INTRODUCTION

This report reviews the operations of the Exchange Fund Account ("EFA") for the 1999 calendar year and the changes in Canada's international reserve holdings against the background of developments in the foreign exchange market. The accompanying Financial Statements provide additional information on the operations of the EFA.

The Exchange Fund Account is the principal repository of Canada's official international reserves. The EFA is governed by the provisions of the *Currency Act* and is held in the name of the Minister of Finance. Foreign currency borrowings by the Government of Canada are the main source of financing of the EFA.

OBJECTIVES

The objectives of the EFA are:

- to promote orderly conditions in the foreign exchange market for the Canadian dollar;
- to provide general liquidity for the government; and
- to minimize the cost of carry of the government's foreign currency liabilities used to fund the EFA's assets, with due attention to risk management.

GOVERNANCE

The Minister of Finance approves the general policies related to the management of the EFA and provides an annual report to Parliament on the operations of the Account. Responsibility for the management of the EFA is jointly shared by the Department of Finance and the Bank of Canada. The Bank of Canada, acting as fiscal agent for the Minister of Finance, effects transactions for the Account.

The Director, Financial Markets Division (Department of Finance) and the Chief, Financial Markets Department (Bank of Canada) are responsible for the on-going management of the EFA. A Policy Committee, comprised of senior management of the Department of Finance and the Bank of Canada in the form of the Assistant Deputy Minister, Financial Sector Policy Branch (Department of Finance) and the Deputy Governor (Bank of Canada), meets semi-annually to review developments, approve major policy initiatives and provide guidance and accountability on the management of the Account.

The Risk Management Unit (RMU), established by the Department of Finance and Bank of Canada to oversee the risk position of the Government of Canada, monitors and advises on the risk position of the EFA, including market, credit and liquidity risks.

KEY PRINCIPLES

Principles governing the management of the EFA include:

- There should be a sufficient amount of high-quality, highly-liquid foreign exchange reserve assets available for intervention and general liquidity purposes;
- The difference between the interest paid on the government's foreign currency liabilities used to fund EFA assets and the interest earned on those assets should be minimised (to the extent that the former is higher);

- Foreign reserves should be managed to ensure, as much as possible, that the assets match the liabilities in currency and duration;
- Credit risk should be managed prudently through diversification of the EFA asset portfolio, with appropriate use of credit ratings and counterparty limits; and
- Foreign currency borrowing activities to fund EFA assets should be conducted so as to maintain Canada's reputation as a successful borrower in international capital markets.

MANAGEMENT OF THE EFA: RECENT DEVELOPMENTS

In October 1999, the Minister of Finance approved a new structure for the government's foreign exchange reserve asset portfolio held in the EFA, including new investment guidelines for the management of the portfolio. These changes are important in helping to:

- ensure that the EFA asset portfolio is structured so that the Exchange Fund Account will continue to be able to meet its liquidity and investment objectives; and
- increase the investment flexibility of the portfolio in order to reduce costs, while ensuring that the government's risk exposure on the portfolio is prudently managed and diversified.

With respect to structure, the EFA asset portfolio is divided into two Tiers: a Liquidity Tier and an Investment Tier. The Liquidity Tier consists of U.S. dollar denominated shorter-term, liquid assets of the highest credit quality, which are available for intervention in support of the Canadian dollar and for government liquidity requirements. The Investment Tier is larger than the Liquidity Tier and consists of a diversified portfolio of primarily longer-term assets of high credit quality. Investment Tier assets may be denominated in US-dollars, Euro or Yen.

In terms of the currency composition of the portfolio, a minimum share of 50% of EFA assets must be denominated in U.S. dollars. This requirement reflects the leading role of the U.S. dollar as a reserve currency and the fact that the U.S. dollar is the traditional currency through which the Bank of Canada (on behalf of the government) has intervened in support of the Canadian dollar. The remainder of the portfolio in excess of the mandated minimum level of U.S. dollar holdings is split among U.S. dollar, Euro and Yen-denominated assets depending on the relative funding and investing opportunities in each currency, although relatively small minimum amounts of Euro and Yen are maintained at all times in the event of concerted international foreign exchange intervention.

With respect to the new investment guidelines, the EFA may hold debt issued in the designated currencies by highly rated sovereign governments, their agencies and by supranational organizations. Eligible issuers must have an AA- rating or better from two of five designated rating agencies (S&P, Moody's, Fitch IBCA, Dominion Bond Rating Service and Canadian Bond Rating Service), one of which must be either Moody's or S&P. The EFA may also make deposits and execute other transactions with commercial financial institutions meeting the same rating criteria, with the term to maturity of commercial deposits limited to three months or less.

ENHANCED FOREIGN EXCHANGE RESERVES DISCLOSURE

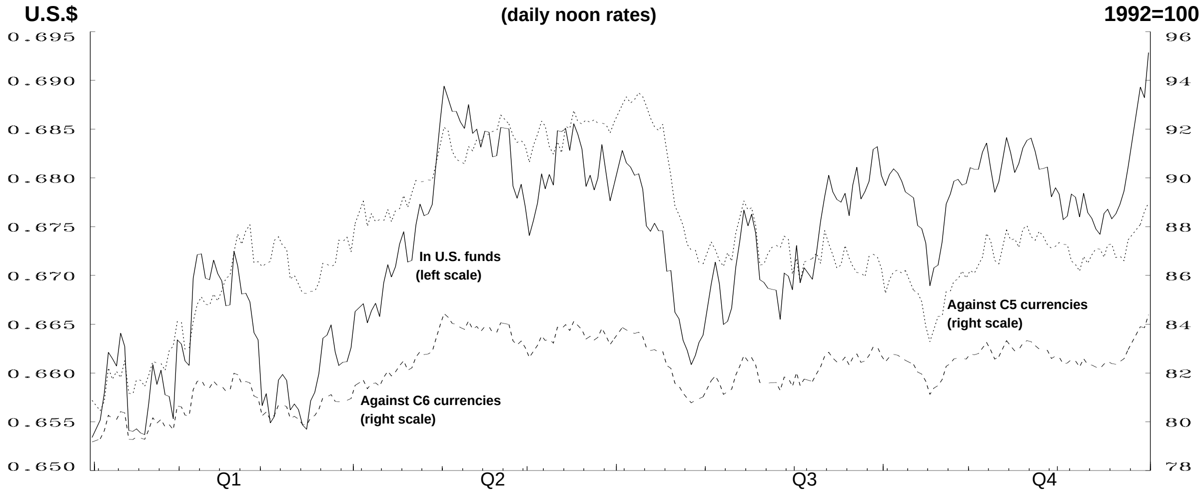
Commencing with the June 1999 Official International Reserves press release, the Government of Canada became one of the first countries to provide enhanced reserves disclosure in a manner consistent with the standards established by the International Monetary Fund and the G-10 central banks. Initiatives to enhance international standards for reserves disclosure reflect the broad international consensus that more comprehensive and timely reserves data would help reduce the possibility of financial crises. An important feature of the enhanced reserve reporting is to provide more extensive, disaggregated data - for example, Canada now reports its reserve position weekly and data related to foreign currency liabilities and off-balance sheet transactions are disclosed on a monthly basis.

