the efforts of the Prices and Incomes Commission to elicit the support of all groups in the economy for its voluntary restraint program have as yet met with only partial success. The nominal increases in incomes arising from wage settlements has continued to average between 8 and 9 per cent, in an economy in which productivity cannot normally be expected to increase by more than 2½ to 3 per cent a year. Such settlements are bound to be largely illusory and eaten up in higher prices. As long as such increases persist, the durability of the more satisfactory price performance recently experienced will inevitably be called into question and sustainable economic expansion will be delayed.

The economic situation and outlook in Canada is, as always, much affected by what happens abroad. The United States is going through a difficult period of adjustment, with a halt in economic expansion and continued upward pressures on costs and prices. Many of Canada's other major trading partners are also subject to strong inflationary pressures. These external forces have contributed to the extraordinarily buoyant foreign demands for Canada's products. The result has been a trade surplus of unprecedented magnitude. The scale of this surplus, augmented by continuing long-term capital inflows, resulted in strong upward pressure on the Canadian dollar and a large build-up of foreign exchange reserves. The imminent danger that developing speculative forces would add to the already serious financing problems associated with the accumulation of reserves, led to the decision of the Government of Canada at the end of May not to observe for the time being a fixed par value but to allow the Canadian dollar to appreciate in the exchange market. The way in which Canada's international payments position will develop is not yet clear, though an appreciable decline in the present rate of trade surplus would not be surprising as temporary stimuli wear off and the appreciation in the exchange value of the Canadian dollar begins to take effect....

EASING OF PRICE INCREASES

In the past six months, substantial progress appears to have been made towards creating an atmosphere more conducive to reasonable cost and price stability and stable growth in the economy over the longer run. Excess demand has been eliminated, and there has been at least a tentative easing of price increases, mainly at the expense of industrial and farm profits. This has led to a number of adjustments in policy designed to guide the economy into a growth path that would limit the amount of slack in the economy to the minimum required to provide some continuing check to persistent inflationary tendencies....

Shortly after the beginning of 1970, interest rates abroad, particularly short-term rates, began to ease. The Bank of Canada permitted this development to have an effect on interest rates in Canada. This was partly to avoid creating any interest-rate incentive for short-term capital to move into Canada, but it was also a recognition that, in the light of the amount of slack that appeared to be in prospect in the economy and the inevitable lags in policy effects, the tightening process had gone about as far as it was appropriate to push it....

The management of monetary policy during the second quarter was complicated by the upward pressure on the Canadian dollar in the exchange market, which gathered force at a time when there had already been a significant rise in bank liquidity and interest rates were declining. As the Government's Canadian dollar balances were used to buy foreign exchange, the total of privately-held currency and bank deposits began to expand at a rate that was a good deal faster than desirable over the longer haul (at an annual rate of 17 per cent over the quarter as a whole). At mid-May, the Government replenished its own balances to the extent of $250 million through a special issue of treasury bills, adding further to bank liquidity. Under the circumstances, the Bank decided to offset this effect by an increase in the chartered banks' minimum secondary reserve ratio from 8 per cent to 9 per cent of deposit liabilities, but the bank rate was reduced at the same time. Unduly high interest rates would have encouraged capital inflows, and the Government's cash requirements would have been increased to finance further accretions to the Exchange Fund. The decision of the Canadian Government to allow the Canadian dollar to float for the time being has reduced this problem for monetary policy but not entirely removed it. The bank rate was reduced again at the beginning of June in the light of the potentially restrictive effects of the appreciation of the Canadian dollar, which seemed likely to occur after the decision to permit the exchange rate to float. In the aftermath of these and other events which created pressures in money markets, the high rates of monetary expansion and additions to bank liquidity continued during June, but these trends have since been moderated....

At present, the Bank is trying to steer a very narrow course. While it must clearly be mindful both of the degree of slack that exists in the economy and the length of time it takes for changes in monetary conditions to have their full effect, it does not wish to sacrifice the significant gains that have been made in reducing the strong inflationary forces in the economy by excessive or premature monetary expansion. So long, however, as care is taken not to ease restraints too rapidly, business will continue to find it difficult to pass cost increases on in the form of higher prices, while the slower rate of increase in prices should lead people to moderate their wage and salary increases. And once the resumption of satisfactory and sustainable growth in the economy is achieved, we should be rewarded with a better productivity performance which will permit a higher proportion of the rise in incomes to be real rather than illusory....