exchange intervention has taken place primarily in the Canadian/US-dollar exchange market.

1 Excludes gold and SDR holdings.

As at December 31, 2004, the US-dollar share of the EFA portfolio was US$14.3 billion (or 47.7 per cent), the euro share was 19.8 billion euros (or 48.7 per cent) and the yen portion was 112.1 billion yen (or 3.6 per cent) (Chart 2).[2] The proportion of euro holdings in the EFA portfolio has increased over the years as a result of attractive yield opportunities in the euro market and the appreciation of the euro against the US dollar. This is consistent with the Government's objective of optimizing return while respecting the liquidity and capital preservation objectives.

Chart 2
Currency Composition of the EFA as at December 31, 2004
(market value)



Asset-Liability Management Policy

Policy requires that foreign currency reserve assets and the liabilities financing those assets be managed together on a portfolio basis. Assets and the liabilities financing those assets are matched as closely as possible in currency and duration, so that exposure to significant currency and interest rate risks is limited.

The Government's practice is to minimize the gap between assets and liabilities, which is monitored on a daily basis, within a range of +/-US$300 million.

2 Excludes gold and SDR holdings.

Risk Management Policy

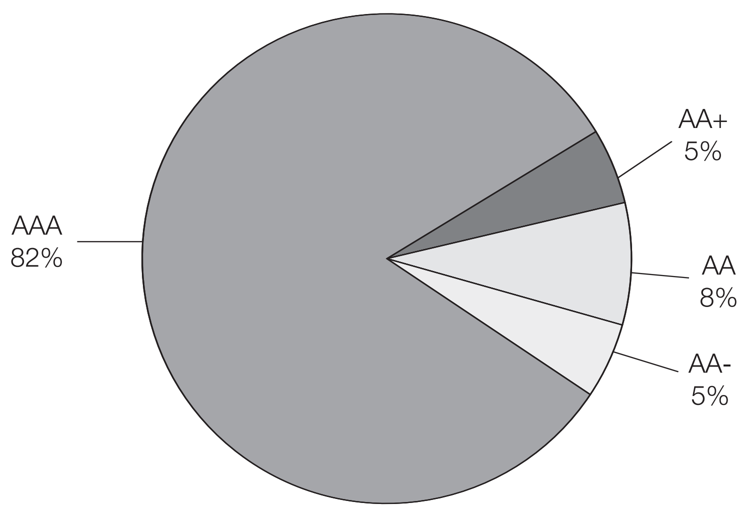
Risk management policy requires identifying and managing treasury risk (including credit, market, operational and legal risks related to the financing and investment of the foreign exchange reserves) and regular and timely reporting of risk exposures.

The Government uses a number of methods to measure financial risk exposures on a timely basis and to ensure compliance with guidelines and specific risk policies. Credit risk is the most important risk faced by the EFA, and it is monitored by measuring actual exposure and potential exposure[3] to counterparties. There is an ongoing assessment of the credit status of the Government's counterparties by relying on third-party credit rating agencies. Counterparty limits are established based on these third-party credit ratings, and compliance with counterparty limits is monitored on a daily basis.

To be eligible for EFA investments, an entity must have a credit rating of at least A-/A3 (see the guidelines in Annex 2 for details). The majority of EFA investments are in the AAA category, as indicated in Chart 3.[4]

The Government also employs measures of market risk exposure that are considered industry standards: stress testing and Value-at-Risk. These measures are described in more detail in the box entitled "New Performance and Risk Measures" in the following section.

Chart 3
EFA Investments by Credit Rating
as at December 31, 2004



[3] Actual exposure is a measure of potential losses to the Government if a counterparty defaults or is downgraded today, while potential exposure is a measure of potential losses in the future.

[4] Excludes gold and SDR holdings.

Collateral management frameworks are used to manage the Government's credit risk to financial institution counterparties associated with cross-currency swaps and commercial deposits. Under these frameworks, high-quality collateral (e.g. cash, securities) is placed with the Government when the market value of the contract exceeds specified limits.

Risk measures are reported on a monthly basis to management at the Department of Finance Canada and the Bank of Canada. The Minister of Finance receives an annual report on treasury risk management prepared in collaboration with the Bank of Canada's Financial Risk Office.

Performance Assessment Policy

Performance assessment policy provides a framework for measuring, analyzing and evaluating financial performance of EFA investing and funding. The policy requires regular and timely reporting to senior management, the Minister and Parliament of the returns on EFA assets and the costs of associated liabilities.

The principal measure is based on accounting information (revenues and the net cost of carry measure), supplemented by an economic measure of asset-liability performance called total return (see the box entitled "New Performance and Risk Measures" in the following section). Performance is reported on a monthly basis to management at the Department of Finance Canada and the Bank of Canada. The Minister is informed every six months of EFA initiatives and performance. Finally, as required by the *Currency Act*, the Office of the Auditor General audits the EFA as an investment portfolio, and performance is reported to Parliament on an annual basis.

Review of Operations in 2004

This section reviews operations related to the official international reserves, including major initiatives undertaken, changes in the level of reserves and portfolio performance. While the report covers all the official international reserves, most of the comments focus on developments affecting the managed element of the reserves, the EFA.

Major Initiatives

In 2004, initiatives focused on strengthening the Government's investment policy and management framework. In addition, extensive work was done to enhance internal reporting through the implementation of a new performance and risk reporting framework.

Review of EFA Investment Principles and Objectives

Over the last decade, the EFA portfolio has grown significantly from US$10 billion in 1995 to US$31 billion in 2004 and, in consequence, investment policy has been subject to periodic revision. In the first half of 2004, investment policy was reviewed with the aim of assessing the range of assets eligible for investment in the EFA portfolio in order to seek a better balance between the low-risk nature of the assets required for the portfolio and the net cost of holding them. A further objective was to ensure that the Government's investment policies are in line with leading practices of other comparable sovereign reserve asset managers. As part of this process, the principles and objectives governing the management of the EFA were restated in order to enhance decision making (see the section entitled "Management Framework").

New Performance and Risk Reporting Framework

During 2004, internal reporting on performance and risks was strengthened through the development and implementation of new performance and risk reports. The new framework combines formerly separate monthly and quarterly investment and risk reports and emphasizes an integrated approach, whereby investment performance and risk exposure information is integrated to give a better sense of the risk/cost trade-offs. Information is also streamlined so as to provide an at-a-glance snapshot of relevant data to senior management, while offering an overall opinion of the financial performance, by drawing on messages in five key areas: investment performance, market risk, credit risk, liquidity risk and operational/legal risk. New performance and risk measures were introduced as part of the new reporting framework (see box below).

New Performance and Risk Measures

New measures to enhance risk and performance reporting were introduced in 2004 based on leading industry standards (see the sections "Total Return" and "Risk Measures" for detailed results).