The June 1999 press release also marked the switch from a book value to a market value basis for the public reporting of Canada's official international reserves. Where possible, this report provides 1999 data on both a book value and a market value basis. The book value basis is provided for historical comparison purposes while the market value data will be the basis for future reporting.

FOREIGN EXCHANGE MARKET DEVELOPMENTS

The Canadian dollar strengthened over the year, gaining almost four U.S cents (or 6.2 per cent) against the U.S. dollar, finishing the year at US$0.6929. The dollar's high for the year was US$0.6935 recorded on December 31 while the low for the year was US$0.6462 recorded on January 13. On a trade weighted basis against the C6[1] currencies the Canadian dollar appreciated by 6.6 per cent, slightly more than it rose against the U.S. dollar alone. This is explained by the fact that the Canadian dollar appreciated by over 10 per cent against the C5 currencies.

CANADIAN DOLLAR EXCHANGE RATES



INTERNATIONAL FINANCIAL DEVELOPMENTS DURING 1999

The global economic environment improved in 1999. Interest rate reductions by the major central banks in the latter part of 1998 helped to rebuild investor confidence and to calm global financial markets. Corporate and emerging market interest rate spreads over government debt also normalized over the year.

Overall, the year 1999 can be divided into two periods. The first part, extending from January to May, was characterized by mixed, yet generally improving growth prospects among the industrialized countries. Then, as the year progressed, concerns about inflation rekindled as growth accelerated in major countries, leading to interest rate increases by some central banks.

(I) FIRST HALF OF 1999 - ECONOMIC CONDITIONS BEGIN TO SHOW SIGNS OF IMPROVEMENT

Early in 1999, most estimates of world economic growth had been revised downwards, with a marked divergence noted among G-7 countries.

In Europe, economic activity was softening, although there were reasons for optimism. First, the introduction of the euro currency had been smooth. (On January 1, Austria, Belgium, France,

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1. With the advent of the euro on January 1, 1999, the former G-10 index (which included the German mark, French franc, Italian lira, Belgian franc and Dutch guilder) was replaced by a C-6 trade-weighted index which includes the U.S. dollar, euro, Japanese yen, U.K. pound, Swiss franc and Swedish krone. Similarly, a C-5 index replaced the G-9 index, which excluded the U.S. dollar.

Finland, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain, 11 of the 15 member countries of the European Union, joined in a currency union - the European Economic and Monetary Union (EMU), resulting in the adoption of the euro). In addition, conditions outside Europe were improving, and interest rates had been reduced, including a 50 basis point cut to 2.50 per cent by the European Central Bank in mid-April.

In Japan, the economy started the year in deep recession and prospects for recovery were dim. However, government spending led to a sharp rebound in growth in the first half of 1999.

The U.S. economy continued to grow vigorously, outperforming most expectations. The Canadian economy started 1999 on a stronger note, with sustained U.S. demand providing an important offset to weak commodity prices and lower demand from Asian countries. In the context of a calmer financial environment, the Bank of Canada cut the Bank Rate by 25 basis points on two occasions, bringing the rate to 4.75 per cent by early May.

The Canadian dollar appreciated from about US$0.6552 in January to US$0.6894 in early May, supported by firming domestic demand, an improving current account balance and more stable world commodity prices.

(II) SECOND HALF OF 1999 - STRONGER GROWTH RAISES CONCERNS ABOUT INFLATION

The outlook for the global economy continued to improve in the second part of the year, while inflation in the major economies remained subdued. In all, the economic outlook for the major industrial countries, with the exception of Japan, showed less divergence in the latter part of the year.

The pace of economic expansion accelerated in the euro area from the below potential growth seen in the first half of the year. By early-November, the European Central Bank had raised interest rates by 50 basis points to 3.00 per cent, noting that its move would help restrain inflation expectations.

Japan, which had grown sharply in the first half of the year, saw output decline after the fiscal support diminished.

In the U.S., GDP growth accelerated further. Although inflation remained subdued, concerns about inflationary pressures were rekindled. In response, the Federal Reserve raised the federal funds target by 25 basis points on three occasions from June to November to reach 5.50 per cent. The rate hikes fully reversed the reductions implemented in reaction to the financial market turbulence in the autumn of 1998.

The Canadian economy also expanded further, supported by the strong U.S. economy, improving domestic demand and recovering Asian economies and world commodity markets. In mid-November, the Bank of Canada raised the Bank Rate by 25 basis points to 5.00 per cent. For most of the period from May to November, the Canadian dollar fluctuated in a range of US$0.6662 to US$0.6894.

Towards year end, various central banks announced contingency arrangements for the period around the year-2000 date change. Likewise, financial market participants took precautions to avoid technical problems over the period, resulting in even quieter-than-normal holiday markets. In any event, the transition to the year 2000 went smoothly.

