Report on the Management of Canada's Official International Reserves

2003

Canada

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

Cette publication est également disponible en français.

Cat. No.: F2-174/2004E
ISBN 0-662-37054-6

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Purpose of the Report

This report reviews the operations of the Exchange Fund Account (EFA) for the 2003 calendar year. The EFA is the main repository of Canada's official international reserves and is the only actively managed portfolio of reserves.

The EFA is governed by the provisions of the *Currency Act*, which states that the Minister of Finance shall report to Parliament on the operations of the EFA for each calendar year within five months after the end of that year.

The report provides a comprehensive account of the context 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 additional information on the year-end financial position and annual changes of the EFA.

What Is the Exchange Fund Account?

The EFA is the principal repository of Canada's official international reserves. It is maintained to provide general foreign currency liquidity for the Government of Canada and to provide a source of funds to help promote orderly conditions for the Canadian dollar in the foreign exchange market.

The Exchange Fund Account as at December 31, 2003

	(market value in millions of US dollars)
Securities	29,421
Deposits	2,005
Gold	45
Special drawing rights	838
Total	**32,309**

The EFA's assets are funded by foreign currency liabilities. Assets and liabilities are managed on a portfolio basis and are matched as closely as possible in currency and duration to minimize exposure to currency and interest rate risks.

Canada's official international reserves stood at US$36.3 billion as of December 31, 2003, composed of the EFA (US$32.3 billion), foreign currency accounts held by the Bank of Canada (US$106 million) and the Receiver General (US$5 million), and the reserve position in the International Monetary Fund (US$3,848 million).

Highlights of 2003

During 2003 notable developments were:

- As at December 31, 2003, official international reserves, at US$36.3 billion, were slightly lower than the reserve levels of US$37.2 billion as of December 31, 2002. This is explained by large foreign currency debt maturities met through sales of assets, which were partly offset by foreign currency revaluations resulting from the appreciation of the euro against the US dollar. There was no change arising from intervention in foreign exchange markets during the year.
- The structure of the EFA portfolio was managed to limit the cost of carrying assets. During 2003, taking into account net interest costs of US$19 million and US$278 million in gains on asset sales, the Government earned net revenues of US$259 million.
- Consistent with the Government's policy to immunize currency and interest risks in Canada's reserve portfolio, the amount of foreign currency assets was brought into line with liabilities. Foreign currency liabilities had exceeded foreign currency assets in recent years, largely as a result of foreign exchange intervention in support of the Canadian dollar in 1998.
- An external evaluation of the management of the Government's reserves concluded that Canada's practices compare well with those of other sovereigns and private financial institutions. The evaluation and the departmental response to the recommendations were tabled in Parliament and submitted to the Office of the Auditor General. It is also available upon request from the Department of Finance.
- In line with continued efforts to increase transparency and to stay at the forefront of sovereign practice, the Government published its investment and credit guidelines governing the EFA portfolio on the Department of Finance Web site (www.fin.gc.ca/efa/EFAGuidelines_e.html).
- A new framework was implemented to move a portion of the Government's short-term US-dollar deposits to a collateralized basis by introducing a US-dollar repo program. As a result, the Government's credit risk to financial institutions has been reduced significantly.
- The last of the Government's gold bullion was sold in December 2003. Proceeds from gold sales over the last 20 years have been invested in interest-bearing assets, raising the return for the EFA by US$13 billion more than would have been the case had the Government maintained its gold holdings. Of note, the Government continues to hold gold coins.
- The Government implemented a new governance framework. The new framework enhances coordination between the Department of Finance and the Bank of Canada in the area of funds and risk management of the Government's debt and reserves. The framework will enhance decision making and risk management of the EFA within the overall strategy approved by the Minister.

Section I: Overview of the Exchange Fund Account

The Exchange Fund Account is the main repository of Canada's official international reserves and is the component that is actively managed by the Government. It is composed of securities (bonds and bills issued by a sovereign, an agency or an international financial organization) and bank deposits denominated in foreign currencies, gold and special drawing rights (SDRs).[1]

Purpose of the EFA

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

Principles and Objectives

The following principles and objectives guide the management of the EFA:

- Prudence: Maintain an appropriate level of reserves invested in high-quality and highly liquid assets. Manage reserves within a framework that matches foreign liabilities to reserve assets to immunize currency and interest rate risk, and that controls credit risk through diversification and collateral management frameworks.
- Cost-effectiveness: Minimize the cost of carrying reserves (i.e. the difference between interest paid on foreign currency liabilities and interest earned on reserve assets).
- Consultations: Seek input from market participants on major adjustments to the foreign reserves management program.
- Best practices: Ensure that the operational framework and practices are in line with the best practices of other comparable sovereign borrowers and the private sector.

Governance Framework

The EFA is governed by the provisions of the *Currency Act*, which states that the Minister of Finance shall report to Parliament on the operation of the EFA each calendar year within five months after the end of that year.

[1] 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.

The Government approves the general policies related to the management of the EFA and, in particular, establishes the target level of reserves and provides an annual report to Parliament on the operations of the EFA. The Department of Finance and the Bank of Canada share responsibility for the management of the EFA. The Bank of Canada, acting as fiscal agent for the Minister of Finance, effects transactions for the Account.

In 2003 the Government implemented a new governance framework for its funds management, including the EFA and risk management. Further information on governance is provided in Section II.

