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July 30, 2025

Bank of Canada: A small step towards a cut?

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The Bank of Canada held its overnight rate at 2.75% again as widely expected, but did take a small step towards potentially delivering a rate cut in the future. While the Bank had already suggested that further rate reductions may be needed to support the economy if inflationary pressures were contained, that verbiage was confined to Governor Macklem's press conference remarks and the minutes from the previous meeting. By suggesting within the statement itself that "there may be a need for a reduction in the policy interest rate", policymakers appear to be a little closer to providing that support than they were in June.

The hold in interest rates today was justified by signs of "some resilience" in the economy, of "ongoing pressures" in core inflation and continued uncertainty surrounding US tariffs. Governor Macklem's press conference remarks once again pointed to a "clear consensus" for the hold. However, the statement also suggested that there were a number of indicators of excess supply increasing since January, and the accompanying Monetary Policy Report estimated that the output gap at Q2 stands at -0.5% to -1.5% (from 0 to -1% in April). This also hints that the Bank is more comfortable in assuming that weakness of the economy will place downward pressure in core inflation over time. While underlying inflation has risen since the start of the year, the Bank suggested that much of this was due to non-energy goods prices (i.e. potentially tariff-driven). Governor Macklem stated in his press conference that the Canadian dollar, weakening unit labour costs and an economy that is in excess supply should see core inflationary pressures ease back to 2%, which is something that our own recent research supports.

The forecast for the economy based on the "current" tariff situation sees GDP contracting at a 1.5% annualized rate in Q2, and growing by only 1.3% this year, and 1.1% in 2026. These forecasts are actually a little weaker than ours (particularly for 2026), although we are assuming some progress on reducing sector-specific tariffs later this year. Note that the Bank of Canada's "current tariff" scenario assumes CUSMA compliance is around 95%, so it is the sector-specific tariffs that have driven our trade-weighted tariff higher. The quarterly forecast for a 1.5% contraction in GDP in Q2 is weaker than the current tracking from industry-level data, although the reverse was true in Q1 when expenditure figures were stronger than the monthly figures had suggested.

As well as forecasts based on the current tariffs situation, the Bank also included two alternative scenarios in its outlook given that tariff outcomes remain uncertain. Under the de-escalation scenario, the US weighted average tariff rate on all countries moves down from 13% to 10%. Canada removes counter tariffs and uncertainty retreats, which sees GDP growth accelerate faster as export demand rebounds along with domestic demand, leaving the level of GDP 0.5% higher relative to the current scenario at the end of 2027. Lower tariffs also put downward pressure on the inflation profile, with CPI inflation falling to a low of 1.4% in Q1 2026, relative to the current forecast of 1.7%, and remaining below target until late 2026.

Under the escalation scenario, the US weighted average tariff rate on all countries increases to 28%, from 13%, and uncertainty remains elevated. Canada and other countries respond by increasing retaliatory tariffs, which sees CPI inflation peak at 2.6% in Q3 2026 (vs. 2.1% in the current scenario). Canada enters a recession that lasts for three quarters, and the level of GDP is 1.25% lower than the current scenario by the end of 2027.

Re: Economic forecast — The Bank appears to be getting a little more comfortable with the notion that the Canadian economy will need support from further interest rate cuts in the future. However, it is clearly not there yet and upcoming data will remain more important than today's slight change in language in determining if that support comes as early as the September meeting as we currently forecast.

Re: Markets — Canadian bond yields fell following today's decision, as investors viewed the change in the statement as slightly increasing the odds of a further interest rate cut before the end of the year.