FINANCIAL REVIEW

1. Foreign Exchange Market Intervention

The objectives of the Exchange Fund Account are to promote orderly conditions in the foreign exchange market for the Canadian dollar and to provide general liquidity for the government. Since September 1998 the Bank of Canada, acting as agent for the Department of Finance, has not undertaken any foreign exchange market intervention in the form of either purchases or sales of U.S. dollars versus the Canadian dollar (see Table 1).[2]

Canada's intervention practices have varied with changes in market conditions. In recent years, intervention has generally been less frequent, reflecting the maturity of the foreign exchange market. However, when required, intervention has often been for greater amounts, reflecting larger market flows and occasionally the increased volatility of the exchange rate.

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 foreign exchange / buying Canadian dollars when there was downward pressure on the exchange rate, or buying foreign exchange / selling Canadian dollars when there was upward pressure on the value of the Canadian dollar). Instead, the current policy is for the Bank of Canada to intervene on a discretionary basis.

Table 1

FOREIGN EXCHANGE MARKET INTERVENTION

	1995	1996	1997	1998	**1999**
	(in millions of U.S. dollars)				
Purchases	5,167	225	1,665	51	**0**
Sales	-5,509	-1,241	-5,326	-9,063	**0**
Net	-342	-1,016	-3,661	-9,012	**0**

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

2. CANADA'S OFFICIAL INTERNATIONAL RESERVES

The Exchange Fund Account is the principal repository of Canada's official international reserves; Canada's foreign assets at the Bank of Canada and the International Monetary Fund are also included in the total of reserves. The composition of Canada's official international reserves and their distribution by holder at year end are shown below:

Table 2

CANADA'S OFFICIAL INTERNATIONAL RESERVES HOLDINGS AS AT DECEMBER 31

	Book Value		Market Value	Of which:			
	1998 Total	**1999 Total**	**1999 Total[1]**	Exchange Fund Account	Bank of Canada	Minister of Finance	Receiver General for Canada
			(in millions of U.S. dollars)				
Convertible foreign currencies[2]:							
U.S. dollars	15,907	**19,170**					
Other	4,004	**5,781**					
Securities (Market Value)			**21,033**	17,578	3,455	-	-
Deposits (Market Value)			**3,399**	3,292	102	-	5
Gold[3]	122	**87**	**524**	524	-	-	-
Reserve position in the IMF	2,297	**3,164**	**3,164**	-	-	3,164	-
Special drawing rights	1,097	**526**	**526**	526	-	-	-
Total holdings	23,427	**28,728**	**28,646**	21,920	3,557	3,164	5

1. The classification of assets in the Statement of Official International Reserves differs from that used in the attached financial statements.
2. The different categories used in this table for book value and market value reflect the change in reporting categories introduced in the June 1999 Official International Reserves press release.
3. From June 30 onward, gold reserves were revalued on a market value basis for reporting purposes. This resulted in an upward revaluation of US$469 million based on the difference between the historical carrying cost (SDR 35 or about US$46.75 per ounce) and the June 30 market price of US$261 per ounce.

   The EFA sold gold on a forward basis during the year, for delivery and settlement in both 1999 and 2000. A total of 681,000 ounces were delivered and settled in 1999 (including 270,000 ounces which had been originally sold forward in 1998 and zero ounces as a result of options being exercised). At year end, the EFA had commitments for sales of 622,000 ounces of gold in 2000 for a total value of US$162.1 million.

Canada's official reserves ended the year at US$28.6 billion on a market value basis. Reserves grew on a book value basis by US$5.3 billion to US$28.7 billion. The increase in the level of reserves over this period was funded in foreign markets using various short, medium and long-term debt issues, swapped domestic issues and spot foreign exchange purchases. These financing activities are set out in greater detail in Table 6. As indicated by the Minister of Finance in the 1996 and 1998 budgets, Canada has moved to increase the level of its foreign exchange reserves, in response to increased flows in foreign exchange markets and in order to maintain a prudent level of liquid reserves in line with other comparable countries.

Table 3 below outlines the main factors affecting the level of reserves:

Table 3A

SOURCES OF CHANGES IN CANADA'S OFFICIAL INTERNATIONAL RESERVES
(book value)

	1998 Book Value	**1999 Book Value**
	(millions of U.S. dollars)	
Market Intervention	-9,012	**0**
Other official transactions[1]	-1,457	**2,744**
Net borrowings including cross-currency swaps	14,138	**1,889**
Foreign currency earnings	1,228	**1,085**
Net proceeds of gold sales	168	**166**
Foreign currency revaluation	400	**-621**
Other	-7	**38**
Total holdings	5,458	**5,301**

Table 3B

SOURCES OF CHANGES IN CANADA'S OFFICIAL INTERNATIONAL RESERVES
(market value)

	1999 Market Value
	(millions of U.S. dollars)
Official intervention	**0**
Net government operations[1]	**4,426**
Foreign currency debt including cross-currency swaps	**1,946**
Gains and Losses on Gold Sales	**16**
Return on investments[2]	**-6**
Foreign currency debt charges	**-1,683**
Foreign currency revaluation	**-587**
Other	**0**
Total holdings	**4,112**

1. Under the previous reserves reporting regime the category *other official transactions* was an aggregate measure of the net use of reserves during the year to meet the currency requirements of the government, including foreign debt servicing, payments and contributions to international institutions and foreign expenditures of government departments. Under the new disclosure regime *other official transactions* is now disaggregated into *official intervention* and *net government operations*, the latter covering net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.
2. *Return on investments* is now comprised of interest earned on investments and changes in the market value of securities resulting from changes in interest rates, while *gains and losses on gold sales* reflects the degree to which proceeds from the sale of gold exceeds the market value of gold that existed at the end of the previous month.

More detailed information on monthly levels and changes in Canada's reserves is presented in Table 7.