EFA Assets

The Level of Reserves

As at December 31, 2003, the level of official international reserves stood at US$36.3 billion and the EFA totalled US$32.3 billion. Reserves are reported on a market value basis. The value of reserves fluctuates due to both external factors (e.g. changes in exchange rates and interest rates) and actions by managers (e.g. an increase in investments). Further information on the sources of changes in reserves can be found in Section II.

Structure and Composition

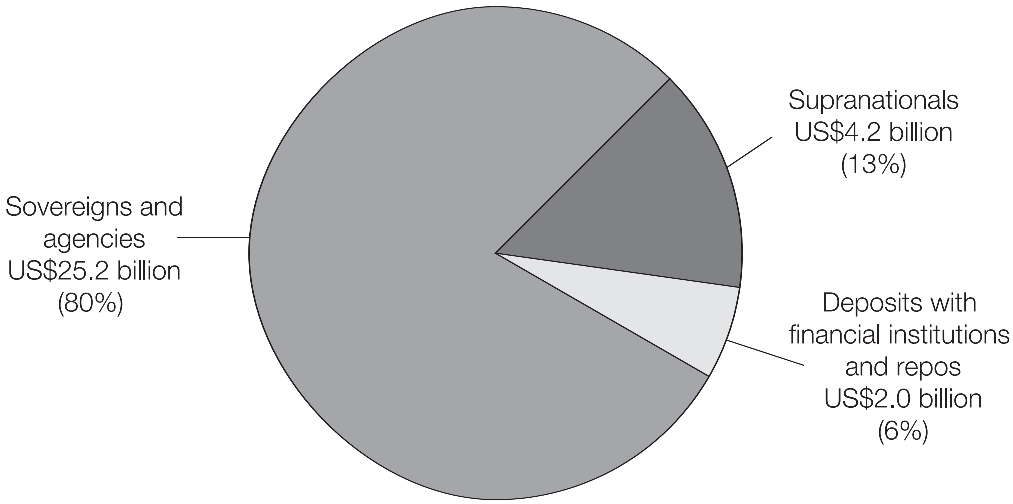
Structure

The EFA is structured 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 marketable short-term (under one year) assets, such as discount notes and bank deposits. The Investment Tier consists of a diversified mix of highly rated liquid bonds denominated in US dollars, euro and yen.

Eligible EFA Investments

The Government can invest in securities (bonds and bills) issued by a sovereign, an agency or an international financial organization. Reserves can also be invested in US-dollar cash deposits with financial institutions or in US-dollar repos. Further information on the Government's repo program can be found in Section II. As indicated in Chart 1, the majority of reserves were invested in securities issued by sovereigns and agencies as at December 31, 2003.

Chart 1
EFA Investments by Issuer
as at December 31, 2003



Note: Numbers may not add due to rounding.

Currency Composition

The EFA can hold investments denominated in three currencies: US dollars, euro and yen. About 50 per cent of the EFA is denominated 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. The remainder of the EFA is split between the euro and the yen, depending on investment opportunities in these markets. As at December 31, 2003, the US-dollar share of the portfolio was US$15.6 billion (or 49.4 per cent), the euro share was 11.9 billion euros (or 47.3 per cent) and the yen portion was 112.5 billion yen (or 3.3 per cent).[2] A more detailed breakdown of the EFA by currency is provided in Section II.

Eligible Credit Ratings

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

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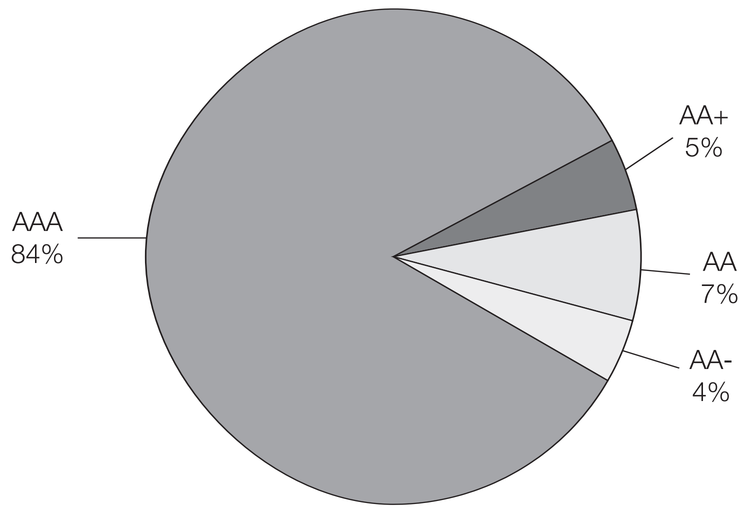
[2] Based on an ongoing assessment of needs, the US-dollar share is maintained at about US$15 billion, plus or minus an operating range, with the remainder of the EFA portfolio in euro and yen assets.

Chart 2
EFA Investments by Credit Rating
as at December 31, 2003



Risk Management

The Government has a comprehensive risk management framework for identifying and managing treasury risk, including market, credit, operational and legal risks related to the financing and investment of its foreign exchange reserves. The main elements of this framework are outlined below.

Asset-Liability Management Framework

The foreign currency reserve assets and the liabilities financing those assets are managed on a portfolio basis. The Government follows an "asset-liability management framework," whereby assets and liabilities financing these assets are matched (as closely as possible) in currency and duration, so that the Government is not exposed to significant currency and interest rate risks.

Investment and Credit Guidelines

The management of reserves is governed by investment and credit guidelines approved by the Minister of Finance (see Annex 2). The guidelines, which encompass all lines of business, limit the Government's credit exposure and call for diversification of assets and counterparties. In addition, high liquidity standards are defined in the guidelines. For instance, to ensure that reserves are invested in liquid securities, the outstanding amount of securities must be at least US$500 million. There are also rules governing the maximum maturity of reserve assets.

