



March 23, 2026

From: Jeremy M. Kronick and Steve Ambler
To: Interest Rate Watchers
Re: IRAN, CUSMA JUST TWO REASONS BANK WAS RIGHT TO HOLD STEADY ON ITS RATE

The loss of 84,000 jobs in February – driven by the evaporation of more than 100,000 full-time positions – led to speculation early last week that the Bank of Canada might cut its policy rate.

And the fall of headline inflation – down to 1.8 percent in February from 2.3 percent in January – fueled that speculation further. But after five straight months of inflation above 2 percent, elevated food inflation, and now oil and gas prices, which have experienced huge jumps since the war in Iran began, the Bank held its policy interest rate at 2.25 percent.

It was the right call.

This does not mean the Bank will continue to leave the policy rate unchanged. As it looks ahead, it will have to weigh a number of demand- and supply-side factors, judge how long each effect is likely to last – in other words, what it can look through and what it cannot – and assess the impact on inflation expectations. Two factors stand out: The duration of the war in Iran and the outcome of the review of the Canada-United States-Mexico agreement. Both are littered with uncertainty.

Start with the Iran war. Two days before US and Israeli attacks began on Feb. 28, the price of crude oil was US\$65 per barrel. By March 15, with the Strait of Hormuz effectively closed – a negative supply-side shock – the price had shot up to over US\$100 per barrel. Retail gasoline prices quickly followed. The national average gas price as of Friday was roughly \$1.60, compared with \$1.30 before the war erupted, a **20-percent jump**.

This surge has not yet fed into official inflation figures, but it will next month. This is a classic supply-side effect, and so the question becomes how long it will last. The longer it lasts, the more it will feed into costs at all stages of the production process, from planting new crops to keeping goods on store shelves. In turn, this could destabilize inflation expectations.

Long-run inflation expectations were remarkably stable during the post-pandemic inflation surge. But gas prices play a disproportionate role in household inflation expectations. As do food prices, and as we **pointed out** after the last announcement, those costs have also been increasing at an uncomfortable clip. If inflation expectations become de-anchored, they can trigger a cycle of wage and price increases that ultimately make those expectations self-fulfilling.

Even before the attacks on Iran, uncertainty was already in the air, after the US Supreme Court invalidated Donald Trump's use of the *International Emergency Economic Powers Act* to impose sweeping tariffs.

That February 20 decision does not affect tariffs imposed under other legal frameworks, such as those on steel and aluminum. In response, the Trump administration announced a new 10-percent global tariff under Section 122 of the *Trade Act of 1974*. Critically for Canada, this change in policy does not affect CUSMA-compliant products. For now, Canada still faces a much lower tariff on average relative to other countries.

But we don't know where CUSMA will end up. Mr. Trump's team has been clear that it will not renew the pact if it doesn't get an agreement it likes. It also has the option to pull out of the deal with six months' notice to its two other trading partners. For an agreement that has led to **\$1.6 trillion a year** in trade between the three countries, there is a lot at stake.

And while Canada's economy was surprisingly resilient in 2025 despite the tariffs, there have been cracks appearing, including a drop in fourth-quarter 2025 gross domestic product. The February job loss pushed the unemployment rate from 6.5 to 6.7 percent, and the only reason it didn't cause a bigger spike was that labour force participation fell – not a good sign.

This all leaves the Bank in a situation where the demand side of the economy is weak and there are inflationary pressures coming from the supply side. It will have to make a judgement call about how long high crude oil prices will last. If the shock proves temporary, they can look through it. If it persists, they must weigh its inflationary impact against the economic damage that trade uncertainty could inflict on employment and production.

At the best of times, the Bank of Canada must juggle new information and weigh the trade-off between inflation and the real economy. In 2026 that task looks particularly difficult. Holding the overnight rate at 2.25 percent and letting things play out some more was the prudent call.

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