

Economics

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October 29, 2025

Bank of Canada: The end of the rate cutting line?

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The Bank of Canada cut interest rates by 25bp as expected today, but signaled that this may be the end of the line for rate reductions. The quarter point cut, bringing the overnight rate down to 2.25%, was widely expected by forecasters and financial markets. However, the accompanying statement said that Governing Council sees the new policy rate as at "about the right level" to keep inflation at 2% while also helping the economy through a period of structural change, suggesting a willingness to respond only if the "outlook changes".

In terms of that outlook, the accompanying Monetary Policy Report returned to providing one base case forecast, although risks around this are obviously even higher than normal and dependent on how trade negotiations with the US play out. The forecast for 1.2% GDP growth this year, 1.1% in 2026 and 1.6% in 2027 is made under the assumption that the effective tariff rate on Canadian goods from the US is about 6% (up from around 4.5% a quarter ago). By the end of 2026, the level of GDP is expected to be roughly 1.5% lower than predicted back in January, with roughly half attributed to a structural shift as a result of the trade disruption, and the other half due to weaker demand.

Our own forecast for GDP growth is slightly stronger in 2026 and 2027, although that includes an assumption that some sectoral tariffs (primarily aluminum) can be reduced and that Federal infrastructure spending will ramp up. As is customary, the Bank of Canada only incorporates fiscal measures that have been tabled, and so wouldn't make any assumptions regarding future infrastructure and defense spending that will form part of next week's budget. Meanwhile the possible reduction of sectoral tariffs was simply cited in the "upside risk" section of the MPR.

The Bank of Canada currently estimates a negative output gap of between -0.5% and -1.5%, which is broadly in line with its assessment back in July. The statement accompanying today's decision suggested that excess capacity in the economy would persist in the near term and be reduced only gradually thereafter. In judging underlying inflation, and in line with an earlier speech by Deputy Governor Mendes, the Bank is looking at a wider range of indicators and not just its two previously "preferred" measure of CPI-Trim and CPI-median. Policymakers are also looking at their previous CPI-X measure, which excludes the 8 most volatile elements, as well as a measure that also excludes food/energy while keeping an eye on the overall dispersion of price pressures.

When asked during the press conference why the Bank appeared less willing to add more stimulus in the future given that interest rates are only just at the lower end of the Bank's 2.25-3.25% neutral range, the Governor reiterated that interest rates can help the demand side of the economy but can't do much to help the structural change happening within the economy at the moment. Asked what would constitute a change to the outlook that would be material enough to cut interest rates again, Governor Macklem noted that wouldn't come from just one month's worth of data, and would be judged relative to its newly released base case forecast.

Re: Economic forecast — Following today's cut, the Bank of Canada appears to be moving back onto the sidelines to assess incoming data, the potential impact of next week's Federal Budget and the progression of trade discussions. On our base case assumptions that the economy starts to gradually recover, and that a trade deal is reached to lower some sectoral tariffs and reduce uncertainty surrounding CUSMA, today's move would be the final one. However, further cuts would certainly be justified if the economy continues to weaken and/or if the outlook for trade doesn't improve.

Re: Markets — Even though interest rates were cut today as expected, bond yields rose slightly following the move as financial markets reduced the probability of further reductions in the future.

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