Collateral Management Frameworks

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

Governance

The governance framework (see Section II) ensures that risk issues are identified and addressed. A Risk Committee meets regularly to review risk reports and to provide guidance and accountability on the Government's treasury risk policies. The Financial Risk Office at the Bank of Canada, jointly established with the Department of Finance, monitors and advises on the risk position of the Government. All aspects of risk management (from market to operational and legal risks) are regularly reviewed by the Risk Committee.

Operational Risk

Operational risk results from deficiencies in information systems and internal controls or from human error, which can result in unexpected loss. The Bank of Canada, as the Government's fiscal agent for debt and reserves management, has put in place a number of initiatives to mitigate operational risk. For instance, the Bank of Canada regularly analyzes operational processes, establishes controls and closely monitors employee turnover and changes in the skill mix of the staff. In addition, indicators of sources of risks have been developed and are closely monitored.

Legal Risk

Legal risk is the risk of loss because of the application of a law or regulation or because a contract cannot be enforced. Legal risk is controlled with the same methods used in the private sector, essentially through proper documentation of all business operations to clarify the rights and obligations of each party. A legal risk review is undertaken periodically to identify any potential issues with respect to existing documentation or other legal risk issues.

Section II: Exchange Fund Account Operations in 2003

Major Initiatives in 2003

In 2003 key initiatives focused on strengthening the Government's risk management framework and enhancing transparency. In addition, an external review of the Government's management of the EFA was undertaken.

Closing the Asset-Liability Gap

Action was taken in 2003 to reduce currency and interest rate risk in Canada's reserve portfolio. In the 1990s foreign currency liabilities came to exceed liquid foreign currency assets, largely as a result of foreign exchange intervention and payments to the IMF. The Government took steps to bring foreign currency liabilities in line with foreign currency assets through a program of purchases of US dollars in foreign exchange markets starting in 1998. In 2003 the Government eliminated the gap between foreign currency assets and liabilities, thereby reducing its exposure to market risk, i.e. both interest and exchange rate risk.

US-Dollar Repo Program[3]

Until April 2003, US-dollar cash balances were invested in unsecured bank deposits with a number of commercial banks. A program of investments in the repo market has been implemented to collateralize approximately one-quarter of the Government's short-term US-dollar investments, consequently reducing the Government's portfolio of unsecured bank deposits.

A New Governance Framework

In October 2003, the Government introduced a new governance framework for its funds management, including the EFA. Under the new framework, a Funds Management Committee (FMC), which meets semi-annually, comprises senior management of the Department of Finance and the Bank of Canada. The FMC's mandate is to advise the Minister on policy and strategy for funds and risk management, oversee the implementation of approved policy and plans, and review performance outcome reports. The responsibilities of the FMC include advising on the target level of the reserves, target liquidity position, intervention guidelines, borrowing program plans and implementation; conducting program reviews; and approving new initiatives for recommendation to the Minister.

[3] Repos are transactions in which one party sells securities to another while agreeing to repurchase those same securities at a prespecified price at a predetermined future date. These transactions are similar to secured loans, with the lender of the money receiving securities as collateral as protection against default risk. The collateral is marked-to-market with appropriate haircuts to protect the Government from market risk in collateral values.

The FMC is supported by the Risk Committee, whose mandate is to oversee and advise on the development and implementation of risk management policy and strategy in line with best practices. The Financial Risk Office (formerly the Risk Management Unit) supports the Risk Committee in this role and is also responsible for monitoring and controlling the risk position of the EFA, including market, credit, operational, liquidity and legal risks.

Increased Transparency

In 1999 the Government of Canada was one of the first countries to provide enhanced reserves disclosure in a manner consistent with the standards established by the IMF and the G-10 central banks. In line with continued global efforts to increase transparency, the Government disclosed its investment and credit guidelines governing the EFA portfolio in April 2003 on the Department of Finance Web site (www.fin.gc.ca/efa/EFAGuidelines_e.html). With the disclosure of these guidelines, Canada has become one of the most transparent countries with regard to reserves management. The guidelines can also be found in Annex 2.

External Evaluation of EFA Management

As part of the Debt Program Evaluation Program, an external evaluation of the management of the Government's reserves, including risk management practices, was undertaken in 2003. The evaluation noted considerable strengths in the management of reserves, and that Canada's practices compare well with the best practices of other sovereigns and private financial institutions. A number of enhancements to the program (e.g. the development of an optimization analytical tool to manage effectively both assets and liabilities within the portfolio framework) were proposed and the Government is following up. The report was forwarded to the parliamentary Standing Committee on Public Accounts and the Office of the Auditor General in August 2003 and is available upon request from the Department of Finance.

Completion of Canada's Gold Bullion Sales Program

In 1980 the Government implemented a policy of selling its gold at a gradual and controlled pace to enhance the return for the EFA. Proceeds from gold sales were invested in interest-bearing foreign currency assets. In December 2003 the Government sold its last gold bullion. This policy has greatly benefited Canadians. Since the start of the gold sales program in 1980, reserve asset income has been US$13 billion higher than it would have been had the Government maintained its gold bullion. As at the end of December 2003, the Government's remaining gold reserves were composed entirely of gold coins.