3. TERM STRUCTURE OF EFA INVESTMENTS AND LIABILITIES

Table 4

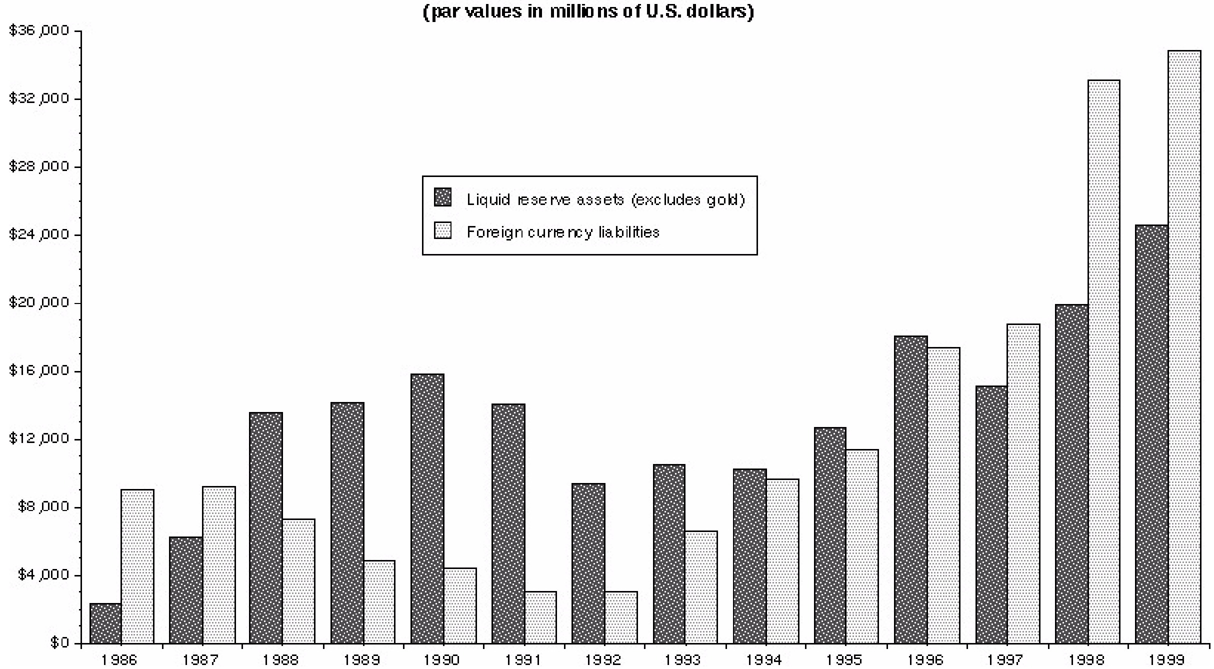
TERM STRUCTURE OF FOREIGN CURRENCY INVESTMENTS AND LIABILITIES
AS AT DECEMBER 31, 1999
(par values[1] in millions of U.S. dollars)

	Foreign currency investments				
Duration	Cash and term deposits	Government securities in domestic currency	Other securities	Total assets[2]	Foreign currency liabilities
US DOLLAR HOLDINGS					
Under 6 months	3,564	300	2,436	6,300	5,110
6 to 12 months	-	-	-	-	44
1 to 5 years	-	4,683	3,087	7,769	11,981
Over 5 years	-	3,118	1,561	4,679	11,748
EURO HOLDINGS					
Under 6 months	24	-	-	24	-
6 to 12 months	-	-	-	-	-
1 to 5 years	-	1,512	70	1,583	1,629
Over 5 years	-	3,013	631	3,644	3,925
YEN HOLDINGS					
Over 5 years	-	488	-	488	416
TOTAL	**3,588**	**13,114**	**7,785**	**24,487**	**34,853**

1. Data in this table reflect the par value of investments. In the attached Financial Statements, investments are reported at their book value which includes unamortized premiums or discounts where applicable and accrued interest. It is expected that next year's EFA annual report will report this table on a market value basis.
2. Includes US$3,483 million (par value) of U.S. Government securities held temporarily by the Bank of Canada at year end, under short-terms asset swaps. See also note 9(a) to the Financial Statements that references these swaps.

Foreign exchange liabilities have grown significantly in recent years, particularly in 1998 due to extensive foreign exchange intervention and important commitments to the International Monetary Fund. As a result, foreign currency liabilities grew to exceed foreign currency assets in the EFA (see Graph 1). Purchases of US dollars in the foreign exchange markets are being used to reduce the mismatch between foreign currency liabilities and assets. The government plans to continue to bring foreign currency liabilities in line with foreign currency assets in an orderly and prudent manner over the next few years.

GRAPH 1 - CANADA'S FOREIGN EXCHANGE RESERVES AND LIABILITIES, 1986-1999
(par values in millions of U.S. dollars)



4. THE EXCHANGE FUND ACCOUNT'S REVENUES

The Exchange Fund Account'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 1999, the EFA's income totalled C$1,935 million, compared with C$1,656 million in 1998. Income earned by other reserve holders is added to official reserves, but is reported directly by those other entities.

The main categories of income earned by the EFA are summarized below:

Table 5

EXCHANGE FUND ACCOUNT INCOME SUMMARY

	1995	1996	1997	1998	**1999**
		(in millions of Canadian dollars)			
INVESTMENT INCOME					
Marketable securities	758	961	1,030	1,364	**533**
Cash and short-term deposits	188	197	260	257	**237**
Special drawing rights	79	63	64	69	**33**
Gold	17	26	23	26	**14**
Total Investment Income	1,042	1,247	1,377	1,716	**817**
OTHER INCOME					
Gains on gold sales	214	156	-	253	**247**
Foreign exchange gains (losses)	127	(101)	(41)	(313)	**871**
TOTAL INCOME	1,383	1,302	1,336	1,656	**1,935**

Pursuant to Note 2a of the financial statements, EFA assets are valued at the lower of their amortized cost (including accrued interest) and their year-end market values. This led to a write down of C$640 million in the value of the EFA's assets in 1999 (see Notes 4 and 5 of the financial statements for details on this write down). Interest rate increases in the U.S. (2-year Treasury yields increased 170 bp, 5-year Treasury yields increased 180 bp and 10-year Treasury yields increased 180 bp) and Europe (2-year Bund yields increased 110 bp, 5-year Bund yields increased 148 bp and 10-year Bund yields increased 150 bp) caused the market value of the EFA's assets to decrease over the year, while the weakness of the euro vis-à-vis the U.S. dollar (from US$1.1723 to US$1.0063) resulted in a translation loss as euro denominated assets are reported in U.S. dollars. These factors were the primary causes of the write down of the EFA assets.

