Intelligence MEMOS

From: Jeremy M. Kronick and Steve Ambler

To: Bank of Canada Observers

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Re: **More Rate Cuts to Come if Inflation Stays Subdued**

On Wednesday, the Bank of Canada cut its policy rate by 25 basis points to 2.5 percent in a move widely anticipated by financial markets. The cracks in the Canadian economy we **outlined** after the Bank's last announcement in July have become far more visible.

Gross domestic product contracted at an annualized pace of 1.6 percent in the second quarter, stirring fears of a possible recession. Per capita GDP has contracted or stagnated in nine of the past 12 quarters. In the face of tariffs and uncertainty related to tariffs, exports fell a whopping 30 percent annualized in the quarter while imports fell by 5 percent. The temporary boost provided by front-running of tariffs earlier in the year evaporated.

Employment tells the same story, and the story is not good. Employment fell by more than 100,000 positions in July and August, with full-time jobs held by people of prime working age bearing the brunt. The unemployment rate hit 7.1 percent in August, its highest since 2016, outside of the pandemic.

Making matters worse, the fall in employment is dispersed widely across sectors. In the six months leading to June, nearly two-thirds of the sectors making up the Canadian economy experienced contracting employment. The wide dispersion means that employment losses are not confined to sectors directly vulnerable to the current tariff wars.

If the effects were more confined, targeted fiscal policy on its own might make the most sense. However, while fiscal policy will still be needed – and, indeed, seems set to take hold – it means that monetary policy stimulus, which is a blunt tool, is appropriate.

Cracks in GDP and employment were part of our concern when the Bank stayed its hand last time. The reason the Bank held then was more about inflation, and in particular core inflation. But here, cracks have been exposed as well.

The different measures of core inflation – of which CPI-trim and CPI-median are the Bank's preferred – strip out the most volatile components of the consumer price index, with the goal of better signalling what will happen to overall inflation over the medium term. CPI-trim excludes CPI components whose rates of change, in either direction, are quite large. CPI-median is the value of the price change at the 50th percentile.

The year-over-year rates of change of those core measures are still quite high: 3 percent for trim and 3.1 percent for median. However, their three-month annualized rates of change are substantially more subdued: 2.4 percent for trim and 2.6 percent for median. And, while over the past month the median measure did increase at an annualized rate of 2.8 percent, trim only increased at an annualized rate of 2.2 percent.

Moreover, in July, services inflation was still pushing up the core measures. While service inflation remains the primary driver of inflation, it is down from 3 percent year-over-year in June to 2.8 percent in both July and August and fell slightly between July and August. This is consistent with economic weakness spreading beyond the goods sectors.

Lastly, Prime Minister Mark Carney's decision not to retaliate against US tariffs will work to bring inflation down further.

We think the case for the cut last week was clear. Going forward, while we think more cuts are to come, we hesitate because one must remember that inflation stems from both demand and supply side factors.

So far, we've largely been discussing the demand side. However, on the supply side, non-residential business investment has contracted in six of the past eight quarters. In the second quarter of 2025, it contracted at an annualized rate of more than 4 percent. This weak business investment suggests that the productive capacity of the Canadian economy may be growing as slowly as aggregate demand, meaning inflation might remain more elevated than a normal slowdown of the economy usually implies – the dreaded stagflation scenario.

The central bank will have to sort through these two opposing forces – demand and productive capacity – as it decides on what to do next. In the meantime, we believe it was correct to cut this time, with economic and employment contractions winning – or losing, depending on your perspective – the day.

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