The Market Environment in 2003

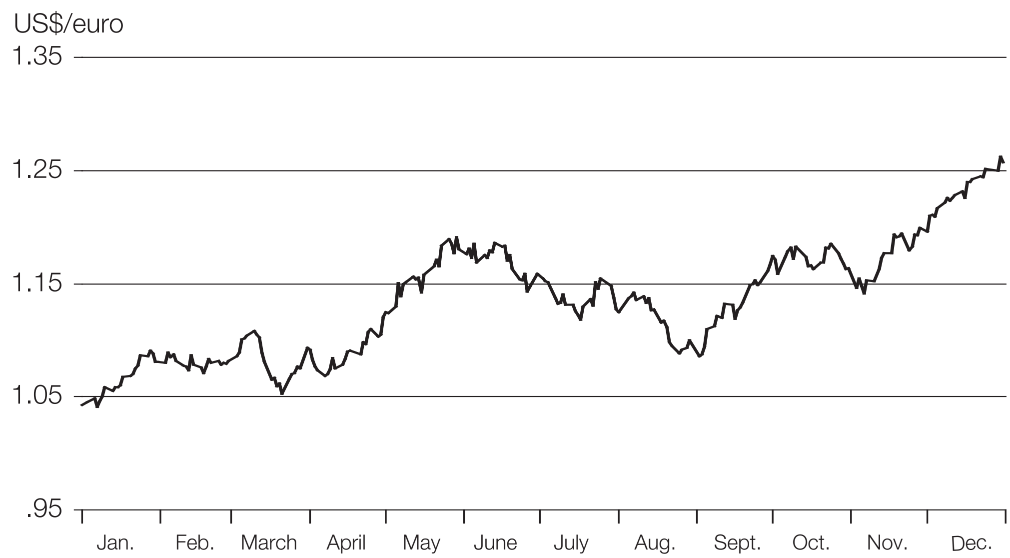
As reserves are reported on a market value basis and in US dollars, changes in exchange rates (i.e. US-dollar/euro and yen/US-dollar exchange rates) and interest rates will affect the level of the EFA.

Developments in Foreign Exchange Markets[4]

As up to 50 per cent of reserves were held in euro-denominated securities during 2003, the EFA's market value has been affected by movements in the euro (see Chart 3). The euro finished 2003 up 20.6 per cent from the previous year. It reached a high of 1.2609 (US dollar/euro) on December 30, 2003, while the low for the year was 1.0396 on January 7, 2003.

The EFA is less subject to changes in the yen/US-dollar exchange rate (see Chart 4) since only 3.3 per cent of reserves are held in yen-denominated assets (as at December 31, 2003). During 2003 the yen appreciated by 9.97 per cent against the US dollar. The high for the year was 106.25 on December 30, 2003, and the low was 121.74 on March 21, 2003.

Chart 3
The Evolution of the Euro in 2003



[4] Charts 3 and 4 show the market standard for cross rates, where the euro is quoted in US-dollar terms (i.e. the amount of US dollars required for 1 euro) and the yen is quoted in yen terms (i.e. the amount of yen required to buy 1 US dollar). Both charts reflect a decline in the US dollar.

Chart 4
The Evolution of the Yen in 2003

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 EFA. Movements in interest rates had little impact on the EFA during 2003 compared to movements in exchange rates. The market value of the EFA declined by US$292 million due to changes in interest rates, whereas foreign currency revaluations increased the market value of the EFA by US$3.0 billion.

Changes in the Level of Reserves

As shown in Table 1, Canada's official reserves as at December 31, 2003, were US$36.3 billion (on a market value basis), down from US$37.2 billion as at December 31, 2002. The decrease in the reserves level during 2003 was in large part due to the use of assets to meet maturing liabilities. The sources of changes in reserves are detailed in the next section.

Table 1
Canada's Official International Reserves Holdings as at December 31

		Foreign currency accounts held by:					
	2002 total	EFA	Bank of Canada	Minister of Finance	Receiver General	2003 total	Change
	(market value in millions of US dollars)						
Securities	30,240	29,421	–	–	–	29,421	-819
Deposits	2,445	2,005	106	–	5	2,116	-329
Gold	205	45	–	–	–	45	-160
Reserve position in the IMF	3,567	–	–	3,848	–	3,848	281
Special drawing rights	712	838	–	–	–	838	126
Total	**37,169**	**32,309**	**106**	**3,848**	**5**	**36,268**	**-901**

Sources of Changes During 2003

As shown in Table 2, the level of reserves fell by US$901 million during 2003 due to large maturities and foreign currency debt-servicing costs.[5] However, the decline was partly offset by foreign currency revaluation, which was mainly due to the appreciation of the euro versus the US dollar.

The level of reserves changes over time due to a variety of factors.

Foreign Exchange Market Intervention

Intervention in the Canadian 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 EFA.

Net Government Operations

Net purchases of foreign currencies for government foreign exchange requirements and for additions to reserves will affect the EFA. Foreign exchange requirements exceeded purchases by US$60 million.

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 (i.e. US$3.7 billion in total, of which over half was due to the maturity of a US$2.0-billion global bond in February 2003) contributed the most to the decline in the level of reserves.

[5] The Government's policy to manage both assets and liabilities on a portfolio basis minimizes net debt-servicing costs. During 2003 the EFA portfolio was in a net liability position in the first half of the year. The gap between foreign currency assets and liabilities was closed as of June 2003.

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. Losses on gold sales slightly exceeded the gains, i.e. by US$8 million. 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$1,154 million) and changes in the market value of securities resulting from changes in interest rates (-US$292 million). The overall effect on the EFA was a net increase of US$862 million.

Net Foreign Currency Debt-Servicing Costs

Net foreign currency debt-servicing costs reduced the level of the EFA by US$1.3 billion.

