Intelligence MEMOS

From: Jeremy M. Kronick and Steve Ambler

To: Interest Rate Watchers

Date: June 12, 2025

Re: WITH RECESSION IN THE WIND, A RATE CUT MIGHT HAVE BEEN WISE

The Bank of Canada left its policy interest rate at 2.75 percent last week, confirming market expectations. Data showing stubbornly high underlying inflation and robust-looking first-quarter GDP had led markets to price in only about a 20-percent probability of any cut.

While we understand the Bank's thinking, we believe it should have cut.

In April, we argued that the high degree of economic uncertainty and some concerning core inflation measures made a good case to pause. So, if uncertainty remains as high as it does, and we saw that strong seeming GDP number alongside rising core inflation – Consumer Price Index-trim to 3.1 percent and CPI-median to 3.2 percent – why a cut this time?

Three reasons: Increasing unemployment, sagging housing markets, and weakness behind the strong-looking data.

This flagging on the demand side will outweigh potential inflationary pressure from the impact of tariffs and trade wars on the economy's supply side. This weakness means the Bank of Canada will have to cut its policy rate sooner or later. Doing it last week may have helped prevent the economy from sliding into recession, something which is looking increasingly likely.

We aren't the only ones worried about a downturn. The economics departments of the major Canadian banks are seeing the same thing. Four of the six big banks are predicting at least one quarter of falling GDP this year, and three of them are predicting two quarters of it.

The stronger-than-predicted GDP growth in the first quarter of the year (2.2 percent annualized) masks some underlying weaknesses. The key driver of growth was exports, much of it caused by US importers front-running tariffs. Consumer spending barely grew, and (already very weak) gross fixed capital formation fell.

As for housing, expectations that the market would start to take off as the Bank cut the overnight rate off its 5-percent peak were an argument for slow rate cuts. However, the market has slumped amid tariffs and economic uncertainty. In March, Canadian home sales were the lowest they've been in that month since 2009, during the slump following the Great Financial Crisis. Sales-to-new listings haven't been this low since February 2009.

The strongest negative signals are coming from the labour market.

After a fall of more than 30,000 in March, employment was stagnant in April, despite the hiring of temporary workers for the federal election. Moreover, employment among core-aged (25 to 54 years old) individuals fell by 36,000 in April. Core-age employees are traditionally those who are the most strongly attached to the labour force, and a fall in employment in this group is typically a sign of layoffs. The unemployment rate increased again in April and now stands at 6.9 percent.

Cutting the policy interest rate when core inflation measures (which strip out the most volatile components of the consumer price index) are moving up would have been a communication problem for the Bank. But we think it would have been appropriate.

The Bank pays attention to core inflation as an indicator of where inflation may be headed in the medium term. The headline inflation drop to 1.7 percent wouldn't be much help in this regard as it is almost entirely due to the suspension of the consumer carbon tax. The key would have been to convince the public that any increase in headline inflation that arises from the current spike in core measures is temporary, and economic weakness will bring price growth down in the medium term. Falling employment among core-age individuals is an especially important part of that messaging. We'd also add that one major difference between the situation now and in 2021 when inflation started to take off is that the growth in broad monetary aggregates, which is strongly linked to inflationary pressures further down the road, is much weaker.

After the GDP strength, and core inflation jump above 3 percent, it was understandable that the Bank would hold off lowering its policy rate. But in our view, the signs of economic weakness were too strong to ignore. With uncertainty likely to remain elevated, these signs will likely continue. And with them will come more cuts.

Jeremy Kronick is vice-president and director of the Centre on Financial and Monetary Policy at the C.D. Howe Institute, where Steve Ambler, a professor of economics at Université du Québec à Montréal, is the David Dodge Chair in Monetary Policy.

To send a comment or leave feedback, email us at blog@cdhowe.org.

The views expressed here are those of the authors. The C.D. Howe Institute does not take corporate positions on policy matters.

A version of this Intelligence Memo first appeared in The Globe and Mail.