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Bank of Canada: Is the economy stuck in a neutral zone trap?

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There won't be anyone surprised by the Bank of Canada's well-telegraphed decision to keep rates on hold today, or its assessment that rates are at the right level if their forecast pans out. The Bank remains firmly neutral on where things go from here, saying that "it's difficult to predict the timing or direction of the next move." But if there's any slight leaning, it's still toward some concerns on the growth front due to trade uncertainties, and slightly more comfort that underlying inflation is decelerating. The Bank hasn't made any major changes in its forecasts, with an upside surprise in Q3 offset by a stall in growth in Q4 2025. With both historical actual growth and potential growth revised higher, the output gap in Q4 is in the range of -1.5% to -0.5%, unchanged from October's estimate. We will stick to our forecast of no interest rate moves by the Bank of Canada in 2026, but we see the odds of a further cut as more likely than a hike, given the potential minefield of trade negotiations ahead, and a starting point that still shows significant economic slack.

The press conference did not provide more colour than the opening statement. The Bank clearly does not want to tip its hand either toward a future rate cut or a future hike, with the Governor's view that, if the status quo is maintained, the hole in Canada's economy would likely never heal, though growth would gradually normalize as businesses adapt by reallocating capital to more productive uses and integrating with other foreign markets. He once again reiterated the view that the Bank has a limited role in facilitating the structural transition, which means the Bank is reluctant to move policy out of its current position at the low end of the neutral range.

But is that the right interpretation of the role of monetary policy during a structural transition? Not everyone would agree. Several leading macro researchers have argued that monetary policy can potentially be more powerful than normal and play a greater role during major structural transitions, or, more generally, in instances where costs can temporarily spike (Guerrieri et al., 2021; Werning et al., 2025). One of the arguments they put forward is that more accommodative monetary policy could boost real wages in sectors less affected by the shock, encouraging workers in hard-hit sectors to move into other sectors and greasing the wheels of labour mobility and capital reallocation, and limiting the permanent damage to the economy. There are also direct gains in interest-sensitive sectors, such as housing and construction.

True, the cost could be somewhat higher inflation in the short-run, but Canada's underlying inflation rate is not exactly sizzling right now, with inflation momentum below 2% on several core measures, and aggregate real wage growth remains paltry. We have yet to see material evidence of the trade cost adjustments in the data, and even if that were to show up, it is not obvious that this would result in persistent inflation as opposed to a price-level shock. The Fed, for all its challenges, seems to be more open-minded than the Bank of Canada about the risks of persistent inflation versus a price-level shock, and it's surprising the Bank has not been more even-handed about how those cost adjustments would impact prices in Canada.

That sort of thinking may be forcing Canada's economy into a neutral zone trap. As in hockey, we're hunkering down and playing defence by keeping policy in neutral, but the trouble is that we're down at least a couple of goals at the end of the first period. Monetary policy cannot lead the offence to bring our trade back with the U.S., but it can help get other parts of our economy going, especially those less affected by the trade war and where gains from trade with new markets, public investment, and greater digitalization could support higher growth. The slight leaning towards worries growth make us hopeful these arguments are being talked about on Wellington Street. But it will take a string of mild inflation reports to move the Bank of its current path and think more carefully about getting out of the neutral zone.

Re: Economic forecast — There weren't any surprises in today's announcement, and the Bank is sticking to the line that it has maintained since October. We continue to expect no change in policy through the end of 2026.

Re: Markets — The CAD has weakened a bit since the decision while yields slightly rose initially before heading back to around pre-decision levels.