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## Bank of Canada: Not too sure, for good reason

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The Bank of Canada isn't so sure about what comes next, but then again, who is? There's enough slack in the economy, and inflation is still tame enough, for the central Bank to deliver an as-expected quarter point cut today, taking the overnight rate to 3.0%. In a technical move, it also shaved a further hair off the deposit rate, setting it at 2.95%, and it announced the planned end to quantitative easing. But the cross currents on the economic outlook are clouded enough that the Bank eschewed any clear message about its plans for future moves.

That would have been the case even without the threat of a trade war. Having now eased "substantially," the Bank faces some uncertainties over where the neutral rate lies, and therefore, how low rates need to be to achieve their projected pickup in economic activity. The data ahead will tell that tale, and our view is that current rates aren't yet low enough to do the trick. The tameness in current inflation (only 0.7% year-on-year ex-shelter) and what the Bank judges as a "soft" labour market tilts the balance of risks towards further cuts. Note that the Bank is counting on a substantial acceleration in residential construction, and that sector faces a headwind from the stickiness of five year rates, and a likely slowing in condo construction in wake of weak presales in 2024.

The Bank did narrow its estimate of economic slack (now in a range of -0.25% to -1.25%), due to an upward revision to historical growth, although we see a conflict there, in the sense that other indicators of slack (from the labour market and core inflation) suggest that the better GDP growth during that period also reflected stronger potential growth. Economic growth has been revised a bit lower over the forecast horizon, but that was offset by a slower forecast for potential growth due to a downward adjustment to population growth.

The impact of a trade war is presented in a simulation in the MPR, showing a major hit to growth, and an upward hit to inflation. But this is clearly a work in progress, and not the final word on the Bank's view. The key question for policy is the extent to which economic slack creates enough downward pressure on trend inflation that the Bank can look through what would then be a one-time lift to the price level. Our research suggests that would most likely be the case, but it would also depend on the degree to which fiscal policy levers are pulled to support growth, thereby reducing the need for additional monetary policy stimulus.

**Re: Economic forecast** — While there's a risk of some pauses along the way if any of the growth or inflation data show an uptick, we're sticking with our call for the overnight rate to reach 2.25%, even in the absence of a trade war. Should major tariffs hit, our view is that the downward pressure on growth would provide enough disinflationary pressure over the medium term to offset the initial upward pressure on inflation coming from the trade war and a weaker C$. But the need for even more aggressive rate cuts would also depend on the fiscal policy response.

**Re: Markets** — The Canadian dollar was already trading weaker against its US counterpart before the decision, and that move was maintained afterwards. Bond yields moved lower on the statement, but partly rebounded during the press conference.

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