Intelligence MEMOS

From: Jeremy M. Kronick and Steve Ambler

To: Interest Rate Watchers

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Re: **The Way Forward for Interest Rate Cuts**

The Bank of Canada cut its policy interest rate to 2.75 percent last week Wednesday, its seventh cut in as many announcements. Notwithstanding recent data showing a strong economy at the turn of the year, the needless trade war, flip-flopping US policy, and the attendant uncertainty sealed the deal.

Markets, businesses, and consumers all crave certainty. We currently have none. A widely-used economic policy uncertainty index sits today at almost twice its level in the depths of the COVID-19 pandemic and more than three times its level during the 2008 financial crisis. Unprecedented, to say the least.

Such extreme uncertainty makes incoming data hard to read and forecasting next to impossible. The Bank of Canada had to make a decision, however. It decided to cut, and we agree.

Put aside the trade situation, and there might have been a case for the Bank to leave the overnight rate unchanged. Core inflation measures – which calculate the underlying trend of price changes in the economy – ticked up in January and remain stubbornly above the 2 percent target. Average hourly earnings are rising considerably faster than productivity. And real gross domestic product in the fourth quarter of 2024 surprised to the upside.

That said, there was plenty of data pointing the other way. The year-over-year increase in the consumer price index has been at or below target since last August. Stripping out mortgage interest costs, which go up when the overnight rate increases and vice versa, CPI inflation sits at 1.5 percent. February's unemployment rate of 6.6 percent is 1.8 percentage points higher than its post-pandemic minimum in July 2022, and 0.8 percentage points above where it was before COVID hit in February 2020.

The Bank's range for the neutral rate – the policy rate consistent with output at potential and inflation on target – is 2.25 to 3.25 percent. Bringing the policy rate down to 2.75 puts us squarely in the middle of the range. With this conflicting data, getting to the midpoint makes sense. The uncertainty surrounding the trade conflict makes it all the more justifiable.

Where to from here?

The unusual combination of supply and demand shocks will make the Bank's next interest rate decision no less hard.

Tariffs from the United States will raise prices in Canada as a depreciating loonie makes imports more expensive. As Canada retaliates with tariffs on imports from the United States, those tariffs will raise prices further. The Bank will have to decide whether these changes to the price level are one-offs, or preludes to higher inflation. If the effects are one-off, the Bank should concentrate on offsetting the tariffs' negative impact on the demand side as our businesses sell less, jobs are lost, and consumers reduce spending.

Canadian fiscal policy adds another complication. The government says it can support businesses and individuals in the face of increases in US tariffs. A substantial increase in government transfers would increase aggregate demand and at least partially counteract the decrease in demand for Canadian exports to the United States. But even here we have uncertainty as the government is on its way out, and Prime Minister Mark Carney is expected to call a snap election as soon as this week.

All this uncertainty is damaging for business investment, already very weak, as projects are temporarily or permanently shelved. This negative impact on the productive capacity of the Canadian economy makes the net effect of the uncertainty on the output gap – the difference between the economy's actual and potential output – ambiguous. For the Bank of Canada itself, the next interest rate announcement in April must at this point be a mystery.

The best that forecasters at the Bank can do is to simulate scenarios based on different assumptions. The Bank was wise to refrain from any forward guidance about its next moves and underline the dependence of its policy rate on the data. But a cut last week was in order.

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