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From: Jeremy M. Kronick and Steve Ambler
To: Interest Rate Watchers
Re: UNCERTAIN ROAD AHEAD FOR BANK OF CANADA INTEREST RATE

Last week, as widely expected, the Bank of Canada cut its policy rate by a quarter-percentage-point to 2.25 percent. On the basis of economic data alone, this was a tough call. While the Bank's Governor Tiff Macklem helped shape market expectations this time, we believe the future path of the overnight rate remains murky.

Start with the data. Headline inflation jumped to 2.4 percent in September, above the 2-percent target for the first time since March. Core inflation measures such as CPI-trim and CPI-median – which remove volatile components in the consumer price index – remain stuck above 3 percent. In September, the economy surprisingly added 60,000 jobs, with the net gain driven entirely by full-time jobs. With these numbers, a pause in cuts would have been justified.

However, at the annual meetings of the International Monetary Fund and World Bank in Washington DC, Governor Macklem expressed skepticism to reporters about September's strong employment numbers and insisted that economic growth, while positive, would remain sluggish. We agree.

Having said that, looking ahead, it will be difficult to rule out the dreaded stagflation scenario – weak economic growth and high inflation – and the challenges this brings for monetary policy.

Interest-rate policy primarily targets the demand side of the economy. The Bank will have to determine whether demand-side effects, which drive down economic growth and lower inflation, will be stronger than supply-side effects, which also drive down growth but increase inflation.

And if it's the supply-side effects that are stronger, the Bank will also have to determine how long these effects will last and whether it can safely look through them. The question is whether the Bank can lower rates regardless without de-anchoring inflation expectations.

The Bank will look closely at the future pressures on inflation arising from the output gap – the difference between actual output and the economy's potential output at full employment.

Let's look at two major sources of uncertainty affecting that gap.

First, tariffs. On the supply side, with uncertainty around trade wars running high, businesses shy away from investment. This is borne out in the Bank's recent business outlook [survey](#), which reported soft hiring and investment intentions, which will slow growth in the economy's potential. Tariffs also distort resource allocation: If productive export industries contract, and labour and capital shift to less efficient sectors, overall productivity declines. There will be less innovation and fewer profitable opportunities in foreign markets.

On the demand side, high US tariffs reduce Canadian exports by making our goods more expensive. This hit to company revenues eventually makes its way down to wages and employment – as we are seeing now in the auto sector – weakening domestic consumption. Moreover, the slowdown in business investment typically affects demand in the economy in the short run before affecting productivity and potential output in the long run.

The net impact of these tariff effects on the output gap and the timing, and therefore the pressure on inflation, is ambiguous and difficult to estimate.

Second, consider the uncertainty surrounding the fallout later today from federal government's first budget in 18 months. Most analysts are predicting significant increases in both spending and the deficit. Higher spending will mean a direct increase in overall demand. However, a higher deficit may push interest rates up, which could crowd out already weak business investment.

The government has been promising a "generational" investment and will take the unprecedented step of separating the operational budget from the capital budget (the investment part of "generational investment"). Reducing operational spending will cool demand, while new capital spending could eventually expand supply capacity. As Mr. Macklem noted in Washington: "When we look at the budget ... it's that balance between demand and supply in the economy that we look at closely."

But the budget's effects will take time to play out.

As the legendary baseball figure Yogi Berra said: "It's tough to make predictions, especially about the future."

In our view, it will be a challenge to determine the relative impacts of, among other factors, tariffs and fiscal policy on demand and supply and, therefore, on inflation. A cut this time made sense as insurance, given the weak economy. Going forward, it is less clear.

Jeremy M. 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.

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