Foreign Currency Revaluations

Revaluation effects reflect changes in the market value of reserve assets resulting from movements in exchange rates. During 2003 foreign currency revaluations increased reserves by US$3.0 billion, primarily due to the appreciation of the euro versus the US dollar.

Table 2

Sources of Changes in Canada's Official International Reserves During 2003

	Value of change
	(market value in millions of US dollars)
Foreign exchange market intervention	0
Net government operations	-60
Reserves management operations	-3,673
Gains and losses on gold sales	-8
Return on investments	862
Net foreign currency debt-servicing costs	-1,299
Foreign currency revaluations	3,043
Other transactions[1]	234
Total change	**-901**

[1] Include increased support for IMF lending operations.

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

Composition of the Asset Portfolio

Table 3 shows liquid EFA investments by currency and term to maturity. As at December 31, 2003, US-dollar holdings made up about half of the portfolio. They 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 liquidity purposes. The euro holdings, which are held for investment purposes, were more heavily weighted towards the longer end of the yield curve, with the majority being medium- and long-term (i.e. over five years) investments. The yen holdings were also mostly invested in securities with medium- and long-term maturities. Over 2003, total euro holdings grew by US$1.1 billion, largely as a result of the appreciation of the euro versus the US dollar. Yen assets increased marginally across maturities, maintaining its maturity profile, due to the appreciation of the yen versus the US dollar.

Table 3

Term Structure of Liquid Foreign Currency Investments as at December 31[1]

Term	2002 total assets	Cash and term deposits	Government securities in domestic currency	Other securities	2003 total assets	Change
	(market value in millions of US dollars)					
US-dollar holdings						
Under 6 months	8,898	1,916	3,195	1,735	6,846	-2,052
6 to 12 months	31	–	–	1,315	1,315	1,284
1 to 5 years	5,848	–	–	5,662	5,662	-186
Over 5 years	3,068	–	–	1,652	1,652	-1,416
Total US-dollar holdings	17,845	1,916	3,195	10,364	15,475	-2,370
Euro holdings[2]						
Under 6 months	175	12	239	303	554	379
6 to 12 months	322	–	949	–	949	627
1 to 5 years	4,937	–	5,927	1,147	7,074	2,137
Over 5 years	8,335	–	5,409	917	6,326	-2,009
Total euro holdings	13,769	12	12,524	2,367	14,903	1,134
Yen holdings						
Under 6 months	69	77	–	–	77	8
6 to 12 months	–	–	–	–	–	–
1 to 5 years	429	–	472	–	472	43
Over 5 years	462	–	499	–	499	37
Total yen holdings	960	77	971	–	1,048	88
Total	**32,574**	**2,005**	**16,690**	**12,731**	**31,426**	**-1,148**

[1] Liquid foreign currency investments represent the securities and deposits held in the EFA and excludes SDRs and gold holdings.

[2] The respective December 31 exchange rates were used for the euro and yen assets.

Financing

The EFA foreign currency reserves are financed by foreign currency borrowings by the Government (see Table 4). Currently all foreign currency marketable assets are matched to foreign currency borrowings.

The Government borrows in foreign currencies exclusively to raise foreign exchange reserves for the EFA. Borrowing requirements for foreign exchange reserves are generally met through cross currency swaps of domestic obligations, which are highly cost-effective compared to other sources of foreign currency funds. Canada bills, Canada notes, Euro Medium-Term Notes (EMTNs) and global bonds may also be used, depending on the funding needs and market conditions.

During 2003 the level of outstanding Canada bills decreased slightly (by US$60 million). There were no new issuances of Canada notes, EMTNs or global bonds. One US-dollar global bond (US$2.0 billion) matured and the total cross currency swap issuances and maturities were US$0.7 billion and US$2.3 billion respectively.

Increases shown for EMTNs and Canada notes are due only to the exchange rate appreciation of the euro and yen versus the US dollar (as reserves are reported in US dollars).

Table 4

Foreign Currency Issues as at December 31

	2002	2003	Change
	(par value[1] in millions of US dollars)		
Global bonds	11,410	9,896	-1,514
Canada bills	1,712	1,652	-60
Swapped domestic issues	18,378	18,456	78
Canada notes	842	931	89
Euro Medium-Term Notes	2,161	2,413	252
Total	**34,503**	**33,348**	**-1,155**

[1] Liabilities are stated at the respective years' December 31 exchange rate.

Revenues

The EFA's revenues include income from its investments, net gains on sales of gold, and foreign exchange gains or losses on its assets and liabilities. In 2003 the EFA's income totalled C$2,963 million, compared with C$2,728 million during 2002.

The main categories of income earned by the EFA are summarized in Table 5. Data is reported in Canadian dollars, as the EFA statements of revenues in the attached financial statements are reported in Canadian dollars.

Table 5
Revenues

	2002	2003	Change
	(millions of Canadian dollars)		
Investment income			
Marketable securities	2,110	1,931[1]	-179
Cash and short-term deposits	91	49	-42
Special drawing rights	23	21	-2
Gold	4	–	-4
Total investment income	2,228	2,001	-227
Other income			
Gains on gold sales	175	205	30
Foreign exchange gains (losses)	325	757	432
Total income	**2,728**	**2,963**	**235**

[1] Includes income from securities lending.

The EFA's securities-lending program enhances the yield earned on the portfolio by lending out to counterparties securities that are highly sought after in the market. At year end, US$2.3 billion (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 income from marketable securities, totalled US$1.0 million during 2003 compared to US$0.6 million during 2002.