- Value-at-Risk (VaR) measures potential losses due to normal market movements (i.e. changes in interest rates and exchange rates) over a given period. VaR is calculated for the EFA and for the liabilities financing the EFA.
  - The gross VaR (i.e. applied to the EFA) is relevant as it provides the probability of loss in total reserves due to market movements over a certain time period.
  - The net VaR (i.e. the VaR on the EFA less the VaR on liabilities) is a useful indicator of how well the portfolio is matched. As assets and liabilities are matched in currency and duration, net VaR is expected to be close to nil as changes in foreign exchange and interest rates should impact both assets and liabilities to the same extent.
- Stress tests are used to evaluate portfolio performance under extraordinary circumstances in the market. Under stress testing, the EFA portfolio is subject to a set of hypothetical scenarios that mimic the market conditions that prevailed during four previous extraordinary market events: the tightening of monetary policy by the US Federal Reserve in 1994; the 1997 Asian financial crisis; the 1998 Russian debt default and Long-Term Capital Management collapse; and the 2001 US terrorist attacks. These hypothetical scenarios allow risk managers to assess how the EFA would perform during periods of market turbulence—the periods in which the EFA would most likely need to be mobilized.
- A "total return" methodology was introduced to accompany existing measures of return. It is based on market values and reflects three key variables: realized gains/losses on sales of assets; unrealized (or valuation) gains/losses on existing portfolio assets and liabilities; and net interest income earned or paid. Return is calculated on the liabilities, as well as the assets, since liabilities fund the assets and assets should match the liabilities in currency and duration. Work will follow in 2005 on the development of a framework for attribution analysis to determine by how much each market variable (i.e. interest rates, exchange rates and credit spreads) impacts total return.

Modernization of the Currency Act

In the second half of 2004, preliminary work was undertaken in preparation for the amendment of the *Currency Act* to enhance the management of the EFA portfolio. The current act sets out a legislated list of approved investments. This approach to investment policy is no longer in keeping with modern legislative drafting practices. The list is very inflexible and excludes instruments that are equivalent to or better in terms of risk and return than some currently eligible assets. As announced in Budget 2005, modernizing the *Currency Act* will improve the flexibility in managing the portfolio by allowing investment in asset classes with lower risk and potentially higher returns. It will also reduce the risk of legal issues arising from antiquated and unclear drafting of some sections of the current legislation.

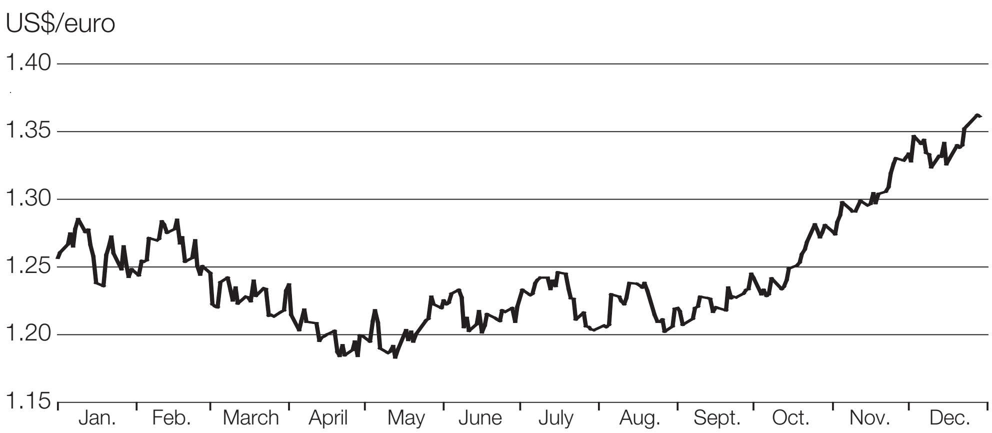
The Market Environment

As the official international reserves are reported on a market-value basis and in US dollars, changes in exchange rates (i.e. US-dollar/euro and yen/US-dollar exchange rates) and interest rates will affect the level of the reserves.

Developments in Foreign Exchange Markets[5]

As roughly 50 per cent of the official international reserves were held in euro-denominated securities during 2004, the market value of the reserves has been significantly affected by movements in the euro. In 2004, the euro appreciated significantly against the US dollar due to a number of international macroeconomic factors. Overall, the euro appreciated by 7.9 per cent during 2004, reaching a high of 1.3643 (US dollar/euro) on December 30, 2004, while the low for the year was 1.1819 on May 13, 2004 (see Chart 4).

Chart 4
The Evolution of the Euro in 2004

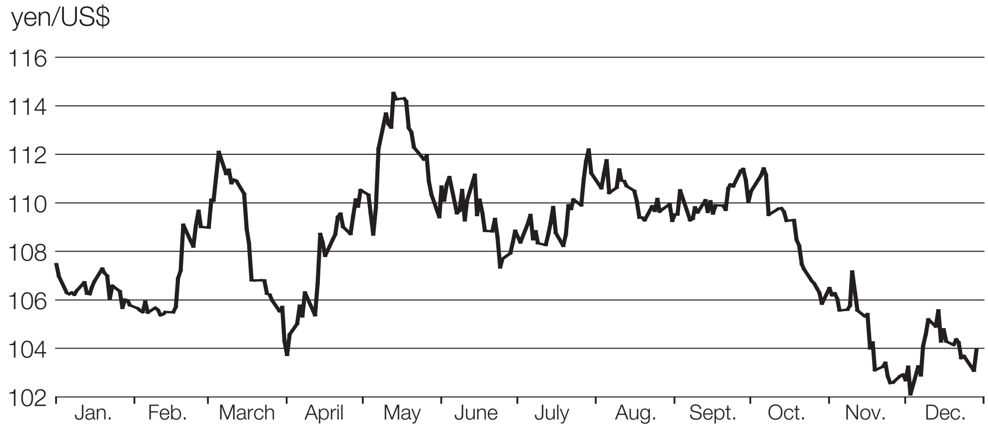


The official international reserves are less subject to changes in the yen/US-dollar exchange rate since only 3.2 per cent of the reserves are held in yen-denominated assets (as at December 31, 2004). Overall, during 2004 the yen appreciated by 4.8 per cent against the US dollar. The high for the year was 102.09 on December 3, 2004, and the low was 114.50 on May 13, 2004 (see Chart 5).

---

5 Charts 4 and 5 show the market standard for cross rates, where the euro is quoted in US-dollar terms (i.e. how many US dollars are required to buy 1 euro) and the yen is quoted in yen terms (i.e. how many yen are required to by 1 US dollar). Both charts reflect a decline in the US dollar.

Chart 5
The Evolution of the Yen in 2004



Developments in Interest Rates

Changes in interest rates affect the market value of investments by either increasing (when rates fall) or decreasing (when rates rise) the price of the investments held in the reserves. Movements in interest rates had little impact on the reserves during 2004 compared to movements in exchange rates. The market value of the reserves declined by US$46 million due to changes in interest rates, whereas foreign currency revaluations increased the value of the reserves by US$1.2 billion (see the section entitled "Sources of Changes During 2004").

Composition of the Official International Reserves

Table 2 shows the investments of the four components of the official international reserves by currency and term to maturity. As at December 31, 2004, US-dollar holdings made up more than half of the reserves and were dominated by relatively short- (i.e. under six months) and medium-term (i.e. one to five years) maturities, as they are held for EFA liquidity purposes. The euro holdings, which are held for EFA investment purposes, were more heavily weighted towards medium-term (i.e. one to five years) investments. Likewise, the yen holdings were mostly invested in securities with medium-term maturities.

