



December 16, 2025

From: Jeremy M. Kronick and Steve Ambler
To: Interest Rate Watchers
Re: CONFLICTING SIGNALS ABOUND AND EXPLAIN INTEREST RATE CAUTION

Last week, the Bank of Canada held its policy interest rate (the overnight rate target) at 2.25 percent, in a move widely anticipated by financial markets. And while the last year has often seen the debate centre on whether the Bank should cut or not, next year could see as much discussion of a rate hike as a rate cut.

When the Bank reduced its policy rate at its last announcement in October, despite the drop in second-quarter GDP and a weak labour market, it strongly hinted that it was done with cuts for the time being.

"If inflation and economic activity evolve broadly in line with the October projection," the Bank said, "Governing Council sees the current policy rate at about the right level to keep inflation close to 2 percent while helping the economy through this period of structural adjustment."

If anything, the data since then has been stronger than expected. While there are a number of caveats to these positive surprises, on balance they justify the Bank's decision to remain on the sidelines.

Let's look at those surprises, coming mainly from goods and labour markets.

First, goods markets. Third quarter GDP grew at an annualized rate of 2.6 percent, beating market (and the Bank's) projections of 0.5 percent. Furthermore, Statistics Canada revised its **historical GDP data**, which boosted economic growth between 2022 and 2024 by 1.7 percentage points.

This news was not wholly positive. As noted by **our colleagues**, strong third quarter GDP growth was almost entirely trade driven, in particular due to a substantial drop in imports, which mechanically increases GDP as net exports increase. A drop in demand for any component of expenditure is not usually a sign of strength. Add a fall in household consumption, and the story is much less rosy.

The data revisions are certainly nice to see from a labour productivity perspective, but for the Bank it's unclear what it means for the likely path of inflation. While realized GDP was higher than we thought, it does not speak to the economy's potential – what it is capable of producing at full employment.

If the Bank revises its estimates for potential output up as it looks ahead, the net effect on the output gap – the difference between actual (demand) and potential GDP (supply) – and therefore on inflation, is ambiguous. However, given the stubbornness of core inflation – CPI-trim and CPI-median are at 2.8 percent – you could make the case that the economy's potential is what we thought it was, and higher actual GDP was responsible for keeping price growth elevated.

If true, this would close the output gap the Bank has been estimating was negative. A negative output gap would possibly justify further cuts; a closed output gap, less so.

Now let's turn to the labour market. The latest **Labour Force Survey** showed unexpectedly strong employment growth in November. The economy added 54,000 jobs, **beating** market expectations of modest employment growth, and causing the unemployment rate to fall by 0.4 percentage points to 6.5 percent.

Once again, the positive news is subject to some qualifications. The increase in employment was driven by the addition of 63,000 part-time jobs, meaning full-time jobs fell by around 9,000. And those in the core 25-54 working age group saw job losses totalling 5,000, driven by the overall drop of almost 16,000 full-time jobs. The drop in the unemployment rate reversed the mostly increasing trend over the last three years, but it remains elevated, well above where it was in July 2022 (4.8 percent). This means there is still some slack in the labour market, which should keep upward pressure on wages (and therefore prices) at bay.

At 2.25 percent, the Bank's policy rate is currently at the bottom end of its estimated range for the neutral rate, the rate compatible with inflation at the 2-percent target and the economy at full employment. Given the positive data surprises, but what we see as underlying weakness, the lower end of the neutral rate range seems appropriate.

The Bank is likely to remain on the sidelines well into the New Year, as long as headline inflation, currently sitting at 2.2 percent, continues to hover around the 2-percent target. As for the direction of rates, there are arguments both ways.

On the one hand, more fiscal spending is on the horizon, alongside elevated core inflation measures. On the other hand, there is a fair amount of underlying weakness in consumption, and uncertainty with the continued trade war. We still see a cut as the most likely next direction change – but would not be surprised to see a hike.

Jeremy M. Kronick is Vice-President, Economic Analysis and Strategy, and director of the Centre on Financial and Monetary Policy at the C.D. Howe Institute, where Steve Ambler, emeritus professor of economics at Université du Québec à Montréal, is the David Dodge Chair in Monetary Policy.

To send a comment or leave feedback, click [here](#).

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 Memo first **appeared** in The Globe and Mail.*