Bank of Canada Rate Announcement

January 29 2025

Bank of Canada cuts to 3.0 per cent as tariff threat looms

The Bank of Canada finds itself in an unenviable situation. After rapid cuts to its policy rate in the latter stages of 2024 in response to a weak economy and risks that inflation would fall below the two per cent target, it recently signaled a more modest path of adjustment ahead. Firming inflation and improvements in the labour and housing market, as well as the likelihood of slower rate cuts by the US Fed and weaker Canadian dollar align with this path. At the same time, the Bank is grappling with the rising threat that the U.S. President Trump could impose severe tariffs on Canada, which could come as early as February 1 (or not) which could trigger a severe recession and necessitate deeper rate reductions.

In line with expectations, the Bank cut the policy rate by 25 basis points today to 3.0 per cent in its first-rate decision of 2025, responding to the data flow and known headwinds rather than incorporating an unknown tariff outcome. It also announced an adjustment to the deposit rate at 2.95 per cent, or 5 bps below the policy rate to improve effectiveness and support short-term funding markets. It also announced plans to complete balance sheet normalization and end quantitative tightening.

The Bank's rate decision was made in the context of soft but improving economic data but elevated levels of uncertainty in the economic outlook which was expected. The statement highlighted the persistence of a soft labour market, including an elevated unemployment rate of 6.7 per cent and wage growth is slowing. That said, there has been recent strength in job growth including the 91k gain in December, and rate cuts have started to lift economic activity related to housing and consumption although investment is weak. CPI inflation has held steady near two per cent, with some volatility due to the temporary GST/HST holiday, but indicators point to a 2 per cent trend.

The basis of the Bank's rate decision was based on the current flow of data, and absent a trade war in its baseline forecast given the unpredictability of potential trade tariffs. Its baseline forecast is currently for modest growth in the global economy, led by robust U.S. economic activity. The Canadian dollar has depreciated against the USD.

It forecasts Canadian growth of about 1.8 per cent this year and next, marking an acceleration from 2024 but held back by weaker population growth. Growth is anticipated to slightly exceed potential growth, and CPI inflation is forecast to remain near 2 per cent.

Of course, this is in the absence of tariffs. Depending on how the potential trade conflict evolves, a longer trade conflict would lead to both lower GDP and higher prices in Canada. Even in the absence of tariffs, we anticipate the policy rate to decline to 2.5 per cent, and in our view, the policy rate could decline to 1.5 per cent in tariff environment as the Bank moves to shore up the economy.

Monetary Policy Report Summary

The Bank's accompanying Monetary Policy Report provided a deeper look at the Bank's baseline outlook underpinning the decision and current economic conditions. As noted, tariffs are not explicitly included as the situation is fluid and tariff implementation, as well as size and duration are unknown. The Bank did include analysis on the potential impact of tariffs which will also be reviewed here.

The Bank downgraded its forecast for Canada GDP growth in 2025 and 2026 to 1.8 per cent from 2.1 and 2.3 per cent, respectively. This is an acceleration from 1.3 per cent in 2024 owing to the impact of lower interest rate cuts but revised down from past forecasts due to lower population growth. Business investment growth was also reduced due to tariff uncertainty. Quarterly growth of 1.8 and 2.0 per cent are forecast for Q4 2024 and Q1 2025. Annual growth is expected to outpace potential growth (revised lower to 1.5 per cent) and remove excess slack from the economy. Its inflation outlook was revised slightly higher to 2.3 and 2.1 per cent for 2025 and 2026. The forecast also assumes a 70 cent dollar.

Global growth is unchanged from the previous forecast at 3.1 per cent for 2025 and 2026, with upward revisions to US growth leading the way at 2.6 and 2.3 per cent growth with assumptions that tax cuts will be extended, and strong underlying performance.

The Bank currently sees inflation risks as being balanced in the absence of tariffs. On the upside, shelter inflation could remain stronger due to mortgage policy changes and rate cuts, while consumer demand could be stronger. On the downside, there is potential that tariff threats could drag more on business investment, while financial conditions in the U.S., namely interest rates and yields could be higher.

The elephant in the room

While the Bank did not include tariff implementation in its outlook, the MPR included a discussion of the threat and potential impact. Tariffs are an import tax that lifts prices of goods and services, but impacts GDP, economic activity, and inflation. The impact depends on substitutability of goods and services and would cause at the least a one-time lift in prices, although impacts on inflation temporary contingent on inflation expectations.

The Bank provided a hypothetical scenario of a 25 per cent U.S. tariff on all goods imported from all countries, and a 25 per cent retaliatory tariffs by Canada, alongside several other assumptions on firm behaviour around prices and distribution of tariff revenue.

Key outcomes:

Lower GDP growth in both the U.S. and Canada is expected. The U.S. experiences higher prices and inflation (offset in part by a stronger US dollar), and there is export substitution away from the U.S. Prices for intermediate and capital goods go up due to integrated supply chains.

Similarly, Canada suffers via export channels, lower commodity prices, and sees lower imports due to substitution. Weaker economic conditions and lower profits lead to weakening labour markets. Government transfers to households are an offset. Inflation rises due to retaliation.

Translating this into numerical growth, the Bank's model suggests this scenario generates a 2.5 per cent hit to GDP growth in year 1, with growth in year 2 being 1.5 per cent lower, before returning to baseline in year 3. This is a permanent shock to GDP level and would temporarily tip the economy into recession. CPI inflation rises over the period as costs are passed on. This is of course contingent on the model, and a severe shock, with timing and impact also depending on tariff pass through to consumer prices.

Broadly, the exercise suggests a significant impact to the Canadian economy which could even be deeper than modelled if export declines are more severe. The modelling also suggests inflation could increase due to retaliation which could limit the magnitude of rate cuts, although our view remains that the Bank would move to shore up the economy if fiscal measures are insufficient.

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