Table 2

Term Structure of the Official International Reserves as at December 31, 2004

Term	Cash and term deposits	Government securities in domestic currency	Other securities	Gold	SDR holdings	Total EFA assets	IMF reserve position	Bank of Canada account	Receiver General account	Total official international reserves
				(market value in millions of US dollars)						
US-dollar holdings										
Under 6 months	2,107	2,983	2,062	–	–	**7,152**	–	105	5	**7,262**
6 to 12 months	–	–	1,038	–	–	**1,038**	–	–	–	**1,038**
1 to 5 years	–	76	3,176	–	–	**3,252**	–	–	–	**3,252**
Over 5 years	–	1,406	1,477	–	–	**2,883**	–	–	–	**2,883**
Indefinite term[1]	–	–	–	48	925	**973**	3,327	–	–	**4,300**
Total US-dollar holdings	2,107	4,465	7,753	48	925	**15,298**	3,327	105	5	**18,735**
Euro holdings[2]										
Under 6 months	35	241	228	–	–	**503**	–	–	–	**503**
6 to 12 months	–	751	–	–	–	**751**	–	–	–	**751**
1 to 5 years	–	7,625	1,580	–	–	**9,206**	–	–	–	**9,206**
Over 5 years	–	3,789	389	–	–	**4,178**	–	–	–	**4,178**
Total euro holdings	35	12,406	2,197	0	0	**14,638**	0	0	0	**14,638**
Yen holdings[2]										
Under 6 months	81	–	–	–	–	**81**	–	–	–	**81**
6 to 12 months	–	–	–	–	–	**–**	–	–	–	**–**
1 to 5 years	–	1,013	–	–	–	**1,013**	–	–	–	**1,013**
Over 5 years	–	–	–	–	–	**–**	–	–	–	**–**
Total yen holdings	81	1,013	0	0	0	**1,094**	0	0	0	**1,094**
Total	2,223	17,884	9,950	48	925	**31,030**	3,327	105	5	**34,467**

1 For reporting purposes, gold, SDR holdings and the IMF reserve position, which have no terms to maturity, are translated into US dollars.

2 The respective December 31 exchange rates are used for the euro and yen assets.

Changes in the Level of the Official International Reserves

As shown in Table 3, Canada's official international reserves as at December 31, 2004, were US$34.5 billion (on a market-value basis), down from US$36.3 billion as at December 31, 2003, in large part due to the use of assets to meet large maturities of liabilities occurring in November and December. The sources of changes are detailed in the next section.

Table 3

Canada's Official International Reserves Holdings as at December 31, 2004

		Total official international reserves					
	2003 total official international reserves	EFA	Bank of Canada account	IMF reserve position	Receiver General account	2004 total official international reserves	Change
			(market value in millions of US dollars)				
Securities	**29,111**	27,834	–	–	–	**27,834**	-1,277
Deposits	**2,426**	2,223	105	–	5	**2,333**	-93
Gold	**45**	48	–	–	–	**48**	3
IMF reserve position	**3,848**	–	–	3,327	–	**3,327**	-521
Special drawing rights	**838**	925	–	–	–	**925**	87
Total	**36,268**	31,030	105	3,327	5	**34,467**	-1,801

Sources of Changes During 2004

The level of the official international reserves can change over time due to a variety of factors.

Foreign Exchange Market Intervention

Intervention in the Canadian-dollar foreign exchange market has not occurred since 1998 (see Annex 1). Intervention involves buying or selling foreign exchange currencies in exchange for Canadian dollars, and therefore affects the level of the official international reserves.

Net Government Operations

Net purchases of foreign currencies for government foreign exchange requirements and for additions to the EFA will affect the official international reserves. There were no net government operations in 2004.

Reserves Management Operations

Debt maturities and purchases of foreign currency assets affect the level of the EFA. Foreign currency assets are purchased with the proceeds of foreign currency issuance (including cross-currency swaps). Large maturities (US$6.0 billion in total, including a US$2.0-billion global bond, three Euro-Medium-Term Note maturities totalling US$1.0 billion, cross-currency swap maturities of US$2.8 billion and a small decline in Canada bills outstanding) contributed the most to the decline in the level of the EFA. These maturities were offset by US$3.1-billion issuance of cross-currency swaps.

Gains and Losses on Gold Sales

This factor reflects the degree to which proceeds from the sales of gold exceed the market value of gold that existed at the end of the previous month. There were no gold transactions in 2004, as the last of the Government's gold bullion was sold in December 2003.

Return on Investments

Return on investments comprises interest earned on investments (US$1.1 billion) and changes in the market value of securities resulting from changes in interest rates (US$46 million). The overall effect on the official international reserves was a net increase of US$1.2 billion.

Foreign Currency Debt-Servicing Costs

Foreign currency debt-servicing costs reduced the level of the official international reserves by US$1.2 billion.

Foreign Currency Revaluations

Revaluation effects reflect changes in the market value of the official international reserves resulting from movements in exchange rates. During 2004, foreign currency revaluations increased the official international reserves by US$1.2 billion, primarily due to the appreciation of the euro versus the US dollar.

As shown in Table 4, the level of the official international reserves fell by US$1.8 billion during 2004. The level decreased due to reserves management operations (US$3.0 billion) and foreign currency debt-servicing costs (US$1.2 billion). The decline was partly offset by return on investments (US$1.2 billion) and foreign currency revaluations (US$1.2 billion), due mainly to the appreciation of the euro versus the US dollar.

Table 4
Sources of Changes in Canada's Official International Reserves During 2004

	Total change in official international reserves
	(market value in millions of US dollars)
Foreign exchange market intervention	–
Net government operations	–
Reserves management operations	-2,963
Gains and losses on gold sales	–
Return on investments	1,176
Foreign currency debt-servicing costs	-1,208
Foreign currency revaluations	1,193
Other transactions[1]	1
Total change	-1,801

[1] Related to the securities assumed by the Government of Canada following the privatization of Petro-Canada in July 1991 and the subsequent dissolution of Petro-Canada Limited in 2001.

More detailed information on monthly levels and changes in Canada's official international reserves is provided in Annex 3.

Financing

The reserves are financed by foreign currency borrowings by the Government, which are used exclusively to raise foreign exchange reserves (see Table 5). All foreign currency marketable assets are effectively matched to foreign currency borrowings.

Funding requirements are primarily met through an ongoing program of cross-currency swaps of domestic obligations.[6] Total cross-currency swap issuances and maturities were US$3.1 billion and US$2.8 billion, respectively. Swaps are particularly cost-effective compared to other sources of foreign currency funds. Foreign currency was raised through cross-currency swaps at 3-month US$ LIBOR less 44 basis points on average, a slightly better funding level than in recent years.

In addition to cross-currency swaps of domestic obligations, the Government has access to a short-term US-dollar paper program (Canada bills), medium-term note issuance in various markets (Canada notes and Euro Medium-Term Notes—EMTNs) and international bond issues (global bonds), the use of which depends on funding needs and market conditions.

[6] Cross-currency swaps involve the exchange of Canadian dollars, which have been raised through the issuance of domestic bonds, for foreign currency. The foreign currency is subsequently invested in an eligible asset (e.g. US Treasuries).

During 2004, the level of outstanding Canada bills decreased by US$228 million. Canada bills were issued, on average, at an all-in cost of US$ LIBOR less 20-30 basis points—generally in line with funding levels of recent years.

There was no new issuance of Canada notes, EMTNs or global bonds in 2004. One US-dollar global bond (US$2.0 billion) and three EMTNs (totalling US$1.0 billion) matured.

While the changes in the numbers shown below may reflect maturities, they also reflect changes in the exchange rates of the euro and the yen versus the US dollar (as the foreign currency issues in Table 5 are reported in US dollars).

