



Bank of Canada

UPDATE

Complicated Economic Times, Hard Choices for Central Bankers

In late 2024 and early 2025, our conversations with customers focused on how **global structural shocks** were contributing to keep Canadian total and core CPI inflation elevated. At the time, we projected the Bank of Canada's (BoC) terminal rate would reach 3.00% by spring 2025, even as households and businesses show caution in spending due to elevated uncertainty. The BoC ultimately lowered the overnight rate target to 2.75%. It has remained at that level since mid-March.

Weak real GDP growth and worsening labour market conditions in North America have prompted us to reassess our outlook. We now expect the BoC to cut rates by 25 basis points at each of its September, October, and December meetings. This would bring the overnight rate target to **2.00% by year-end 2025** near the bottom of the estimated neutral range of 2.25%–3.25%.

Additional easing could be required in 2026 if the U.S. withdraws from United States–Mexico–Canada Agreement (USMCA) or faces deeper economic troubles due to U.S. Federal Reserve developments and/or rising U.S. long-term interest rates. At the same time, **Canadian CPI inflation could remain relatively elevated**. **Supply-driven inflation** could limit how far the Bank of Canada will be able to lower its policy rate.

Sluggish Real GDP Growth and Broader Deterioration of Job Market Conditions

The combination of the **real GDP contraction in Q2 2025** and **weak momentum** heading into Q3 are adding slack to the Canadian economy already in an excess supply situation. While it is challenging to assess the exact incremental addition of excess supply, a modest cumulative policy rate cut of at least 50 basis points appears necessary at this stage.

Despite the volatility in Canadian exports triggered by the **front-loading activity ahead of tariff implementation**, expenditure components of GDP—such as consumer spending, housing activity, and government expenditures—have been trending positively. Encouraging signs of recovery in the Toronto and Vancouver resale housing markets suggest the formation of a possible bottom. Combined with healthier conditions in other urban markets, the nation-wide housing market does not require a policy rate below 2%. Otherwise, shelter inflation may end up higher than expected.

Canadian consumer confidence has partially recovered since the lows of April. **Consumer spending has outpaced sentiment** so far but this may not last, due to the broadening deterioration of labour market conditions. The BoC's July [Summary of Deliberations](#) noted: *"further monetary policy support would likely be needed given the estimated amount and persistence of slack in the economy, particularly if the labour market softened further"*. The [Labour Force Survey released on September 5](#), underscored the **growing deterioration**. Labour market conditions are no longer just soft—they're nearing a critical threshold.



Unemployment rose by 0.2pp to 7.1% in August relative to the previous month—the highest figure since the 2016 oil shock (excluding the pandemic). At the provincial level unemployment is elevated not only in communities directly impacted by U.S. tariffs—such as some in Southern Ontario—but also in other regions across the country. **Job losses are widespread**, not just in manufacturing, wholesale, and transportation. Combined with fewer job postings, the **risk of long-term unemployment** is rising.

Too Many Canadian Companies Still Planning to Raise Prices

Even with weak real GDP momentum and further deterioration of labour market conditions, surveys show that **Canadian CPI inflation is unlikely to fall significantly**. This rules out a 50 basis points cut in a single meeting or a BoC terminal rate closer to 1.0%-1.5%. Instead, surveys point to continuous stickiness of underlying inflation. A reliable indicator of total and core CPI inflation turning points is the [Survey on Business Conditions](#) from Statistics Canada. The latest Q3 2025 results signal an acceleration of inflationary pressures. **26% of businesses plan to raise prices** over the next 12 months—slightly more than in early 2025 and 2024. Additionally, **39% of businesses intend to pass on tariff-related costs**, substantially up from 24%, previously.

Furthermore, the [Canadian Federation of Independent Businesses](#) reports the **average price increase intention remains elevated, at 2.7%**. Moreover, as of July, 40% of items in the CPI basket rose more than 3% year-over-year—the **highest level since the early 2010s**, excluding the pandemic period, when inflation was mostly driven by excessive demand outpacing unusually high supply-driven inflation. Even though U.S. tariff-related price impacts are expected to affect American consumers more than Canadian ones in the coming months, we can infer from the San Francisco Federal Reserve's [Supply- and Demand-Driven PCE Inflation report](#) that goods CPI inflation excluding energy in Canada is mainly supply-driven this year. This has altered the traditional link between Canada's output gap and CPI inflation, limiting the magnitude of monetary easing going forward.