At year end, the EFA's portfolio of marketable securities consisted entirely of discount and fixed-rate securities; there were no floating rate investments held.

The EFA's securities lending programs enhance the yield earned on its securities portfolio by lending out to counterparties securities which are highly sought after in the market. However, at year end, no U.S. Government securities were held by financial institutions that act as agents for on-lending these securities in the market. (The lending program was temporarily suspended in late 1999 in order that all EFA securities would be available on a contingency basis for Y2K-related concerns.) Similarly, at the end of its first year in operation, there were no euro-denominated securities on loan to eligible counterparties. This compares with a total of US$ 2,775 million in U.S. government securities on loan at the end of 1998. Income from securities lending was US$4.6 million in 1999.

The EFA continues to lend gold in the market on a short term basis, periodically using forward rate agreements in order to benefit from occasional upward fluctuations in rates offered on gold loans and to establish rollover rates on these loans prior to their maturity. It also continued sales of call options on part of the gold holdings. Income from these activities is reported as investment income on gold.

5. FINANCING OF EFA ASSETS

EFA foreign currency reserves are financed by foreign currency borrowings by the government (see Table 6). Currently, all foreign currency marketable assets are matched by foreign currency borrowings. In addition, because of heavy intervention in support of the Canadian dollar in 1998, there are currently more foreign currency liabilities than foreign currency assets (i.e. a portion of foreign currency liabilities is not matched by foreign currency assets). As indicated earlier, the government plans to continue to bring foreign currency liabilities in line with foreign currency assets in an orderly way over the next few years.

Table 6

FOREIGN CURRENCY ISSUES
AS AT DECEMBER 31

	1998	**1999**
	(in millions of U.S. dollars)	
Bonds	13,217	**15,038**
Canada Bills	6,622	**3,293**
Swapped domestic issues	8,341	**12,807**
Floating Rate Note	2,000	**-**
Canada Notes	416	**661**
Euro Medium Term Notes	2,485	**3,054**
TOTAL	33,081	**34,853**

6. COST OF THE EFA

To calculate the cost of the EFA one can use the interest paid on foreign currency borrowings. Off-setting that cost is the interest earned on the EFA's foreign currency assets. As the EFA is currently in a net foreign currency liability position there is a proportion of liabilities that cannot be matched to any foreign currency asset revenues. In order to calculate the true economic cost of the EFA it is necessary to include an estimate of the revenues that are associated with that excess foreign currency liability position.

In order to estimate the revenues earned on the net foreign currency liability portion of the EFA it is necessary to realize that sales of foreign currency assets used for intervention produce Canadian dollar cash and, therefore, these Canadian dollars can be considered as a substitute for Canadian dollar borrowings. The cost of short-term Canadian dollar liabilities over the same period (since unmatched foreign currency liabilities are largely short-term, floating-rate liabilities) can be used to estimate revenues associated with the excess foreign currency liability position.

Beyond the difference in costs and estimated revenues on the excess foreign currency liability position, there is the risk that the cost will increase because of foreign exchange rate changes. This is why the excess liability position is being eliminated.

Following the above approach, the cost of funding the EFA in 1999 was estimated at between C$1,730 million and C$1,780 million, compared to total income for the EFA of C$1,935 (Table 5).

7. Risk Management and Financial Instruments

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

Credit Risk

The main criteria for designating institutions, governments, and their agencies whose securities or notes can be purchased or with which deposits can be made, is the credit rating assigned by prominent international and domestic credit agencies. To ensure that the EFA 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, while there are further limits on exposure to any one issuer or counterparty.

Liquidity Risk

The EFA's liquidity management is designed to provide a level of liquid assets sufficient to meet the requirements of foreign exchange market intervention, disbursements related to maturing foreign currency borrowings, or the costs of foreign currency debt servicing and other government departmental currency requirements. Liquidity risk management is especially important for the EFA given that intervention requirements are inherently unpredictable. Liquidity management in the EFA therefore includes the management of cash balances and short-term investments. At year end, assets with less than six months to maturity represented 26% of the EFA's portfolio.

Liability management is also an important element of liquidity management given that the EFA is largely funded by foreign currency borrowings, including a US dollar commercial paper program (see "Canada Bills" in Table 6). The government manages foreign currency borrowings so as to typically keep total liabilities on foreign currency borrowings coming due within one year to an amount that is less than one-third of total liquid foreign currency assets. At year-end, total EFA liabilities coming due within one year were US$5,154 million, as compared to total liquid assets of US$24,487 million.

Interest Rate Risk

Interest rate risk arises from differences in the duration of assets and liabilities, or from the need to liquidate investments prior to maturity to meet disbursements. Risk is minimized by managing the duration structure of the EFA's assets and implicit liabilities; by maintaining portfolios of short-term and longer-term investments; and by monitoring gaps in the duration structures or in the relative levels of interest rates on assets and implicit liabilities. Liabilities used as reference for risk management are the foreign currency borrowings of the CRF, the proceeds of which have been advanced to the EFA.

Foreign Exchange Risk

Due to the nature of the EFA's holdings, fluctuations in the value of the U.S. dollar vis-à-vis the Canadian dollar are reflected in income for the year. To a large extent, however, EFA assets are funded by liabilities denominated in the same currency so as to minimize foreign exchange risk. Such an asset/liability matching framework eliminates much of the foreign exchange exposure on euro and Japanese yen assets (all of the EFA's assets and liabilities which had been initially denominated in German marks or French francs were redenominated into euro early in the year).