The EFA lends gold in the market on a short-term basis, occasionally using forward rate agreements in order to benefit from occasional upward fluctuations in rates offered on gold loans. Income from this activity is reported as investment income on gold. Given that the last of the bullion was sold at the end of 2003, this source of income will be removed during 2004.

Net Cost of the EFA

One objective in managing the EFA is to minimize the cost of carrying reserves. The Account must be invested in liquid high-quality fixed-income securities, which provide a relatively low rate of return. In recent years policy changes have been taken to broaden the eligible asset mix, within prudent limits, and to invest more in euro-denominated assets. These measures have helped to increase portfolio returns. Further means used to minimize the carry of the EFA have been the use of cross currency swaps, which are highly cost-effective compared to other sources of funds. The EFA's carry has been further improved by proceeds derived from the securities-lending program.

The EFA's cost of carry is currently estimated by subtracting the interest paid on Canada's foreign currency liabilities from interest earned on the EFA's assets (i.e. net interest earned or paid). It does not include realized gains/losses or revaluation effects on assets and liabilities. Work is underway to develop a new measure of portfolio performance for 2004 that will include realized and unrealized gains/losses in addition to net interest income.

Table 6 provides an estimate of the net interest cost of carry for the EFA portfolio as a whole and for segments of the portfolio. The carry of the total EFA portfolio during 2003 is estimated at -6 basis points, a level that is lower than what it would have been had the Government not sold older assets for newer issues (during the year, older, higher-yielding securities were switched into newer issues offering lower yields while maintaining a matched asset/liability portfolio, and interest rates payable on liabilities remained at a level near that of previous years.)[6] However, the reduction in interest earnings was offset by realized market value gains on the securities sold. When the realized gains are taken into consideration, the overall gain is estimated at +96 basis points. (The EFA realized US$131 million in gains on US-dollar asset sales, and US$147 million in gains on euro asset sales. These gains were accumulated over several years, and were realized in 2003 when the assets were sold.)

Table 6

Carry for the EFA During 2003

	Interest earned on assets	Interest paid on liabilities	Net interest earned on assets	Average value of assets	Carry in basis points[1]	Carry in basis points (including net realized gains)
	(millions of US dollars)					
Euro portfolio	615.5	608.2	7.3	13,225.1	+2	+45
Yen portfolio	10.8	11.3	(0.5)	941.1	0	0
US$ portfolio	525.8	565.6	(39.8)	16,278.4	-12	+47
Subtotal	1,152.1	1,185.1	(33.0)	30,444.6	-10	+92
IMF position[2]	66.7	52.4	14.3	3,527.2	+4	+4
Total	**1,218.8**	**1,237.5**	**(18.7)**	**33,971.8**	**-6**	**+96**

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

[2] Interest earned on Canada's reserve position in the IMF and SDR holdings. Interest paid includes interest paid on Canada's cumulative allocation of SDRs, plus interest paid on a portion of the US-dollar floating-rate liabilities; it is assumed that the IMF position is partially funded by these liabilities.

[6] As US interest rates reached 45-year lows in 2003, coupons attached to interest-bearing bonds issued in 2003 were generally lower compared to bonds issued in previous years. Since older securities were redeployed into newer issues (with smaller coupons) in 2003, the interest earned on US-dollar assets is lower than in previous years.

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.[7] Since that time its only market intervention was the purchase of euros in 2000 as part of Canada's participation in the G-7 concerted intervention in support of the euro, as shown in Table 7.

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. A more detailed description of foreign exchange market intervention can be found on the Bank of Canada's Web site (www.bankofcanada.ca/en/backgrounders/bg-e2.htm).

Table 7

Foreign Exchange Market Intervention

	1999	2000	2001	2002	2003
	(millions of US dollars)				
Purchases	0	97	0	0	0
Sales	0	0	0	0	0
Net	**0**	**97**	**0**	**0**	**0**

[7] 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) and 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						
Total potential exposure for all FI counterparties	1,250						

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
Single-A sovereign investments	
In local currency	5 years
In foreign currency	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)								
2002															
December	30,240	2,445	205	712	3,567	37,169	668	-692	-1	444	-195	855	257	0	0
2003															
January	29,377	3,719	220	728	3,591	37,635	466	-44	0	127	-33	423	-16	0	9
February	28,160	3,266	177	738	3,560	35,901	-1,734	-2,030	-5	283	-107	34	0	0	91
March	27,946	3,309	170	739	3,762	35,926	25	84	0	-102	-165	165	0	0	43
April	28,819	2,813	142	745	3,744	36,263	337	-30	-1	94	-66	340	0	0	0
May	30,377	2,319	153	777	3,797	37,423	1,160	-85	0	458	-104	847	-1	0	45
June	29,213	2,463	107	766	4,150	36,699	-724	-29	-2	-2	-213	-395	0	0	-83
July	28,771	2,027	110	761	4,096	35,765	-934	-126	0	-366	-152	-376	-43	0	129
August	28,575	2,100	65	765	3,785	35,290	-475	-111	1	-24	-26	-315	0	0	0
September	29,095	2,751	67	794	3,971	36,678	1,388	36	0	394	-83	1,041	0	0	0
October	29,258	1,789	67	795	3,947	35,856	-822	-399	0	-222	-120	-81	0	0	0
November	28,671	2,573	69	812	3,968	36,093	237	-215	0	-19	-47	518	0	0	0
December	29,421	2,116	45	838	3,848	36,268	175	-724	-1	241	-183	842	0	0	0
Total	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**	**-901**	**-3,673**	**-8**	**862**	**-1,299**	**3,043**	**-60**	**0**	**234**

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 Other transactions cover increased support for IMF lending operations.