Déjà Vu? Elevated Inflation Expectations Cannot be Ignored

The **lingering psychological impact of pandemic-era inflation** calls for prudence during this upcoming easing phase. Canadians are wary of reliving another period of rapid increase in the cost of living. According to the BoC's [consumer expectations survey](#), about **60% of Canadians plan to reduce spending** due to inflation concerns. Additional policy rate cuts could further fuel inflation expectations already above 3% across the 1- to 5-year horizon.

Modest Easing Scenario Versus Bolder Easing Scenario

Historically, the BoC has never lowered the overnight rate target when core CPI inflation measures and consumer expectations are as high as they are today. **Economic uncertainty** is making it hard for policymakers to feel extremely confident that both total and core inflation are heading toward 1.5% in 2026. As such, it will be difficult for the Bank of Canada to begin a substantial rate-cutting cycle of at least 100 basis points. By year-end, the BoC could find itself in an **unusual position**: on the fringe of stimulative monetary territory, with core CPI inflation closer to 2.5%–3% than the mid-point target of 2%.

We focus on core CPI inflation metrics and surveys because they better reflect underlying price pressures. Total CPI inflation has been temporarily lowered—by 0.7 percentage points over the past 12 months—due to the removal of Canada's federal consumer carbon tax in April.

BoC officials may be tempted to look to the European Central Bank's report [Economic Uncertainty Weakens Monetary Policy Transmission](#) and say there is very little risk to embark on a modest easing adjustment. Since **businesses and households are hesitant to spend** due to economic uncertainty, one could even argue that even the cumulative 75 basis points cut we forecast may not be enough to boost aggregate demand.



The argument that **multiple BoC policy rate cuts would not fundamentally improve the outlook faced by industries hit hardest by U.S. tariffs** is still valid, but it now overlooks the fact that broader economic conditions have deteriorated. At the same time, bringing the overnight rate target closer to 1.5% could eventually be justifiable. This would depend on whether the U.S. administration issues a six-month notice to withdraw from USMCA in 2026 and significantly raises tariffs on Canadian export products across the board.

Meanwhile, developments in the U.S. economy and at the Federal Reserve—such as **concerns over debt sustainability** or **political interference** on U.S. monetary policy—could also affect the BoC outlook.

The upcoming **shift toward a less restrictive monetary policy stance in the U.S.**, expected to begin on September 17th, may sufficiently lower Canadian interest rates on the yield curve to reduce the need for the BoC to cut its policy rate to substantially below 2%. The **significant drop in U.S. and Canadian bond yields** on September 5—except in the 30-year sector—was somewhat encouraging, as it challenges the growing concern that central bankers have lost control of the yield curve. According to [staff from the Dallas Fed](#), each percentage point increase of the debt-to-GDP ratio lifts long term rates by more basis points than previously estimated. Accordingly, it will limit the boost to US GDP coming from the One Big Beautiful Bill Act. The same can be said about the upcoming federal budget in Ottawa poised to show a rising debt-to-GDP ratio.

The situation could become trickier if the U.S. administration appoints a Fed Chair who favours a stimulative federal funds target. A [study from the Peterson Institute](#) suggests a loss of **Fed independence** could trigger **large capital outflows from the U.S. and inflows to other industrialized economies**, which may push Canadian benchmark interest rates down. In that case, the BoC might not need to bring down the policy rate substantially. However, a swift appreciation of the Canadian dollar and a weaker U.S. economic outlook—driven by capital outflows and rising long-term U.S. interest rates—could complicate the overall picture.

Takeaway

The [BoC's LinkedIn](#) tagline reads “*Canadians count on us.*” A **challenging communication exercise** lies ahead for BoC officials. They will likely have to explain to Canadians their decision to cut the policy rate, even as inflation anxiety and elevated underlying inflation may persist. We **project three consecutive 25 basis points incremental reductions** at the September, October and December meetings. Considering the **conflicting forces and moving parts**, we acknowledge that the total amount of easing could ultimately reach a minimum of 50 basis points or more than 100 basis points.