Table 5

Foreign Currency Issues as at December 31, 2004

	2003	2004	Change
	(par value[1] in millions of US dollars)		
Global bonds	9,896	8,131	-1,765
Canada bills	1,652	1,424	-228
Swapped domestic issues	18,456	19,378	922
Canada notes	931	976	45
Euro Medium-Term Notes	2,413	1,434	-979
Total	33,348	31,343	-2,005

1 Liabilities are stated at the respective years' December 31 exchange rates.

Portfolio Performance

Revenues

The revenues of the official international reserves include income from its investments and foreign exchange gains. In 2004, the income of the official international reserves totalled C$1.8 billion, compared to almost C$3.0 billion in 2003.

The main categories of income earned by the official international reserves are summarized in Table 6. Data is reported in Canadian dollars, as EFA revenues, which account for the bulk of the revenues of the official international reserves, are reported in Canadian dollars in the attached financial statements.

The EFA's securities-lending program enhances the income earned on the portfolio by lending out securities that are highly sought after in the market. At year-end, C$3.6 billion[7] (par value) in US government securities were held by the two financial institutions that act as agents for lending these securities to market participants. Income from securities lending, included in investment income from marketable securities in Table 6, totalled C$2.6 million during 2004 compared to C$1.3 million in 2003.

7 Securities-lending numbers are stated at the respective years' December 31 exchange rates.

Table 6

Revenues for the Official International Reserves as at December 31, 2004

		Official international reserves				
	2003 total revenue	EFA	IMF reserve position	Bank of Canada account	Receiver General account[1]	2004 total revenue
	(millions of Canadian dollars)					
Investment income						
Marketable securities	**1,931**	1,588	–	–	–	**1,588**
Cash and short-term deposits	**49**	35	–	2	0	**2**
Special drawing rights	**21**	21	–	–	–	**21**
IMF reserve position	**–**	–	–	–	–	**–**
Total investment income	**2,001**	1,644	–	2	0	**1,646**
Other income						
Net gain on sales of gold	**205**	–	–	–	–	**–**
Foreign exchange gains (losses)	**757**	154	–	–	0	**154**
Total income	**2,963**	1,798	–	2	0	**1,800**

1 Zero values in this column indicate that the values reported were less than C$500,000.

Net Return

As the EFA is managed on an integrated asset-liability basis, from an economic perspective, the key measures of portfolio performance should include both assets and liabilities. Historically, the net performance, incorporating the cost of funding, has been measured and reported using the cost of carry methodology. The cost of carry is an accounting-based measure estimated by subtracting the interest earned on assets from the interest paid on Canada's foreign currency liabilities (i.e. the net interest earned or paid). Last year, the measure was improved by adding realized gains/losses incurred over the year.

The new measure, total return, is calculated for both the assets and the liabilities and for each currency, with the return on the liability portfolio being used as a benchmark for the assets (since liabilities fund the assets and assets must match liabilities in currency and duration). Work is continuing on improving both the cost of carry measure and the total return methodology. Performance according to both measures is presented below.

Cost of Carry

Table 7 provides an estimate of the cost of carry for the official international reserves[8] and for segments of the reserves. The cost of carry during 2004 is estimated at -19 basis points, which is lower than in 2003. The carry would have

8 The cost of carry calculations do not apply to the Bank of Canada and Receiver General accounts as they are not managed according to the principle of asset-liability matching.

been better had the Government not sold older, higher-coupon assets for newer issues with a lower coupon; therefore it earned less interest over the year. However, interest earnings were supplemented by market-value gains accumulated over several years on the high-coupon securities sold in 2004. When the realized gains are taken into consideration, the overall carry is estimated at +27 basis points. The cost of carry performance, including realized gains, was also lower than in 2003. The net cost of carry declined primarily due to higher US yields in 2004, which in turn caused a decrease in asset prices and lowered market values of US securities.

Table 7

Carry for the Official International Reserves During 2004

	2003		2004				
	Carry in basis points (bps)	Carry in bps (including net realized gains)	Interest earned on assets	Interest paid on liabilities	Net interest earned on assets	Carry in bps[1]	Carry in bps (including net realized gains)
			(millions of US dollars)				
Euro portfolio	2	45	586.9	610.9	-24.0	-7.2	19.7
Yen portfolio	0	0	11.7	11.8	0.1	–	–
US$ portfolio	-12	47	508.9	554.0	-45.1	-13.4	5.3
EFA[2]	**-10**	**92**	**1,107.5**	**1,176.7**	**-69.2**	**-20.6**	**25.0**
IMF reserve position	4	4	47.2	42.1	5.1	1.5	1.5
Total carry	**-6**	**96**	**1,154.7**	**1,218.8**	**-64.1**	**-19.1**	**26.5**

1 The carry figures show the contribution of each currency portfolio to the overall carry.

2 Excludes gold holdings.

Total Return

Table 8 provides an estimate of the total return for the official international reserves[9] as a whole and for segments of the reserves. The total return was +59 basis points in 2004, reflecting total returns of +20 basis points for the EFA and +409 basis points for the IMF reserve position. These numbers include interest flows as well as all realized and unrealized gains/losses. As total return is a new measure, no comparison for 2003 is available.

Two general factors contributed to the strong investment performance of the EFA in 2004: advantageous funding levels for cross-currency swaps, which were the main tool used to raise foreign currency, and an appreciation in the value of assets relative to the liabilities that fund these assets.

9 The total return calculations do not apply to gold, SDR holdings and the Bank of Canada and Receiver General accounts as they are not managed according to the principle of asset-liability matching.

The +409-basis-point net return on the SDR-denominated IMF reserve position was largely driven by an appreciation of the SDR against the US dollar, which drove up the return on the assets from 1.50 per cent in SDR to 5.75 per cent in US dollars (the IMF reserve position is financed by US-dollar-denominated liabilities).

Table 8

Total Return for the Official International Reserves During 2004

	US$ portfolio	Euro portfolio	Yen portfolio	Total EFA	IMF reserve position	Total official international reserves[1]
	(millions of US dollars, unless otherwise stated)					
Market value	14,324	14,637	1,094	**30,055**	3,064	**33,119**
Change over the period	-1,152	-265	46	**-1,371**	-472	**-1,844**
% of the portfolio	43%	44%	3%	**91%**	9.3%	**100%**
Return in original currency	1.95%	5.56%	0.74%	**n/a**	1.50%	**n/a**
Return in US$ (A)	1.95%	13.90%	5.59%	**7.74%**	5.75%	**7.53%**
Liability benchmarks						
Market value	14,205	14,458	1,090	**29,753**	3,064	**32,816**
Change over the period	-1,427	-210	47	**-1,591**	-308	**-1,898**
Return in original currency	1.64%	5.47%	0.75%	**n/a**	1.64%	**n/a**
Return in US$ (B)	1.64%	13.80%	5.61%	**7.54%**	1.64%	**6.94%**
Return vs. benchmark in basis points (A – B)	31	10	-1	**20**	409	**59**[2]

1 The total return calculations do not apply to gold, SDR holdings and the Bank of Canada and Receiver General accounts as they are not managed according to the principle of asset-liability matching.

2 The returns of the three currency portfolios and the IMF reserve position show their weighted contributions to the overall total return.

Risk Measures

Various methods, including scenario analysis, stress testing as well as Value-at-Risk (VaR), a statistical measure of risk exposure, are employed to measure the EFA's exposure to market risk.[10] Scenario analysis is also carried out to gauge the sensitivity of the EFA portfolio to changes in exchange rates and interest rates. As part of the scenario analysis, the results of the portfolio impact of a 1-per-cent depreciation of the euro and yen vis-à-vis the US dollar, and those of a 1-per-cent increase in interest rates across the yield curve, are also reported. The results show that, on a net basis, the EFA portfolio has very minimal exposure to currency depreciations and upward shifts in the yield curve (Table 9).

