International Commentary — April 22, 2025

Bank of Canada to Tread Carefully Amid Uncertain Outlook

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Summary

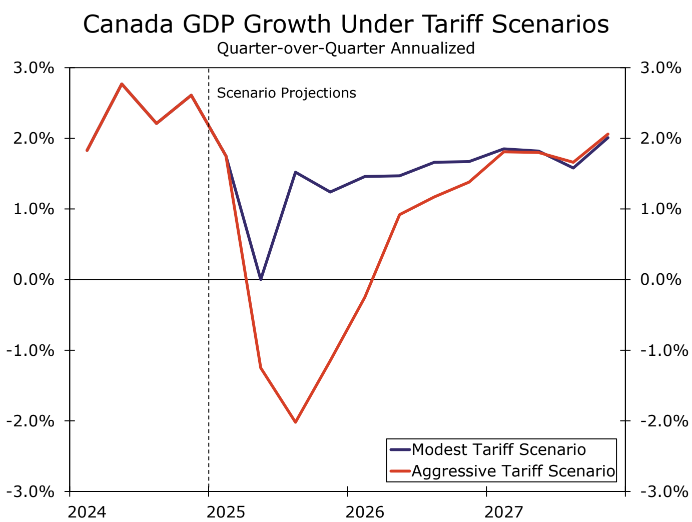
- The Bank of Canada (BoC) last week held its policy rate steady at 2.75%, its first pause since it began its easing cycle in June of last year. At the same time, the BoC highlighted elevated uncertainty and offered very limited future policy guidance.
- In a significant departure from its typical approach, the BoC refrained from offering a base-case forecast, but instead offered outlooks that considered the impact of different U.S. trade policies. In a “modest tariff” scenario, Canada's economy briefly stalls while inflation remains well-behaved. In contrast, in an “aggressive tariff” scenario, Canada's economy experiences a protracted recession, while inflation briefly spikes above 3% before receding thereafter.
- Our own outlook leans closer to the aggressive tariff scenario, in that we expect most of the tariffs that have already been implemented to remain in place. We think this type of scenario favors more gradual easing (given the uncertainty created by a spike of inflation) but more pronounced easing overall (given the likely sharp slowdown of the Canadian economy).
- Against this backdrop, our base case is for BoC rate cuts to continue at a once-per-quarter pace, and we anticipate 25 bps reductions at the June, September and December announcements, for a policy rate low of 2.00%. We do however see the risks as tilted even later easing, in which case we expect the BoC's policy rate would not reach a low until early 2026.

Bank of Canada Holds Rates Steady As Outlook Becomes Ever Cloudier

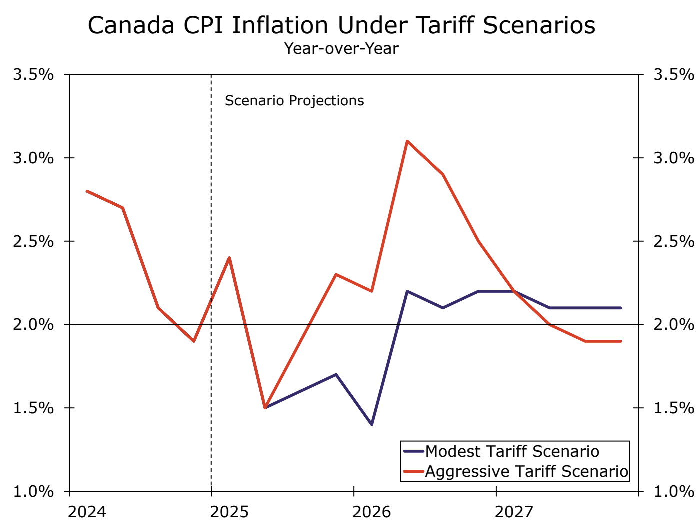
The Bank of Canada (BoC) last week held its policy rate steady at 2.75%, matching the consensus forecast, while at the same time acknowledging an increasingly clouded outlook for the Canadian economy ahead. The decision to hold rates steady was the first pause since the central bank began its easing cycle in June of last year, and the central bank offered very limited future guidance on policy amid heightened uncertainty. Indeed, this uncertainty was front-and-center in the central bank's announcement, with the BoC saying the "major shift in direction of U.S. trade policy and the unpredictability of tariffs have increased uncertainty, diminished prospects for economic growth, and raised inflation expectations." In its statement, the BoC cited softer consumer and business confidence, and said that consumption, residential investment and business spending all look to have weakened in the first quarter. Overall, while uncertainly prevails, we view the tone of the BoC announcement as consistent with further monetary easing.

The elevated level of uncertainty also prompted a notable departure from the Bank of Canada's typical approach of offering an updated economic assessment. Instead of providing a base-case forecast, the BoC offered two illustrative scenarios that considered the impact of different U.S. trade policies. The first scenario, which we describe as a "modest tariff" scenario, envisages most of the tariffs introduced since the trade conflict began being negotiated away, albeit with that process being unpredictable. The second scenario, which we describe as an "aggressive tariff" scenario, sees the tariffs remaining in place, other tariffs being added, and uncertainty persisting. In this scenario, a long-lasting global trade war unfolds.