Gold Loans and Gold Sales

The EFA lends most of its gold on a short-term basis to financial institutions and to major gold trading firms. Gold loans are secured by the provision of collateral by borrowers, in the form of letters of credit or promissory notes issued by major financial institutions. The EFA has made use of forward agreements to obtain higher yields on its gold loans. Under such agreements, during periods where loan rates are volatile, interest rates on the renewal of loans are fixed in advance of the renewal date.

The EFA sells gold in spot and forward markets. Under forward contracts, the EFA is committed to selling gold at future dates for predetermined prices. It also sells call options on a portion of its gold holdings. Under call options contracts, the EFA receives a premium against commitments to sell gold at predetermined dates and prices, at the option holders' discretion.

Securities Lending

The EFA's US dollar-denominated securities lending program involves lending securities through agents to various counterparties. These loans are secured through collateral provided by the counterparties, as well as the guarantee of the agent. Income flows from the underlying securities continue to accrue to the EFA while they are on loan.

A euro-denominated securities lending program was initiated in the latter half of the year. It involves lending euro-denominated securities directly to various counterparties. These loans are secured through collateral provided by the counterparties. Income flows from the underlying securities continue to accrue to the EFA while they are on loan.

Table 7A

CANADA'S OFFICIAL INTERNATIONAL RESERVES[1]
(book value in millions of U.S. dollars)

	Foreign Currencies						Month-to-Month Changes						
								of which					
Month End	U.S. Dollars	Other[2]	Gold[3]	Special Drawing Rights[4]	Reserve Position in the IMF[4 5]	Total	Total Monthly Change	Net Borrowings or Repayments in Foreign Currency	Gain on Gold Sales	Earnings on Investments	Revaluation Effects	Official Government Operations[6]	Other Transactions
1998													
December	15,907	4,004	122	1,097	2,297	23,427							
1999													
January	16,238	3,649	121	1,083	2,354	23,445	18	-168	-	134	-173	226	-1
February	15,421	3,437	119	366	3,012	22,355	-1,090	-1,191	-	73	-236	258	6
March	17,233	4,255	111	456	2,903	24,958	2,603	2,398	41	93	-41	112	-
April	17,610	4,152	104	454	2,997	25,317	359	-234	33	143	-110	527	-
May	17,550	4,098	103	467	2,982	25,201	-116	-497	-	131	-76	326	-
June	17,527	4,644	102	464	2,963	25,700	499	14	-	81	-1	387	18
July	16,912	5,038	101	474	3,025	25,550	-150	-405	20	91	256	-120	8
August	16,947	5,082	93	492	3,111	25,725	175	-78	43	70	-10	150	-
September	17,033	5,312	88	499	3,211	26,143	418	-100	29	45	120	327	-3
October	17,333	5,573	87	496	3,195	26,684	541	325	-	41	-87	266	-4
November	19,478	5,575	87	510	3,170	28,820	2,136	1,998	-	83	-248	302	1
December	19,170	5,781	87	526	3,164	28,728	-92	-173	-	100	-15	-17	13

1. Due to a different accounting treatment for accrued earnings on SDR-denominated assets and year-end revaluation of holdings of other currencies and the investment portfolio, the numbers in this table differ slightly from the corresponding numbers in the attached Financial Statements.
2. Valued at closing market rates in terms of U.S. dollars.
3. Gold is valued at SDR 35 per ounce.
4. SDR-denominated assets are valued at the U.S. dollar rate the SDR established by the IMF. A rise in the SDR in terms of the U.S. dollar generates an increase in the U.S. dollar value of Canada's holdings of SDR-denominated assets.
5. 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.
6. Official government operations include purchases and sales of foreign exchange aimed at moderating movements in the Canadian dollar and net government requirements of foreign exchange.

Table 7B

CANADA'S OFFICIAL INTERNATIONAL RESERVES
(market value in millions of U.S. dollars)

	Foreign Currencies						Month-to-Month Changes	of which						
Month End	Securities	Deposits	Gold[1]	Special Drawing Rights[2]	Reserve Position in the IMF[2 3]	Total	Total Monthly Change	Foreign Currency Debt	Gains and Losses on Gold Sales	Return on Investments[4]	Foreign Currency Debt Charges	Revaluation Effects	Net Government Operations[5]	Other
1998														
December	16,622	3,803	715	1,097	2,297	24,534								
1999														
January	16,885	3,505	710	1,083	2,354	24,537	3	-168	-	-9	-99	-47	326	-
February	16,007	3,041	714	366	3,012	23,140	-1,397	-1,191	-	-309	-160	-154	417	-
March	18,750	2,854	650	456	2,903	25,613	2,473	2,398	3	111	-179	-151	291	-
April	18,571	3,359	628	454	2,997	26,009	396	-234	2	166	-80	-65	607	-
May	17,860	3,684	589	467	2,982	25,582	-427	-497	-	-140	-75	-115	400	-
June	18,943	2,864	572	464	2,963	25,806	224	66	-	-105	-202	-124	589	-
July	18,787	2,786	540	474	3,025	25,612	-194	-394	3	89	-248	228	128	-
August	18,471	3,143	495	493	3,111	25,713	101	-79	8	44	-101	-22	251	-
September	19,017	2,969	540	499	3,211	26,236	523	-93	-	94	-183	194	511	-
October	19,562	2,975	540	496	3,195	26,768	532	318	-	18	-18	-70	284	-
November	20,837	3,854	526	510	3,170	28,897	2,129	1,995	-	77	-208	-244	509	-
December	21,033	3,399	524	526	3,164	28,646	-251	-175	-	-42	-130	-17	113	-

1. Gold valuation is based on the London p.m. fix on the last business day of the reporting month.
2. SDR-denominated assets are valued at the U.S. dollar rate the SDR established by the IMF. A rise in the SDR in terms of the U.S. dollar generates an increase in the U.S. 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. Return on investments are comprised of interest earned on investments and changes in the market value of securities resulting from changes in interest rates.
5. Net government operations are the net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

EXCHANGE FUND ACCOUNT

FINANCIAL STATEMENTS

DECEMBER 31, 1999

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 of the Government of Canada set out in Note 2 to the financial statements. 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 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 his audit to the Minister of Finance.