10 These risk measures apply to the EFA only, excluding the SDR and gold holdings.

Table 9

Risk Measures as at December 31, 2004

Risk measure	EFA	Net EFA (EFA assets less liabilities)
	(millions of US dollars)	
Scenario analysis		
1% depreciation of euro/yen	-157	-2
1% parallel shift in yield curve	-797	-5
Stress test		
1994 Fed tightening	-2,345	12
1997 Asian financial crisis	-814	48
1998 Russian default/LTCM collapse	-1,149	68
2001 terrorist attacks	993	38
99% 10-day VaR	1,103	18

Stress testing is a risk management tool that is used to assess the potential impact on the EFA portfolio of extreme market turbulence. To this end, the EFA portfolio is subjected to some hypothetical scenarios that mimic the market conditions during four previous extraordinary market events: the tightening of monetary policy by the US Federal Reserve in 1994; the 1997 Asian financial crisis; the 1998 Russian debt default and Long-Term Capital Management (LTCM) collapse; and the 2001 US terrorist attacks. The four stress tests reveal that the EFA generally performs well during periods of market turmoil.

In addition, this report includes a new measure of market risk exposure, the VaR, as a complement to scenario analysis and stress testing. This measure estimates the maximum loss in portfolio value expected within a specific time period during normal market conditions as a result of interest rate and exchange rate changes. This is reported on the entire EFA portfolio and on the net position between assets and liabilities. As of December 31, 2004, the EFA had a 99-per-cent 10-day VaR of $18 million, which implies that 99 per cent of the time, the value of the portfolio is not expected to decline by more than $18 million, on a net basis, over a 10-day period.

Currently, a measure of credit VaR is being developed for estimating the maximum expected losses over a specified time period as a result of a credit event, such as a counterparty downgrade or default.

Annex 1: Foreign Exchange Market Intervention

Since September 1998, the Bank of Canada, acting as agent for the Government, has not undertaken any foreign exchange market intervention in the form of either purchases or sales of US dollars versus the Canadian dollar.[11] Since that time, its only market intervention was the purchase of euros in 2000 as part of Canada's participation in the Group of Seven concerted intervention in support of the euro, as shown in Table 10.

Intervention in the foreign exchange market for the Canadian dollar might be considered if there were signs of a serious near-term market breakdown (e.g. extreme price volatility with both buyers and sellers increasingly unwilling to transact), indicating a severe lack of liquidity in the Canadian-dollar market. It might also be considered if extreme currency movements seriously threatened the conditions that support sustainable long-term growth of the Canadian economy; the goal would be to help stabilize the currency and to signal a commitment to back up the intervention with further policy actions, as necessary.

Table 10
Foreign Exchange Market Intervention

	2000	2001	2002	2003	2004
	(millions of US dollars)				
Purchases	97	–	–	–	–
Sales	–	–	–	–	–
Net	97	–	–	–	–

[11] Official intervention is separate from net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

Annex 2: Investment and Credit Guidelines for the EFA

I. Eligible Issuers

To be eligible for EFA investments, an entity must have a credit rating in the top seven long-term categories from at least two of the following four rating agencies, at least one of which must be either Moody's Investors Service or Standard & Poor's:

Ratings agency	Minimum rating
Moody's Investors Service	A3 or better
Standard & Poor's	A- or better
Fitch Ratings	A- or better
Dominion Bond Rating Service	A (low) or better

Notes: The Bank for International Settlements (BIS) and the IMF are deemed to be eligible entities. Rating references elsewhere in this document use the ratings scale of Standard & Poor's.

II. Aggregate and Individual Limits on Holdings

a) Sovereigns and Directly Guaranteed Agencies

Type of issuer	Aggregate category limits (% of liquid reserves)	Individual counterparty limits (% of liquid reserves)
AAA sovereigns in domestic currency (including directly guaranteed agencies)	Unlimited	Unlimited
AAA sovereigns in foreign currency (including directly guaranteed agencies)	25	10
AA- to AA+ sovereigns in domestic and foreign currency (including directly guaranteed agencies)	25	10
Single-A sovereigns (including directly guaranteed agencies)	2	See below[1]

[1] *The limits for single-A sovereigns (including directly guaranteed agencies) are as follows:*

Credit rating	Total exposure	Of which home currency	Of which non-home currency
	(millions of US dollars)		
A+	500	500	50
A	250	250	25
A-	100	100	10

b) Other Eligible Securities/Deposits

Type of issuer/ financial institution	Aggregate category limits (% of liquid reserves)	Individual counterparty limits (% of liquid reserves)
Implicitly guaranteed sovereign agencies (including eligible US agencies)	15	3
Supranationals (not including deposits at the BIS)	25	10
Deposits at the BIS	10	–
Commercial bank deposits	US$1.5 billion	See limits below

III. Financial Institution (FI) Counterparty Credit Risk Limits

a) For Swaps, Deposits and Forwards

	Credit rating of FI counterparty						
Type of exposure	**A-**	**A**	**A+**	**AA-**	**AA**	**AA+**	**AAA**
	(millions of US dollars)						
Actual exposure	10	25	50	100	150	200	300
Aggregate actual exposure for all FI counterparties	2% of liquid reserves			n/a	n/a	n/a	n/a
	25% of liquid reserves						
Potential exposure[1]	10	25	50	200	200	200	200
Total potential exposure for all FI counterparties	1,250						

[1] Potential exposure on swaps and forwards is calculated based on BIS guidelines.

b) For Repo Transactions

Minimum credit rating for a counterparty	A-	
Business line limits for counterparties, by credit rating	AAA	US$750 million
	AA	US$500 million
	A	US$300 million
Eligible collateral	US Treasuries and agencies	
Minimum rating for collateral	AAA	
Maximum term of collateral	10.5 years	

IV. Terms of Investments

Instrument	Maximum term
Commercial bank deposits and other non-marketable investments	3 months
Commercial bank marketable investments	1 year
All other marketable securities	10.5 years (unless matching a specific liability that exceeds 10.5 years)

V. Liquidity Limits

Minimum holdings of US Treasuries	10% of liquid reserves
Minimum issue size	US$500 million
Maximum holding of any issue/note program/commercial paper (CP) program	10% of the issue/note program/CP program
Maximum non-marketable investments beyond 5 days in term	15% of liquid reserves

VI. Currency Composition Guideline

Currency	Portion of liquid reserves
US dollar	US$15 billion, subject to an operating range
Euro and/or yen	Remainder of the EFA