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 Wood Gundy Inc., Credit Suisse First Boston Corporation, 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 Corporation, Goldman, Sachs & Co., Lehman Brothers Inc., Nesbitt Burns Securities Inc. and Scotia Capital Markets (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 return for another (e.g. a fixed for a floating rate of interest) and the principal amount for the term of the swap. Cross currency swaps of domestic obligations are a cost-effective alternative to foreign-currency-denominated bond issues as a means of meeting the Government's targets for longer-term foreign currency funding.

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 London-based dealer group includes CIBC World Markets plc, Goldman Sachs International and J.P. Morgan Securities Ltd. among others. 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.

repo; repurchase agreement: A transaction in which a party sells a security and simultaneously agrees to repurchase it at a given price after a specified time.

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

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.

W. P. Jenkins

Paul Jenkins
Senior Deputy Governor
Bank of Canada

Kevin G. Lynch
Deputy Minister
Department of Finance

S. Vokey

S. Vokey, CA
Chief Accountant
Bank of Canada

Ottawa, Canada

Auditor's Report

To the Minister of Finance

I have audited the balance sheet of the Exchange Fund Account as at December 31, 2003 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, 2003 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 G. Timmins, CA
Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
March 12, 2004

Exchange Fund Account

Balance Sheet as at 31 December 2003

	2003		2002	
	US	**Canadian**	**US**	**Canadian**
		(millions of dollars)		
Assets				
Denominated in US dollars				
Cash and short-term deposits	2,277	2,952	2,529	3,990
Marketable securities (Notes 5 and 6)	12,812	16,611	14,635	23,088
	15,089	19,563	17,164	27,078
Denominated in other foreign currencies				
Cash and short-term deposits (Note 7)	89	116	134	211
Marketable securities (Notes 5 and 7)	15,261	19,786	13,899	21,928
	15,350	19,902	14,033	22,139
Denominated in Special Drawing Rights				
Special drawing rights (Note 8)	842	1,090	719	1,134
Gold and gold loans (Note 9)	6	7	28	45
	848	1,097	747	1,179
Official international reserve assets	31,287	40,562	31,944	$ 50,396
Due to the Consolidated Revenue Fund				
Advances (Note 10)		37,599		47,668
Net revenue for the year		2,963		2,728
		40,562		**50,396**

Approved:

W. P. Jenkins

Paul Jenkins
Senior Deputy Governor
Bank of Canada

Kevin G. Lynch
Deputy Minister
Department of Finance

S. Vokey

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
Year Ended 31 December 2003

	2003	2002
	(millions of Canadian dollars)	
Revenue from investments		
Marketable securities	1,931	2,110
Cash and short-term deposits	49	91
Special drawing rights	21	23
Gold	–	4
	2,001	2,228
Other revenue		
Net gain on sales of gold	205	175
Net foreign exchange gains	757	325
	962	500
Net revenue for the year due to the Consolidated Revenue Fund	**2,963**	**2,728**

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

Exchange Fund Account

Notes to the Financial Statements
Year Ended 31 December 2003

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. In September 1998, the Department of Finance and the Bank of Canada decided to move away from intervening in the foreign exchange market in a predictable or automatic fashion (selling/buying foreign currencies / buying/selling Canadian dollars when there were market forces on the value of the Canadian dollar). Instead, the current policy is for the Bank of Canada to intervene on a discretionary basis.

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* and to the category of expenses determined by the Minister as authorized by legislation. 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.

All expenses determined by the Minister to have been incurred in respect of the operations of the Account are paid out of the Account. This excludes the cost of administrative, custodial, and fiscal- agency services that are provided by the Bank of Canada with regard to the transactions in the Account and that 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) Valuation of Assets

The estimated fair market value of cash, short-term deposits, and special drawing rights (SDRs), which are recorded at cost and generally held to maturity, is deemed to be equal to their book value.

Marketable securities are adjusted for unamortized premiums or discounts, where applicable, and are reported at the lower of their amortized costs, including accrued interest and year-end market values. Purchases and sales of securities are recorded at the settlement dates.

Marketable securities, short-term deposits and SDRs include accrued interest. The SDR is a unit of account issued by the International Monetary Fund (IMF), and its value is determined in terms of a basket of four major currencies.

Gold and gold loans include accrued interest. Gold and gold loans are 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*.

c) Revenue from Investments

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, revenues from gold loans, and revenues from securities-lending activities. Writedowns of securities to their year-end market values (if applicable) are netted against investment revenue in the year in which they occur.

d) Gold

Net gains on gold sales are recorded at settlement dates and are included in the category *Other revenue* in the *Statement of Revenue*. Interest revenue from gold loans is recorded on an accrual basis and premiums on the sales of call options on gold are recorded when received. Both are included in category *Revenue from investments* in the *Statement of Revenue*.

e) Tri-party Reverse Repurchase Agreement

In 2003, tri-party reverse repurchase transactions were implemented. Tri-party reverse repurchase trades are money market transactions where the Account lends funds on a secured basis to 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*. They include amounts at which the securities were originally loaned plus the accrued interest. Revenue from these transactions is included in the category *Revenue from investments* in the *Statement of Revenue*.

f) Translation of Foreign Currencies and SDRs

Assets and advances denominated in foreign currencies and SDRs are translated into Canadian and US-dollar equivalents at year-end market exchange rates, which were as follows:

	2003	2002
	(Canadian dollars)	
US dollars	1.2965	1.5776
Euros	1.6282	1.6568
Japanese yen	0.01207	0.01328
Special drawing rights	1.92656	2.13699

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 in the category *Other revenue* in the *Statement of Revenue*. Unrealized foreign exchange gains or losses on forward currency contracts are also recorded in revenue as net foreign exchange gains.