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

G.G. Thiessen
Governor
Bank of Canada

Kevin G. Lynch
Deputy Minister
Department of Finance

F.J. Mahoney
Chief Accountant
Bank of Canada

EXCHANGE FUND ACCOUNT
BALANCE SHEET

AS AT DECEMBER 31, 1999

	1999		1998	
	(in millions of dollars)			
	US	***Canadian***	US	Canadian
ASSETS				
Denominated in U.S. dollars				
Cash and short-term deposits	**$ 3,575**	**$ 5,160**	$ 3,536	$ 5,422
Marketable securities (Note 4)	**11,696**	**16,881**	9,327	14,301
	15,271	**22,041**	12,863	19,723
Denominated in other foreign currencies				
Cash and short-term deposits (Note 5)	**24**	**35**	254	390
Marketable securities (Note 5)	**5,564**	**8,030**	3,708	5,685
	5,588	**8,065**	3,962	6,075
Denominated in special drawing rights				
Special Drawing Rights (Note 6)	**529**	**764**	1,391	2,133
Gold and gold loans (Note 7)	**88**	**127**	124	191
	617	**891**	1,515	2,324
Official international reserve assets	**$ 21,476**	**$ 30,997**	$ 18,340	$ 28,122
DUE TO THE CONSOLIDATED REVENUE FUND				
Advances (Note 8)		**$ 29,062**		$ 26,466
Revenues for the year		**1,935**		1,656
		$ 30,997		$ 28,122

Approved:

G.G. Thiessen
Governor
Bank of Canada

Kevin G. Lynch
Deputy Minister
Department of Finance

F.J. Mahoney
Chief Accountant
Bank of Canada

See accompanying notes to the financial statements

EXCHANGE FUND ACCOUNT
STATEMENT OF REVENUE

FOR THE YEAR ENDED DECEMBER 31, 1999

	1999	1998
	(in millions of Canadian dollars)	
Revenue from investments		
Marketable securities	**$ 533**	$ 1,364
Cash and short-term deposits	**237**	257
Special drawing rights	**33**	69
Gold	**14**	26
	817	1,716
Other revenue (loss)		
Gain on sales of gold	**247**	253
Net foreign exchange gains (losses)	**871**	(313)
	1,118	(60)
Net revenue for the year due to the Consolidated Revenue Fund	**$ 1,935**	$ 1,656

See accompanying notes to the financial statements

NOTES TO FINANCIAL STATEMENTS
December 31, 1999

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 which 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*.

2. SIGNIFICANT ACCOUNTING POLICIES

Significant accounting policies of the Account are set out below. As required by the *Currency Act*, they conform to the stated accounting policies used by the Government of Canada to prepare its financial statements.

a) *Valuation of assets*

The estimated fair market value of cash and short-term deposits, which are 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 Special Drawing Rights (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 (five for the comparative year).

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 conforms to the value used in the *Public Accounts of Canada*.

b) *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, and revenues from securities lending activities. Write-downs of securities to their year-end market values (if applicable) are recorded as a charge to investment revenue in the year in which they occur.

c) Gold

Gold sales and net gains on gold sales are recorded at settlement dates. Interest revenue from gold loans is recorded on an accrual basis and is included in revenue. Premiums received on the sales of call options on gold are recorded in revenue.

d) Translation of foreign currencies and SDRs

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

	Canadian dollars	
	1999	1998
US dollar	**1.4433**	1.5333
Japanese yen	**0.01416**	0.01350
German mark	**0.7426**	0.9191
French franc	**0.2214**	0.2741
Euro	**1.4525**	-
Special Drawing Right	**1.97869**	2.1570

Foreign exchange gains or losses result from the translation of assets and advances denominated in foreign currencies and SDRs, as well as transactions throughout the year. Unrealized foreign exchange gains or losses on short-term currency swap arrangements with the Bank of Canada and on currency hedges are recorded in revenue as *Net foreign exchange gains (losses)*. See also Note 9.

The reported amount at year-end of assets that are hedged against exchange rate fluctuations includes unrealized gains or losses on the translation of the related outstanding hedge contracts. See also Notes 5 and 9.

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.

e) Disposition of revenues

The revenues for the year are payable to the Consolidated Revenue Fund of the Government of Canada within three months after the end of the year in accordance with the *Currency Act*.

f) Services received without charge

The Account receives without charge administrative, custodial and fiscal agency services from the Bank of Canada.

g) Interest-free advances

The Account receives interest-free advances from the Consolidated Revenue Fund.

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. During the year 1999, official international reserves increased by US$ 2,744 million as a result of these operations (versus a decrease of US$ 10,467 million in 1998). None of these transactions during 1999 was aimed at moderating movements in the value of Canadian dollar (compared to the sale of US$ 9,063 million and purchase of US$ 51 million in 1998).

4. MARKETABLE SECURITIES DENOMINATED IN US DOLLARS

	1999			1998		
	(in millions of dollars)					
Securities	***Par value US***	***Amortized cost US***	***Amortized cost Canadian***	Par value US	Amortized cost US	Amortized cost Canadian
US Government	**$ 4,617**	**$ 4,736**	**$ 6,837**	$ 5,482	$ 5,645	$ 8,656
US Federal Agencies	**3,800**	**3,762**	**5,430**	1,856	1,855	2,844
Sovereign paper and International Institutions	**3,283**	**3,251**	**4,692**	1,704	1,713	2,626
Accrued interest	**-**	**203**	**292**	-	114	175
	$ 11,700	**$ 11,952**	**$ 17,251**	$ 9,042	$ 9,327	$ 14,301
Estimated market value:		**$ 11,696**	**$ 16,881**		$ 9,524	$ 14,603

Estimated market values are based on quoted market prices.

At year-end, the value of securities was written down by US$ 256 million (C$ 370 million) from their amortized cost including accrued interest, to reflect the estimated net market value of these assets. A charge of C$ 370 million was made against the investment income for 1999.