Annex 3: Canada's Official International Reserves

Month-to-Month Changes

Month-end	Securities	Deposits	Gold[1]	Special drawing rights[2]	Reserve position in the IMF[3]	Total	Total monthly change	Reserves management operations[4]	Gains and losses on gold sales	Return on investments[5]	Foreign currency debt charges	Revaluation effects	Net government operations[6]	Official intervention	Other transactions[7]
							(market value in millions of US dollars)								
2003															
December	29,421	2,116	45	838	3,848	36,268	-901	-3,673	-8	862	-1,299	3,043	-60	0	234
2004															
January	29,488	2,163	44	835	3,836	36,366	98	109	0	134	-41	-104	0	0	0
February	29,683	1,805	43	847	3,705	36,083	-283	-506	0	251	-24	-4	0	0	0
March	30,043	1,874	46	847	3,602	36,412	329	444	0	167	-120	-162	0	0	0
April	29,039	1,785	42	832	3,415	35,113	-1,299	-461	0	-235	-65	-538	0	0	0
May	28,867	2,806	43	851	3,411	35,978	865	670	0	-69	-32	296	0	0	0
June	28,957	2,234	43	849	3,335	35,418	-560	-355	0	65	-275	5	0	0	0
July	29,194	1,852	43	845	3,267	35,281	-217	26	0	153	-164	-232	0	0	0
August	29,517	2,128	44	857	3,345	35,891	690	256	0	269	-24	194	0	0	-5
September	30,057	2,103	45	862	3,198	36,265	374	106	0	43	-86	306	0	0	5
October	30,327	1,945	46	880	3,262	36,460	195	-371	0	181	-126	511	0	0	0
November	27,887	1,889	49	912	3,334	34,071	-2,389	-2,984	0	44	-111	662	0	0	0
December[8]	28,151	2,016	48	925	3,327	34,467	396	103	0	173	-140	259	0	0	1
Total	n/a	n/a	n/a	n/a	n/a	n/a	-1,801	-2,963	0	1,176	-1,208	1,193	0	0	1

1 Gold valuation is based on the London p.m. fix on the last business day of the reporting month.

2 Special drawing right (SDR)-denominated assets are valued in US dollars at the SDR rate established by the IMF. A rise in the SDR in terms of the US dollar generates an increase in the US-dollar value of Canada's holdings of SDR-denominated assets.

3 The reserve position in the IMF represents the amount of foreign exchange which Canada is entitled to draw from the IMF on demand for balance of payments purposes. It equals the Canadian quota, less IMF holdings of Canadian dollars, plus loans to the IMF.

4 Net change in securities and deposits resulting from foreign currency funding activities of the Government. (Issuance of foreign currency liabilities used to acquire assets increases reserves, while maturities decrease reserves).

5 Return on investments comprises interest earned on investments and changes in the market value of securities resulting from changes in interest rates.

6 Net government operations are the net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

7 Related to the securities assumed by the Government of Canada following the privatization of Petro-Canada in July 1991 and the subsequent dissolution of Petro-Canada Limited in 2001.

8 Numbers are from the official international reserves press release. Securities and deposits numbers may not be consistent with numbers throughout the text due to a difference in classification.

Annex 4: Glossary

basis point: One-hundredth of a percentage point (0.01 per cent).

Canada bill: Promissory note denominated in US dollars and issued only in book-entry form. Canada bills mature not more than 270 days from their date of issue, and are discount obligations with a minimum order size of US$1,000,000 and a minimum denomination of US$1,000. Delivery and payment occur in same-day funds through Chase Manhattan Bank in New York City. Primary distribution occurs through five dealers: CIBC World Markets, Credit Suisse First Boston LLC, Goldman, Sachs & Co., Lehman Brothers Inc. and RBC Dominion Securities Inc. Rates on Canada bills are posted daily for terms of one to six months. Canada bills are issued for foreign exchange reserve funding purposes only.

Canada note: Promissory note usually denominated in US dollars and available in book-entry form. Canada notes are issued in denominations of US$1,000 and integral multiples thereof. At present, the aggregate principal amount outstanding issued under the program is limited to US$10.0 billion. Notes can be issued for terms of nine months or longer, and can be issued at a fixed or a floating rate. The interest rate or interest rate formula, issue price, stated maturity, redemption or repayment provisions, and any other terms are established by the Government of Canada at the time of issuance of the notes and are indicated in the Pricing Supplement. Delivery and payment occur through the Bank of New York. The notes are offered by the Government through five dealers: Credit Suisse First Boston LLC, Goldman, Sachs & Co., Harris Nesbitt Corporation, Lehman Brothers Inc. and Scotia Capital (USA) Inc. The Government may also sell notes to other dealers or directly to investors. Canada notes are issued for foreign exchange reserve funding purposes only.

cross-currency swap: An agreement that exchanges one type of obligation for another involving different currencies and the exchange of the principal amounts and interest payments.

Euro Medium-Term Note (EMTN): Medium-term note issued outside the United States and Canada. Government of Canada EMTNs are sold either by dealers in the dealer group, or by dealers who are not in the dealer group but who are acting as the Government's agent for the particular transaction (called reverse inquiry). EMTNs are sold on a bought-deal basis (i.e. the dealer purchasing EMTNs is responsible for the sale of the notes) and on an intermittent basis. The arranger for the EMTN program is Morgan Stanley Dean Witter. The EMTN program further diversifies the sources of cost-effective funding for the foreign exchange reserves. Notes issued under this program can be denominated in a range of currencies and structured to meet investor demand. EMTNs are issued for foreign exchange reserve funding purposes only.

global bond: Syndicated, marketable debt instrument issued in a foreign currency with a fixed interest rate. The majority of global bonds issued by Canada are denominated in US dollars. Global bonds are issued for foreign exchange reserve funding purposes only.

repo; repurchase agreement: Transaction in which one party sells securities to another while agreeing to repurchase those same securities at a pre-specified price on a predetermined future date. This transaction is similar to a secured loan, where the lender receives securities as collateral for protection against default risk. The collateral is marked-to-market with appropriate haircuts to protect the Government from market risk in collateral values.

securities lending: A loan of a security from one counterparty to another, who must eventually return the same security as repayment. The loan is collateralized. Securities lending allows a counterparty in possession of a particular security to earn enhanced returns on the security.

special drawing right (SDR): An SDR is an international reserve asset created by the International Monetary Fund (IMF) in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of key international currencies.

Exchange Fund Account

Management Responsibility for the Financial Statements

Responsibility for the financial statements of the Exchange Fund Account (the Account) and all other information presented in this Annual Report rests with the Department of Finance. The operation of the Account is governed by the provisions of Part II of the *Currency Act*. The Account is administered by the Bank of Canada as fiscal agent.

The financial statements were prepared in accordance with the stated accounting policies set out in Note 2 to the financial statements, which conform to those used by the Government of Canada. These policies were applied on a basis consistent with that of the preceding year.

The Department of Finance establishes policies for the Account's transactions and investments, and for related accounting activities. It also ensures that the Account's activities comply with the statutory authority of the *Currency Act*.

The Bank of Canada effects transactions for the Account and maintains records, as required to provide reasonable assurance regarding the reliability of the financial statements. The Bank reports to the Department of Finance on the financial position of the Account and on the results of its operations.

The Auditor General of Canada conducts an independent audit of the financial statements of the Account and reports the results of her audit to the Minister of Finance.

The Annual Report of the Account is tabled in Parliament along with the financial statements, which are also part of the Public Accounts of Canada and are referred to the Standing Committee on Public Accounts for their review.

D. A. Dodge
Governor
Bank of Canada

Ian E. Bennett
Deputy Minister
Department of Finance

S. Vokey, CA
Chief Accountant
Bank of Canada

Ottawa, Canada
March 11, 2005

Auditor's Report

To the Minister of Finance

I have audited the balance sheet of the Exchange Fund Account as at December 31, 2004 and the statement of revenue for the year then ended. These financial statements have been prepared to comply with Sections 20 and 21 of the *Currency Act*. These financial statements are the responsibility of the Account's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I 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 my opinion, these financial statements present fairly, in all material respects, the financial position of the Account as at December 31, 2004 and its revenues and its cash flows for the year then ended in accordance with the accounting policies set out in Note 2 to the financial statements, which conform to the accounting policies of the Government of Canada.