The charts below illustrate how the Canadian economy could perform under these scenarios. In the "modest tariff scenario" GDP growth stalls in Q2-2025, before rebounding to around a 1.5%-2.0% growth pace in the quarters thereafter. CPI inflation remains below the 2% target for several quarters, before rising slightly above target by the middle of next year. In terms of full year projections, under "modest tariffs" Canadian GDP grows 1.6% in 2025 and 1.4% in 2026, while CPI inflation prints at 1.8% for 2025 and 2.0% for 2026.



Source: Bank of Canada and Wells Fargo Economics



Source: Bank of Canada and Wells Fargo Economics

The outlook under the "aggressive tariff" scenario is starkly different. A protracted recession ensues, with Canadian GDP contracting for four quarters in a row from Q2-2025 to Q1-2026 at an average pace of 1.2%, before gradually recovering thereafter. CPI inflation jumps above 3% by Q2-2026 before receding thereafter. In terms of full year projections, under "aggressive tariffs" Canadian GDP grows 0.8% in 2025 but shrinks by 0.2% in 2026, while CPI inflation prints at 2.0% for 2025 and quickens to 2.7% for 2026. In terms of the potential policy outcomes under these scenarios, we believe the modest tariff scenario favors faster easing (since inflation remains well-behaved), but also less pronounced easing overall (given that GDP growth remain steadier). In contrast, the aggressive tariff scenario likely favors more gradual easing (given the uncertainty created by a spike of inflation) but more pronounced easing overall (given the sharp downturn of the Canadian economy).

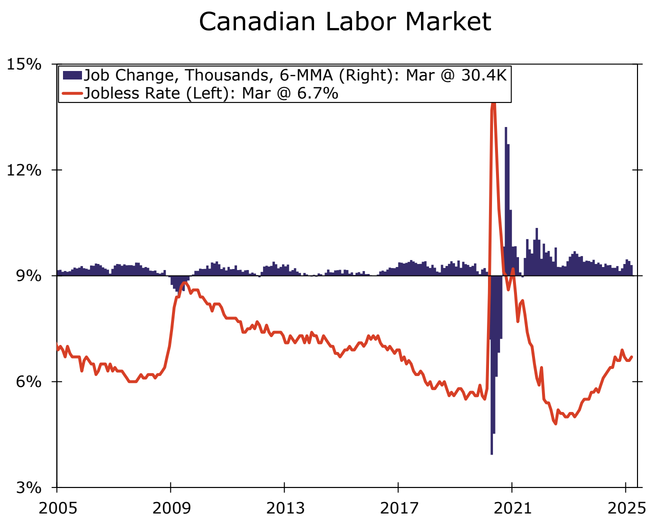
Our own outlook leans closer to the aggressive tariff scenario, in that we expect most of the tariffs that have already been implemented to remain in place over our entire forecast horizon through 2025 and 2026. We estimate that the effective tariff rate on U.S. imports from Canada is now 11.7%, up from just 0.1% in 2024. Presuming most of these tariffs remain in place, our outlook for the Canadian economy follows a “middle ground” between the central bank's two scenarios. As tariff tensions between the U.S. and Canada have ratcheted higher, we have revised our forecast for Canadian economic growth lower, while we have revised our forecast for Canadian inflation higher. Our recently revised outlook now sees Canadian GDP growth of 0.9% for 2025 and 1.0% for 2026, while CPI inflation is seen at 2.7% in 2025 and 2.0% in 2026.

Bank of Canada Likely to Proceed More Cautiously Than Usual

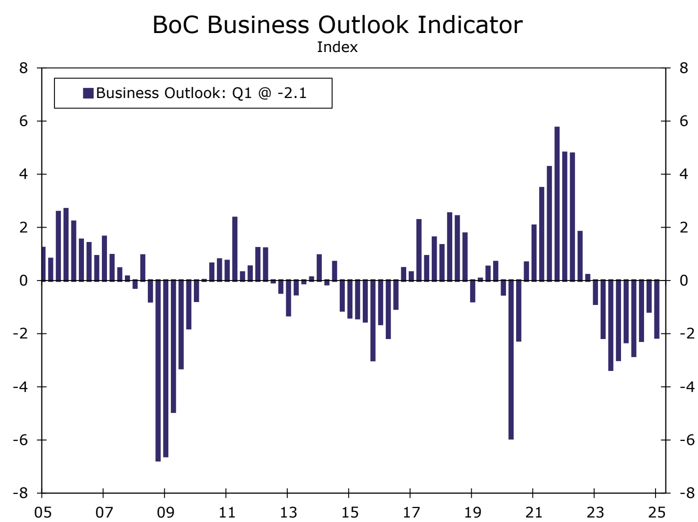
Another takeaway from the elevated level of uncertainty, in our view, is that the Bank of Canada is likely to proceed very carefully as it contemplates its monetary policy decisions at its upcoming meetings. The central bank said, for example, that “monetary policy cannot resolve trade uncertainty or offset the impacts of a trade war. What it can and must do is maintain price stability for Canadians.” In separate comments, Governor Macklem said that a lot has happened over the past several weeks, while adding:

> “But the future is no clearer. We still do not know what tariffs will be imposed, whether they’ll be reduced or escalated, or how long all of this will last. At this meeting, we decided to hold our policy rate unchanged as we gain more information about both the path forward for US tariffs and their impacts....Faced with pervasive uncertainty, Governing Council will proceed carefully, with particular attention to the risks. That means being less forward-looking than usual until the situation is clearer. It also means we are prepared to act decisively if incoming information points clearly in one direction.”

