ATB Financial – January 29, 2025

Cutting through (tariff) uncertainty: BofC lowers policy rate again

Mark Parsons || January 29, 2025

The Bank of Canada delivered a 0.25 percentage point cut this morning, bringing its policy rate to 3% - the lowest since September 2022.

The stage was set. Markets were pricing in the cut and we were expecting the same.

While there are some lingering inflation pressures (particularly core inflation), other factors were harder for the Bank to ignore: elevated unemployment, excess supply, easing wage growth, inflation at target, and tariff headwinds.

This was more than just a rate announcement. We also got a fresh slate of forecasts in the *Monetary Policy Report (MPR).* As tariffs have not yet been implemented, the Bank of Canada published a forecast *without* tariffs, although it does try to capture the negative impact of tariff uncertainty on investment.

A special feature, however, illustrated downside risk. The Bank estimates that in the 'benchmark calibration' a 25% broad-based U.S. tariff and Canadian countertariff, would shave 2.5 percentage points off GDP growth in the first year and 1.5 points off growth in the second year, relative to the base case without tariffs.

Back to the base case (no tariffs), there were downgrades to the GDP growth forecast, reflecting the impacts of new lower federal immigration targets. The Bank is now forecasting growth at 1.8% in both 2025 and 2026, down from 2.1% and 2.3% respectively in October.

The Bank sees lower interest rates supporting consumption and housing, but highlighted weakness in business investment. The Bank noted the "outlook for exports is being supported by new export capacity for oil and gas".

The Bank seems confident that inflation will remain anchored close to its target of 2% in its base case. From the statement: "A broad range of indicators, including surveys of inflation expectations and the distribution of price changes among components of the CPI, suggests that underlying inflation is close to 2%".

The decision comes as the U.S. Federal Reserve is widely expected to stay on hold later today at the target range of 4.25-4.5% amid a sturdier economy, sticky inflation, and now policy uncertainty under a Trump presidency.

Our quick take: The Bank of Canada doesn't want to be behind the curve. Inflation is at target, tariffs loom and pose downside risk to growth, and there is slack in the economy. Why not move again.

What's next?

The Bank was clear today that much will depend on actions in the U.S. With more uncertainty than normal, we are really in 'wait and see' mode as the Bank will need to quickly digest new developments and respond accordingly in future meetings. From the forward looking paragraph: "However, if broad-based and significant tariffs were imposed, the resilience of Canada's economy would be tested. We will be following developments closely and assessing the implications for economic activity, inflation and monetary policy in Canada."

The pace will depend on the upcoming data and tariff action, but our current call is for two more 0.25 percentage point cuts in the first half of this year—bringing the policy rate to 2.5% by June. However, if 25% tariffs become reality and they prove persistent, we think the Bank may need to cut deeper, possibly moving to 2% by mid year. It gets trickier if Canada counters with its own tariffs on U.S. goods, which would increase price pressures. However, the impact on inflation would be temporary as long as inflation expectations remained anchored. We could see the Bank slowing or even pausing its rate cuts in this environment.

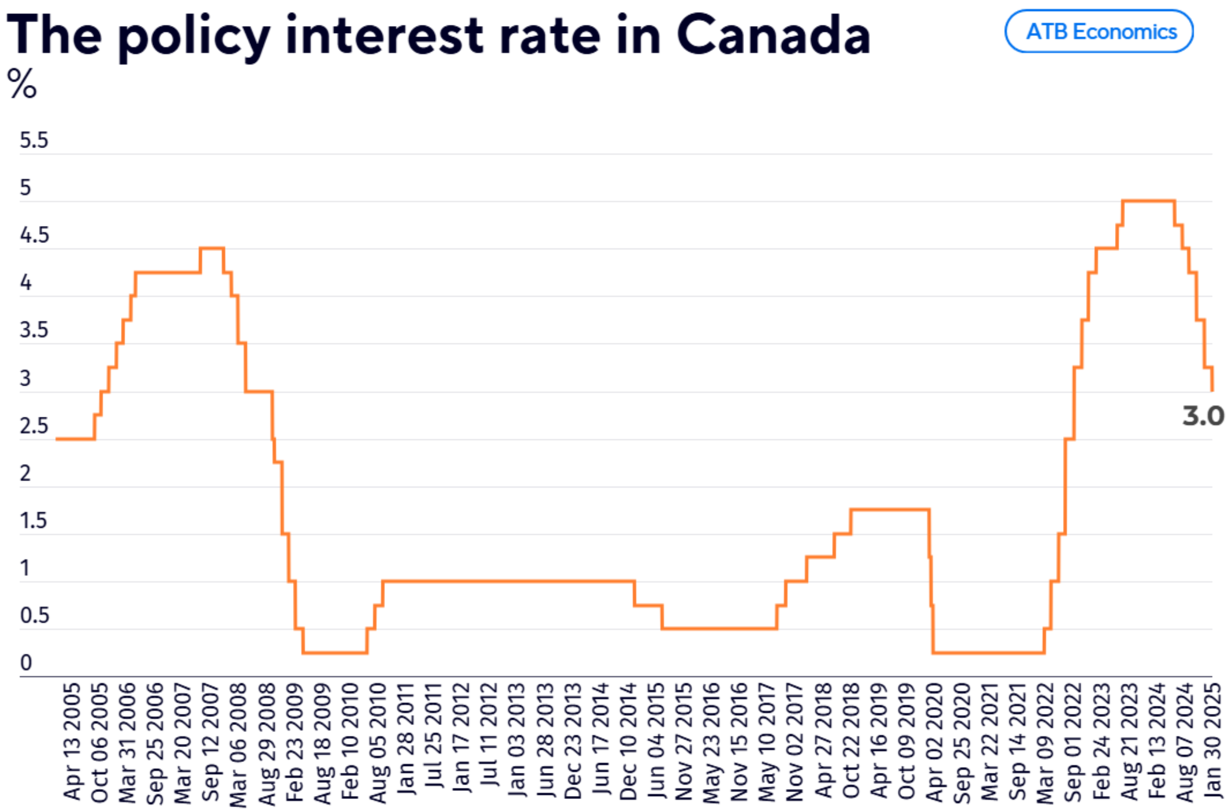
How did we get here?

The rate cuts started in the spring, when the Bank of Canada adopted a more dovish tone. A brief and simplified timeline:

- April - Getting more confident, but waiting to see more progress on inflation
- June - Inflation cooperates, the Bank cuts by 0.25 percentage points
- July-September - Economy slowing, the Bank warns of downside risks and cuts twice by 0.25 percentage points
- October - Inflation falls below 2% target, the Bank cuts 0.5 percentage points

- December - With inflation still at target and the economy weak, the Bank makes another 0.5 point cut.

The policy interest rate in Canada



Source: Bank of Canada/Haver Analytics and ATB Economics

Bank of Canada Projections

ATB Economics

Forecasts for national indicators, annual % change

	2024		2025		2026	
	October 2024	January 2025	October 2024	January 2025	October 2024	January 2025
Real GDP Growth	1.2	1.3	2.1	1.8	2.3	1.8
Headline Inflation	2.5	2.4	2.2	2.3	2.0	2.1

Source: Bank of Canada January 2025 Monetary Policy Report and ATB Economics