These financial statements, which have not been, and were not intended to be, prepared in accordance with Canadian generally accepted accounting principles, are solely for the information and use of the Minister of Finance for complying with Sections 20 and 21 of the *Currency Act* as set out in Note 2 to the financial statements. The financial statements are not intended to be and should not be used by anyone other than the specified users or for any other purpose.

Further, in my opinion, the transactions of the Account that have come to my notice during my audit of the financial statements have, in all significant respects, been in accordance with Part II of the *Currency Act*.

Douglas Timmins

Douglas G. Timmins, CA
Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
March 11, 2005

Exchange Fund Account

Balance Sheet as at 31 December 2004

	2004	2003
	(millions of Canadian dollars)	
Assets		
Cash and short-term deposits (note 4)	2,668	3,065
Marketable securities (note 5)	31,761	35,707
	34,429	38,772
Other assets		
Special drawing rights	1,107	1,087
Gold	7	7
Accrued interest and other receivables (note 6)	637	696
	1,751	1,790
	36,180	40,562
Liabilities		
Due to the Consolidated Revenue Fund		
Advances (note 7)	34,382	37,599
Net revenue for the year	1,798	2,963
	36,180	40,562

Approved:

D. A. Dodge
Governor
Bank of Canada

Ian E. Bennett
Deputy Minister
Department of Finance

S. Vokey, CA
Chief Accountant
Bank of Canada

(The accompanying notes are an integral part of these financial statements.)

Exchange Fund Account

Statement of Revenue
For the Year Ended 31 December 2004

	2004	2003
	(millions of Canadian dollars)	
Revenue from investments		
Marketable securities	1,588	1,931
Cash and short-term deposits	35	49
Special drawing rights	21	21
	1,644	2,001
Other revenue		
Net gain on sales of gold	–	205
Net gain on foreign exchange	154	757
	154	962
Net revenue for the year	1,798	2,963

(The accompanying notes are an integral part of these financial statements.)

Exchange Fund Account

Notes to the Financial Statements Year Ended 31 December 2004

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

1. Authority and Objective

The Exchange Fund Account (the Account) is governed by Part II of the *Currency Act*. The Account is in the name of the Minister of Finance and is administered by the Bank of Canada as fiscal agent. The *Financial Administration Act* does not apply to the Account.

The legislative mandate of the Account is to aid in the control and protection of the external value of the Canadian dollar, and the Minister of Finance acquires or sells for the Account those assets that are deemed appropriate for this purpose in accordance with the *Currency Act*. The Account is empowered to invest in instruments approved by the Minister of Finance in accordance with the *Act*.

The objectives of the Account are to provide general liquidity for the government and to promote orderly conditions in the foreign exchange market for the Canadian dollar. Canada's current policy is to intervene in foreign exchange markets on a discretionary, rather than a systematic, basis and only in the most exceptional of circumstances.

The net revenue for the year is payable to the Consolidated Revenue Fund (CRF) of the Government of Canada within three months after the end of the year in accordance with the *Currency Act*.

2. Significant Accounting Policies

As stipulated in the *Currency Act*, the financial statements of the Account are prepared in accordance with the accounting policies used by the Government of Canada to prepare its financial statements. The financial statements of the Account are prepared for the Minister of Finance in compliance with Sections 20 and 21 of the *Currency Act*.

The basis of accounting used in these financial statements differs from Canadian generally accepted accounting principles because it excludes the disclosure of the notional cost of advances. The advances are provided interest free under the terms and conditions prescribed by the Governor in Council and the Account reflects only transactions pertaining to the assets of the Account. The significant accounting policies of the Account are set out below.

a) Basis of Presentation

The purpose of the financial statements is to report to Parliament on the operations of the Account to comply with the *Currency Act*. The Bank of Canada, on behalf of the Minister of Finance, may sell, lend, borrow, or deal in assets under the terms and conditions prescribed by the *Currency Act*. The reporting entity of the Account is limited to those transactions permitted by the *Currency Act*. For that purpose, the following operations are recorded in the Account:

All proceeds, earnings, and interest from transactions relating to the assets are credited to the Account, along with all amounts received on the maturity of deposits, securities, and notes held for the Account.

The Account's administrative, custodial, and fiscal agency services are provided and paid for by the Bank of Canada. These costs are not recognized in the financial statements.

Interest-free advances to the Account from the CRF are authorized by the Minister under the terms and conditions prescribed by the Governor in Council.

The annual net revenue of the Account is paid to the CRF (or charged to the CRF when net revenue is a negative amount).

All material changes in cash flows are evident from the financial statements. A separate statement of cash flows has not been prepared.

b) Use of Estimates

The preparation of the financial statements of the Account requires management to make estimates and assumptions, based on information available as of the date of the financial statements. The most significant use of estimates is in the presentation of assets at fair value. Actual results could differ from those estimates.

c) Translation of Foreign Currencies and Special Drawing Rights

Assets and advances denominated in foreign currencies and special drawing rights (SDRs) are translated into Canadian dollar equivalents at rates prevailing on the balance sheet dates, which were as follows:

	2004	2003
US dollars	1.2020	1.2965
Euros	1.6287	1.6282
Japanese yen	0.011727	0.01207
SDRs	1.86050	1.92656

Gains or losses resulting from the translation of assets and advances denominated in foreign currencies and SDRs, as well as transactions throughout the year, are recorded as net foreign exchange gains and are included separately in the category *Other revenue* in the *Statement of Revenue*.

Investment revenue in foreign currencies and SDRs is translated into Canadian dollars at the foreign exchange rates prevailing on the date the revenue is earned.

d) Revenue

Revenue from investments is recorded on an accrual basis and includes interest earned, amortization of premiums and discounts, gains or losses on sales of securities, and revenues from securities lending activities. Interest is accrued on short-term deposits, marketable securities, and special drawing rights. Accrued interest is recorded in the category *Other assets* on the *Balance sheet*.

e) Assets

Short-Term Deposits
Short-term deposits are money market transactions where the Account invests funds with designated counterparties. Short-term deposits are recorded at cost and are generally held to maturity.

Marketable Securities
Marketable securities are recorded at cost and are adjusted for amortization of purchase discounts and premiums. Purchases and sales of securities are recorded at the settlement dates. Write-downs to reflect other than temporary impairment in the fair value of securities are included in *Revenue from investments*.

Special Drawing Rights
The special drawing rights (SDR) serves as the unit of account of the International Monetary Fund (IMF) and its value is based on a basket of key international currencies. SDRs are recorded at year-end market value.

Gold
Gold is carried in the Account at a value of 35 SDRs per fine ounce, which approximates cost and conforms to the value used in the *Public Accounts of Canada*. The Account sold its remaining gold bullion in 2003 and continues to hold gold coins. Net gains on gold sales are recorded at settlement dates.

f) Tri-Party Reverse Repurchase Agreement

Tri-party reverse repurchase agreements are money market transactions where the Account invests funds on a secured basis with designated counterparties at prevailing market rates. The collateral on these transactions is held by a tri-party custodian. Tri-party reverse repurchase transactions are recorded on the *Balance sheet* under the category *Cash and short-term deposits* at the amount originally invested. Revenue from these transactions is included in the category *Revenue from investments* in the *Statement of Revenue*.

g) Securities Lending Program

The Account has agency agreements with two major financial institutions. Loans of securities are effected on behalf of the Account by these agents who guarantee the loans and obtain collateral of equal or greater value from their approved counterparties in these transactions. The securities loaned continue to be accounted for as investment assets. Revenue from the securities-lending program is included in *Revenue from investments* in the *Statement of Revenue*.