To be sure, there are only very limited data so far on the potential impact of higher U.S. tariffs on the Canadian economy. That said, some hints of a slowdown are starting to emerge. Employment rose by just 1,100 in February before falling by 32,600 in March, likely reflecting increased caution by businesses as higher tariffs went into effect. Business confidence also softened in the first quarter. The BoC's Business Outlook Indicator dropped to -2.1, essentially fully reversing the improvement seen in Q4-2024. Within that same survey, indicators of future sales, employment and investment also softened. On the price front, both the Q1 business confidence and consumer confidence surveys revealed higher inflation expectations, while other incoming inflation signals have been mixed. March headline inflation unexpectedly slowed to 2.3% year-over-year, but average core inflation remained elevated at 2.9%.

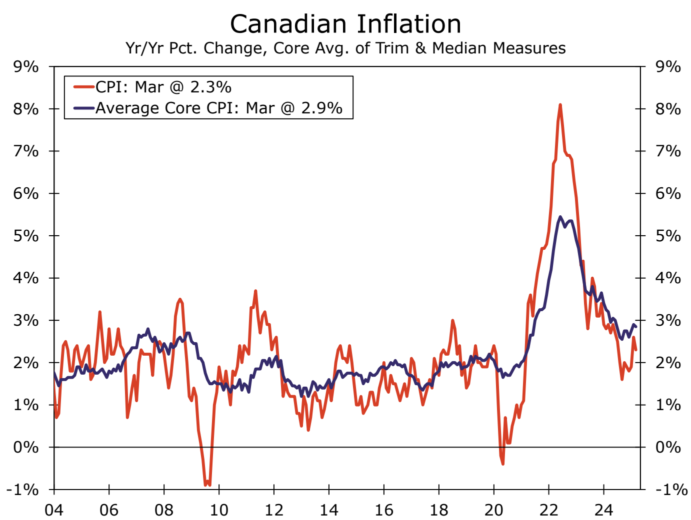


Source: Datastream and Wells Fargo Economics

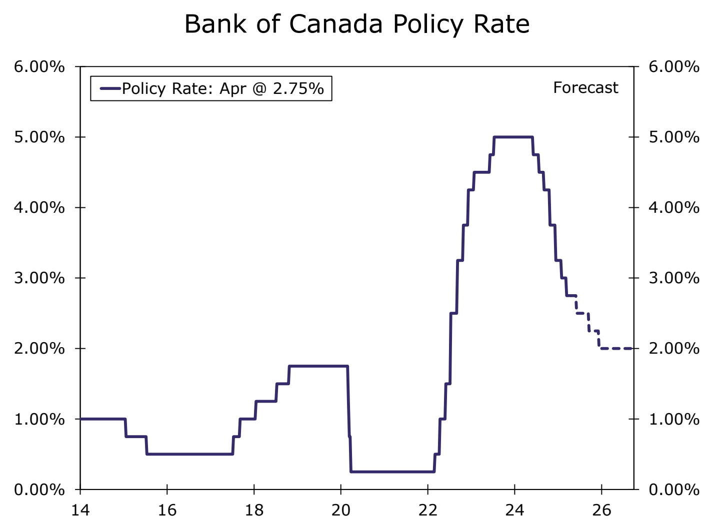


Source: Bloomberg Finance L.P. and Wells Fargo Economics

With scant evidence on the impact of tariffs so far, and with our own outlook leaning more toward the BoC's aggressive tariff scenario, we favor a more gradual, but also more pronounced, monetary easing cycle from the central bank. **For the time being, our base case is for BoC rate cuts to continue at a once-per-quarter pace, and we anticipate 25 bps reductions at the June, September and December announcements, for a policy rate low of 2.00%. We do, however, see the risks as tilted toward even later easing.** If the outlook for U.S. trade policy and its impact on the Canadian economy still remains unclear by the time of the next scheduled BoC announcement in early June, one could easily see the central bank's schedule of rate cuts getting pushed back by one meeting. That is, in this risk scenario we anticipate 25 bps rate cuts would take place in July and October this year, and January 2026, meaning the Bank of Canada's policy rate would instead reach a low of 2.00% by early next year. Finally, although the Canadian dollar has shown resilience, and indeed some strength, versus the greenback since early April, we still expect the Canadian economy's underwhelming growth performance and BoC easing will likely be consistent with a moderate weakening of the Canadian dollar over the medium term. We will provide a comprehensive update of our currency views in our April International Economic Outlook, scheduled for publication in the coming days.



Source: Bloomberg Finance L.P. and Wells Fargo Economics



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