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.

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, but not all, of Canada's official international reserves reside inside the Account. The Account represents approximately 89 per cent (90 per cent in 2002) of Canada's official reserves.

4. Risk Management and Financial Instruments

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 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 prescribed by the Minister of Finance, 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 an A-rating or better 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.

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.

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.

5. Term Structure of Foreign Currency Investments

	2003						2002
	Par value						
	Under 6 months	6 to 12 months	1 to 5 years	Over 5 years	Unamortized premium/ discount and accrued interest	Amortized cost	Amortized cost
				(millions of US dollars)			
US-dollar holdings							
Government securities	3,200	–	–	–	(5)	3,195	3,114
Other securities	1,375	1,265	5,248	1,504	225	9,617	11,521
Total US-dollar holdings	4,575	1,265	5,248	1,504	220	12,812	14,635
Other foreign currencies							
Euro holdings							
Other securities	521	927	6,539	5,838	501	14,326	13,053
Yen holdings							
Government securities	–	–	465	465	5	935	846
Total other foreign currencies	521	927	7,004	6,303	506	15,261	13,899
Total	**5,096**	**2,192**	**12,252**	**7,807**	**726**	**28,073**	**28,534**

6. Marketable Securities Denominated in US Dollars

	2003			2002		
	Par value	Amortized cost		Par value	Amortized cost	
Securities	US	US	Canadian	US	US	Canadian
			(millions of dollars)			
US government	3,200	3,193	4,141	3,125	3,114	4,913
US federal agencies	5,124	5,182	6,718	4,366	4,415	6,965
Sovereign paper and international institutions	4,268	4,306	5,583	6,875	6,901	10,886
Accrued interest	–	131	169	–	205	324
	12,592	12,812	16,611	14,366	14,635	23,088
Estimated market value at year-end		13,199	17,113		15,316	24,163

Estimated market values are based on quoted market prices.

Loans of securities are effected on behalf of the Account by agents who guarantee the loans and obtain collateral of equal or greater value from their approved counterparties in these transactions. At year-end, a portion of the Account's holdings of US government securities consisting of US$2,250 million (par value) in Treasury Bills (US$2,200 million in 2002) is being used in securities-lending operations with financial institutions.

7. Assets Denominated in Other Foreign Currencies

Cash and short-term deposits

	2003		2002	
	US	Canadian	US	Canadian
		(millions of dollars)		
Euros	13	17	65	102
Japanese yen	76	99	69	109
	89	**116**	**134**	**211**

Marketable securities

	2003			2002		
	Par value	Amortized cost		Par value	Amortized cost	
	US	US	Canadian	US	US	Canadian
	(millions of dollars)					
Euros	13,825	14,326	18,573	12,637	13,053	20,593
Japanese yen	931	935	1,213	842	846	1,335
	14,756	15,261	19,786	13,479	13,899	21,928
Estimated market value at year-end		15,862	20,565		14,597	23,028

Estimated market values are based on quoted market prices.

8. Special Drawing Rights (SDRs)

	2003		2002	
	US	Canadian	US	Canadian
	(millions of dollars)			
Held at year-end	838	1,087	717	1,130
Accrued interest	4	3	2	4
	842	**1,090**	**719**	**1,134**

9. Gold and Gold Loans

During the year, the Account sold 490,067 fine ounces of gold (452,516 fine ounces in 2002).

	2003		2002	
	US	Canadian	US	Canadian
	(millions of dollars)			
Held at year-end				
Gold loans	–	–	23	37
Gold	6	7	5	8
	6	**7**	**28**	**45**

The year-end carrying values and market values (based on London fixings) of gold and gold loans, excluding accrued interest, are:

	2003		2002	
	Price per fine ounce	Total value in millions	Price per fine ounce	Total value in millions
Carrying value				
US	52.01	6	47.41	28
Canadian	67.43	7	74.79	45
Market value				
US	417.25	45	347.20	208
Canadian	540.96	59	547.74	328

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

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

	2003	2002
	(millions of Canadian dollars)	
US dollars	23,898	32,852
Canadian dollars	(4,347)	(5,447)
Euros	17,920	20,132
Japanese yen	1,303	1,435
Special drawing rights	(1,175)	(1,304)
	37,599	**47,668**

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.

11. 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 2003 or 2002, and there were no commitments outstanding as at 31 December 2003.

b) Gold Options and Forward Contracts

The Minister of Finance has authorized the sale of call options, as well as forward sales, on part of the Account's gold holdings. At year-end, the Account had no commitments to sell gold under gold options (20,000 fine ounces in 2002) or forward contracts (US$ 66 million in 2002).

c) Foreign Currency Contracts

The following table presents the fair value of foreign currency contracts with contractual amounts outstanding at 31 December:

	2003		2002	
	Contractual value	**Fair value**	**Contractual value**	**Fair value**
	(millions of canadian dollars)			
Forward sales	4	–	2,975	(29)
Forward purchases	–	–	2,991	29

The estimated fair values of foreign exchange contracts are calculated using the year-end exchange rates. Foreign exchange contracts that have a positive fair value are those contracts that, if settled immediately, would result in a gain. Conversely, immediate settlement of a contract with a negative fair value would result in a loss.