3. Official Government Operations

Official government operations involve purchases and sales of Canadian dollars against foreign currencies. These are undertaken to promote orderly conditions in the market for the Canadian dollar or to meet net government requirements for foreign exchange. Since September 1998, no transactions were aimed at moderating movements in the value of the Canadian dollar.

The majority of Canada's official international reserves reside inside the Account. The Account represents approximately 90 per cent (89 per cent in 2003) of Canada's official reserves. The remainder of the official reserves reside in the foreign currency accounts of the Minister of Finance.

4. Cash and Short-Term Deposits

Cash and short-term deposits are held as follows:

	2004	2003
	Carrying value	Carrying value
US dollar holdings	2,529	2,950
Euro holdings	42	16
Japanese yen holdings	97	99
	2,668	3,065

5. *Marketable Securities*

Marketable securities are held as follows:

Term to maturity

	2004									2003
	Under 6 months		6 months to 1 year		1 to 5 years		Over 5 years		Total	Total
	Carrying value	Yield	Carrying value	Yield	Carrying value	Yield	Carrying value	Yield	Carrying value	Carrying value
US dollar holdings										
Sovereign	3,979	2.31%	181	6.85%	308	3.81%	1,889	4.33%	6,357	5,812
Supra National	981	5.46%	363	4.33%	1,244	4.15%	121	4.46%	2,709	3,912
Agencies and other	1,042	4.33%	677	3.45%	2,229	4.25%	1,337	4.83%	5,285	6,718
Carrying value	6,002		1,221		3,781		3,347		14,351	16,442
Euro holdings										
Sovereign	286	2.89%	719	3.64%	7,281	4.23%	3,357	4.95%	11,643	12,330
Supra National	–		–		660	4.54%	329	4.73%	989	1,169
Agencies and other	264	4.27%	163	3.41%	2,390	4.39%	788	4.85%	3,605	4,558
Carrying value	550		882		10,331		4,474		16,237	18,057
Yen holdings										
Sovereign	–		–		1,173	1.24%	–		1,173	1,208
Carrying value	–		–		1,173		–		1,173	1,208
Total securities										
Carrying value	6,552		2,103		15,285		7,821		31,761	35,707

The yield in the above table represents the weighted average yield to maturity based on the carrying value at the end of the year for the respective securities.

The outstanding unamortized premium/discount on marketable securities amounts to $230 million ($251 million in 2003).

At year-end, a portion of the Account's holdings of US government securities, consisting of US$1,830 million (par value) in Treasury Bills (US$2,550 million in 2003) and US$1,165 million (par value) in Treasury Notes (nil in 2003), is being used in securities-lending operations with financial institutions.

6. Accrued Interest and Other Receivables

	2004	2003
Accrued interest		
Cash and short-term deposits	4	2
Marketable securities		
US dollar holdings	164	169
Euro holdings	461	516
Japanese yen holdings	4	5
SDRs	4	3
Other receivables	–	1
	637	696

The fair value of the accrued interest and other receivables is deemed equal to their carrying value given their maturity date.

7. Due to the Consolidated Revenue Fund (CRF)—Advances

The Account is funded by advances from the CRF. These are limited to $60 billion by Order-in-Council dated 26 April 2001. At year-end, advances from (deposits with) the CRF consisted of:

	2004	2003
US dollars	20,332	23,898
Canadian dollars	(2,108)	(4,347)
Euros	16,027	17,920
Japanese yen	1,266	1,303
SDR	(1,135)	(1,175)
	34,382	37,599

The proceeds of Canada's borrowings in foreign currencies and allocations of SDRs by the IMF have been advanced from the CRF to the Account. Subsequent repayments of foreign currency debt are made using the assets of the Account and result in reductions in the level of foreign currency advances. Interest payable by Canada on borrowings in foreign currencies and charges on allocations of SDRs to Canada are charged directly to the CRF.

Canadian-dollar advances are required by the Account for the settlement of its purchases of foreign currencies. Sales of foreign currencies result in receipts of Canadian dollars that are remitted to the CRF, causing reductions in the level of outstanding Canadian-dollar advances. Cumulative net sales of foreign currencies can result in overall net deposits of Canadian dollars by the Account with the CRF.

8. Financial Instruments

a) Risk Management

The role of the Account as principal repository of Canada's official international reserves determines the nature of its assets and of its operations, as well as its use of financial instruments.

To ensure that the Account asset portfolio is prudently diversified with respect to credit risk, the investment guidelines prescribed by the Minister of Finance specify limits on holdings by class of issuer (sovereign, agency, supranational, or commercial financial institution) and type of instrument. There are also limits on exposure to any one issuer or counterparty.

With respect to investment guidelines, the Account may hold debt issued in the designated currencies by highly rated sovereign governments and their agencies, as well as by supranational organizations. Eligible issues must have a minimum long-term rating of A- or A3 from two of four designated rating agencies (Standard & Poor's, Moody's, Fitch, and Dominion Bond Rating Service), one of which must be either Moody's or Standard & Poor's. The Account may also make deposits and execute other transactions with commercial financial institutions that meet the same rating criteria, with the term to maturity of commercial deposits limited to three months or less.

Through the securities-lending program, agents can lend securities only up to a prescribed maximum amount and only to a list of counterparties approved by the Government. Each borrower must enter into a Securities Loan Agreement with either of the agents. Borrowers are also required to provide collateral for securities borrowed, according to a specific list approved by the government. Collateral is limited to specific security types, terms to maturity, and credit ratings. The agents also provide an indemnity in the event of default by the borrower. The Account enters into securities lending in order to earn extra return on investments.

b) Interest Rate and Foreign Currency Risk

Interest rate and foreign currency risks are managed by adopting a strategy of matching the duration structure and the currency of the Account's assets with the related foreign currency borrowings of the Government of Canada.

c) Fair Value of Financial Instruments

	2004		2003	
	Carrying value and accrued interest	Fair value	Carrying value and accrued interest	Fair value
Investments				
Cash and short-term deposits	2,672	2,672	3,067	3,067
Marketable securities				
US dollar holdings	14,514	14,685	16,611	17,113
Euro holdings	16,698	17,552	18,573	19,306
Japanese yen holdings	1,178	1,218	1,213	1,259
	35,062	36,127	39,464	40,745
SDRs	1,111	1,111	1,090	1,090
Gold	7	57	7	59

The estimated fair value of cash, short-term deposits, and SDRs is deemed equal to their carrying value given their maturity date.

Estimated fair values of marketable securities are based on quoted market prices.

The estimated fair value of gold is based on London fixings of $526.48 ($540.96 in 2003) per fine ounce.

9. Commitments

a) Currency Swaps

The Account may enter into short-term currency swap arrangements with the Bank of Canada to assist the Bank in its cash-management operations. There were no drawings under this facility in 2004 or 2003, and there were no commitments outstanding as at 31 December 2004.

b) Foreign Currency Contracts

In the normal course of operations, the Account enters into foreign currency contracts. As at 31 December 2004, the Account was under contract to sell $8 thousand ($4 million in 2003) of foreign currency. Unrealized gains (losses) are calculated using the year-end exchange rates. As of that date, there were no unrealized net gains (losses) included in net revenue (nil in 2003).

10. Comparative Figures

Certain comparative figures have been reclassified to conform to the presentation adopted in the current year.