CIBC CAPITAL MARKETS

Economics

ECONOMIC FLASH!

economics.cibccm.com

March 12, 2025

Bank of Canada: a Band-Aid, for a wound of unknown size

by **Avery Shenfeld** avery.shenfeld@cibc.com

The Bank of Canada's quarter point rate cut today might be only a Band-Aid, but it's to address an economic wound of unknown size at this point. As data rolled in showing a stronger-than-expected economy at the turn of the year, we opted to stick with our call for further rate cuts, including this March move, hoping for the best, but fearing the worst on US trade policy, or at least a period of heightened uncertainty. It's eminently clear from the central bank's statement today that the hit to confidence from developments on the trade front was the only reason we saw a rate cut today. Although the Bank sees two-sided risks from tariffs that complicate its decisions ahead, and avoided any signals of where it's headed, the very fact that it opted to cut today suggests that its worry over growth was greater than its concerns over upside risks to inflation.

The hit to business and consumer confidence from the tariff uncertainties, and even more serious, the damage to exports and capital spending should tariffs remain in place, has easily offset the good news on growth in recent months. If not for the trade threat, modest further rate cuts might still have been needed, but there would have been no urgency to deliver an easing today. The only negative to that outlook would have been signs of a slowing pace to US growth. On the domestic front, lower interest rates were starting to deliver their promised boost to demand, and the first steps towards narrowing slack in the labour market.

Instead, while the Bank notes that Q1 will get a lift from a surge in exports aimed at beating the imposition of tariffs, activity looks set to sag in the second quarter. That's consistent with the surveys that the Bank unveiled today which show a decline in spending intentions by households, and business expectations for sales and hiring. The Bank implicitly put more weight on those downside risks to growth, and their implications for economic slack, than on the survey results on inflation, which showed businesses expecting rising costs and prices.

Our research suggests that while a sustained trade war will indeed push inflation up in the near term, that will be offset over the medium term by the disinflationary impact of rising unemployment, weaker income growth, and the resulting hit to household spending power. If so, the trade war will on balance be a factor pushing down the policy rate. That could be a different outcome in the US, given the narrower economic slack in the American economy, and the smaller hit to growth in a trade war outcome.

In the press conference, the Governor noted the lack of enough certainty to really pin down either growth or inflation impacts from tariffs. He also emphasized, once again, that his tool kit isn't a cure all, and that they are limited in how aggressively they can use rate cuts given the upside risks to inflation. That suggests that further moves will come in 25 basis point doses, rather than anything larger, to allow the Bank to keep tabs on the inflation pressures. Indeed, the Governor said that the committee didn't seriously consider a 50 basis point cut this month.

Re: Economic forecast — We're sticking with our existing forecast for a further 25 basis point cut at each of the next two rate decisions. The resulting 2.25% overnight rate could end up being the trough for this cycle if, by summer, Canada and the US are able to hammer out a deal that largely removes tariffs on both sides. That's still our base case forecast at this point. But a longer and more protracted trade war would entail a major recession, with the extent of further rate cuts being dependant on how strongly fiscal policy steps in to support growth, and on evidence showing that the initial upswing in prices is starting to be offset by downward pressure on inflation from greater economic slack.

Re: Markets — Today's widely expected move was, not surprisingly, not a market-moving event, with 2-year Canada yields and the Canadian dollar little swayed after the announcement. Indeed, the currency market has been less reactive to news of late, in part because investors have seen tariff announcements quickly reversed or delayed, and because views on the US economy have also turned less positive. That change in view on the US outlook makes today's rate cut in Canada seem less out of step with where Fed policy might head, albeit further out in the year.