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 counter-parties in these transactions. At year-end, there were no US Government securities being used in securities lending operations, whereas for 1998 there were US$ 2,350 million (par values) of US Treasury Notes and US$ 425 million of US Treasury Bills being used in securities lending operations with financial institutions. Subsequent to year-end, the Account has resumed securities lending operations.

5. ASSETS DENOMINATED IN OTHER FOREIGN CURRENCIES

	Cash and Short-term Deposits			
	1999		1998	
	(in millions of dollars)			
	US	**Canadian**	US	Canadian
Euro	**$ 24**	**$ 35**	-	-
German marks	**-**	**-**	**$ 252**	$ 386
French francs	-		1	2
Japanese yen	**-**	**-**	1	1
Accrued interest	**-**	**-**	-	1
	$ 24	**$ 35**	$ 254	$ 390

	Marketable Securities			
	1999		1998	
	(in millions of dollars)			
	US	**Canadian**	US	Canadian
Euro	**$ 5,259**	**$ 7,590**	-	-
German marks	-	**-**	$ 2,747	$ 4,211
French francs	-	**-**	715	1,097
Japanese yen	**493**	**711**	246	377
Amortized cost at year-end:	**$ 5,752**	**$ 8,301**	$ 3,708	$ 5,685
Estimated market value at year-end:	**$ 5,564**	**$ 8,030**	$ 3,864	$ 5,925

Estimated market values are based on quoted market prices.

At year-end, the value of securities was written down by US$ 188 million (C$ 271 million) from their amortized cost, to reflect the estimated net market value of these assets. A charge of C$ 271 million was made against the investment income for 1999.

6. SPECIAL DRAWING RIGHTS (SDRS)

	1999		1998	
	(in millions of dollars)			
	US	***Canadian***	US	Canadian
Held at the end of the year	**$ 526**	**$ 759**	$ 1,384	$ 2,123
Accrued interest	**3**	**5**	7	10
	$ 529	**$ 764**	$ 1,391	$ 2,133

7. GOLD AND GOLD LOANS

During the year, the Account sold 681,289 fine ounces of gold (600,000 fine ounces in 1998).

	1999		1998	
	(in millions of dollars)			
	US	***Canadian***	US	Canadian
Held at the end of the year				
Gold loans	**$ 82**	**$ 117**	$ 117	$ 180
Gold	**5**	**8**	5	8
Accrued interest on gold loans	**1**	**2**	2	3
	$ 88	**$ 127**	$ 124	$ 191

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

		1999		1998	
		Price per fine ounce	***Total value in millions***	Price per fine ounce	Total value in millions
Carrying value	- US	**$ 47.98**	**$ 87**	$ 49.24	$ 122
	- Canadian	**69.25**	**125**	75.50	188
Market value	- US	**290.25**	**524**	287.45	715
	- Canadian	**418.92**	**756**	440.75	1,096

8. DUE TO THE CONSOLIDATED REVENUE FUND (CRF) - ADVANCES

The Account is funded by advances from the CRF. During the year, these were limited to C$ 35 billion by Order in Council dated February 21, 1997 (revised by Order in Council to C$ 40 billion effective December 30, 1999). At year-end, advances from (deposits with) the CRF consisted of:

	1999	1998
	(in millions of Canadian dollars)	
US dollars	**$ 41,686**	$ 45,951
Canadian dollars	**(19,598)**	(24,340)
German marks	-	3,676
French francs	-	1,096
Euro	**7,473**	-
Japanese yen	**708**	-
Special Drawing Rights	**(1,207)**	83
	$ 29,062	$ 26,466

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 SDR allocations 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.

9. COMMITMENTS

a) Currency swaps

The Account enters into short-term currency swap arrangements with the Bank of Canada. The objective of these swaps is to assist the Bank in its cash management operations. As part of these agreements, the Account sells US government securities denominated in US dollars for Canadian dollars, with simultaneous agreements to repurchase these securities from the Bank on future dates at the same exchange rates in effect at the time the swaps were entered into. The maximum term of the swaps is equivalent to the term of the underlying securities; however, they are generally reversed earlier based on operational requirements of the Bank.

These swaps result in receipts of Canadian dollars by the Account, which are remitted to the Consolidated Revenue Fund. These transactions are reversed when the swaps are unwound.

At year-end, the Account had commitments to repurchase US dollar securities under swap arrangements with the Bank of Canada of US$ 3,534 million (US$ 2,941 million in 1998). The Canadian dollar equivalent at the year-end exchange rate was $5,101 million ($4,509 million in 1998).

b*)* ***Currency hedges and other uncompleted transactions***

At year-end, there were no commitments for forward sales and purchases of various currencies, whereas in 1998 there were commitments for net forward sales of 832 million of German marks and 35 billion of Japanese yen against total net forward purchases of US$ 774 million.

c) ***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.

Under gold options, the Account receives a premium against commitments to sell gold at predetermined prices. No gold is sold unless the holders of the options exercise their rights by the expiry dates. At year-end, the Account had outstanding commitments to sell 50,000 fine ounces of gold under call option contracts (200,000 fine ounces in 1998) with a potential total value, if the options were exercised, of US$ 14 million (US$ 63 million in 1998). These options mature by the end of the 1st quarter in 2000.

Under forward contracts, the Account is committed to sell gold at predetermined prices on future dates. At year-end, the Account had outstanding commitments to sell 622,000 fine ounces of gold (270,000 fine ounces in 1998) for a total value of US$ 164 million (US$ 82 million in 1998). The dates of these contracts extend until August 31, 2000.

10. Uncertainty Due to the Year 2000 Issue

The Year-2000 computer issue arose chiefly because many date-sensitive automated systems had not been designed to recognize correctly the year 2000. This represented a significant challenge for all organizations. If not addressed properly, the Year-2000 issue could have had an impact on operations and financial reporting, ranging from minor errors to the failures of critical systems. Although the change in date has occurred, it is not possible to conclude that all aspects of the Year-2000 issue that may affect the Account, including those related to customers, suppliers, or other third parties, have been fully resolved.