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**From:** Jeremy M. Kronick and Steve Ambler  
**To:** Interest Rate Watchers  
**Re:** WEAK SUPPLY SIDE AND FALLING DEMAND: A BANK OF CANADA CONUNDRUM

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Markets had been confident the Bank of Canada would hold its policy rate constant last week, which it did despite the upward blip in inflation to 2.4 percent in March, up from 1.8 percent in February.

As was the case in March, when it also held its policy rate steady, the Bank emphasized several sources of risk to the Canadian economy, notably the uncertain breadth and duration of the conflict in the Middle East, the attendant supply chain disruptions, and the upcoming review of the Canada-United States-Mexico trade agreement.

To this we would add that these uncertainties, when taken together – as well as others we will discuss – create both upward and downward pressure on inflation, making the job of a central bank all the more difficult. As a result, we think the Bank of Canada was wise to leave its policy rate unchanged.

Monetary policy has an effect on inflation via its impact on the output gap, which is the difference between the economy's actual output (gross domestic product) and its potential. Tight monetary policy reduces aggregate demand, decreasing actual GDP and shrinking the output gap, thereby exerting downward pressure on the inflation rate. Loose monetary policy does the opposite.

Critical for the Bank in deciding whether to hike, cut, or hold, is a clear understanding of the gap's magnitude. A positive gap signals tight monetary policy is necessary if there are fears inflation might become de-anchored from its 2-percent target. A negative gap signals the opposite.

The situation we find ourselves in today makes a determination of the output gap difficult.

On the supply side, the Iran war has created a negative shock that is shrinking the economy's potential. The sharp drop in oil and fertilizers passing through the Strait of Hormuz has led to a sharp increase in prices for these commodities and reduces productive capacity in sectors that depend on these inputs.

These developments notably put additional pressure on food prices, which were already elevated, threatening to de-anchor overall inflation expectations. The latter still have not returned to their pre-pandemic levels. De-anchored inflation expectations may force the central Bank to not wait as long as it might prefer to in determining whether it needs to tighten monetary policy.

At the same time, demand-side signals point in the opposite direction. Manufacturing output continues a downward trend that began almost exactly three years ago. Housing markets are weakening in several big urban centres. And jobs declined in the first quarter of 2026, with core employment – those aged 25-54 – falling by a little over 50,000. CUSMA uncertainty is weighing on business investment, and if the review of the agreement slated for July 1 goes sideways, this effect would be exacerbated.

These demand-side effects pull actual output down, relative to productive capacity, making the Bank lean toward looser monetary policy.

Let's add one other complication for the Bank. Preliminary estimates from Statistics Canada show that Canada's population decreased from January 2025 to January 2026, the first yearly drop in population since Confederation.

Slowing population growth has a plethora of possible effects, but critically for the story we are telling here, it affects both the demand and supply side of the economy. Canada's labour force will grow more slowly. This will affect the economy's ability to produce.

A smaller population also means lower aggregate demand for goods and services. One of the sectors most affected will be the demand for apartment rentals because of fewer temporary foreign workers and foreign students on visas. We are already seeing the impact of this lower demand, with average rents falling by 5.3 percent in the year ending in March 2026.

Combined with the collapse of condominium prices in Toronto and a decrease in average home prices even in the Greater Vancouver area, this may affect the incentives for builders to undertake new multi-dwelling projects, despite available incentives. Lastly, a slowly growing or shrinking population increases the likelihood of a recession (because there are fewer people making purchases).

Last week's federal fiscal update had new measures that may give a boost to the economy. How big a boost is unclear today. When combined with existing areas of uncertainty, and an opaque output gap, we think the Bank was right to leave its policy rate unchanged.

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