BANK OF CANADA
BANQUE DU CANADA

Monetary Policy Report—January 2025

Economic growth has ticked up in Canada, boosted by past cuts in interest rates. In the absence of new tariffs, growth is forecast to strengthen, and inflation remains close to 2%. But the threat of new tariffs is causing major uncertainty.

Trade policy assumptions

The **economic outlook** presented in this *Monetary Policy Report* does not incorporate any new US tariffs, although it does recognize that the threat of tariffs is already affecting financial markets and business decisions. This assumption reflects a situation that is evolving rapidly, along with the high degree of uncertainty around whether wide-ranging tariffs will be imposed and the specifics of those tariffs and any possible retaliation. A detailed discussion of how the Canadian economy could be impacted if significant new tariffs were to be imposed, including an illustrative scenario, can be found in **In focus: Evaluating the potential impacts of US tariffs**.

Overview

Inflation in Canada has been around 2% since August 2024. Inflation rates for most major components of the consumer price index are below their historical averages, but inflation in shelter prices is elevated and is easing slowly. Inflation expectations have largely normalized.

Inflation is projected to be volatile through March, reflecting the effects of the GST/HST holiday on some goods and services. Inflation is expected to remain near the 2% target over the **projection horizon**.

Growth in the **Canadian economy** was softer than expected in the third quarter of 2024, but there are signs activity has since gained momentum despite a slowdown in population growth. Past interest rate cuts are contributing to an increase in household spending and housing activity. The labour market is still soft, and there are some signs that wage growth has slowed. The economy remains in modest excess supply.

Canadian economic growth is **forecast** to average 1.8% in 2025 and 2026. Household spending strengthens and is anticipated to remain robust, supported by past cuts to interest rates. Excess supply is expected to gradually dissipate over the projection.

The **global economy** is anticipated to grow at around 3%. Growth in US gross domestic product (GDP) has been strong and is projected to remain so in 2025. It is then anticipated to moderate in 2026. Inflation in the United States has been persistent but is expected to ease through 2025 and 2026. In the euro area, growth is subdued. In China, policy measures are fuelling economic activity in the near term, with a slowdown expected later in the projection.

Both upside and downside **risks** surround the outlook, and the Bank is equally concerned with inflation rising above the 2% target or falling below it. Excluding new wide-ranging US tariffs, the risks to the outlook for inflation are roughly balanced. However, US trade policy has emerged as a major source of uncertainty.

The new US administration has threatened significant tariffs on imports from its trading partners, including Canada. This has prompted discussion of retaliatory tariffs. While many details remain unknown, broad-based tariffs would severely disrupt global trade. In Canada, there are already signs that the threat of tariffs is weighing on consumer and business confidence and investment intentions. This threat has also contributed to the recent depreciation of the Canadian dollar.

In this Report, the Bank uses an **illustrative scenario** to explore how a hypothetical set of tariffs and countermeasures could affect economic activity and inflation in Canada. The Bank will continue to consult with other policy-makers, businesses and labour groups and will analyze new information as it becomes available. The Bank's analysis will be updated as the situation evolves.

The *Monetary Policy Report* is a product of the Governing Council of the Bank of Canada: Tiff Macklem, Carolyn Rogers, Toni Gravelle, Sharon Kozicki, Nicolas Vincent and Rhys Mendes.

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Current conditions

Inflation remains close to 2%, and past cuts in interest rates are boosting economic growth in Canada. At the same time, the threat of wide-ranging tariffs by the new US administration has increased uncertainty.

Quarterly growth in gross domestic product (GDP) is estimated to have been about 1.4% in the second half of 2024. The labour market is still soft, and the economy remains in modest excess supply. Spending has begun to increase on housing and on goods and services that are sensitive to interest rates.

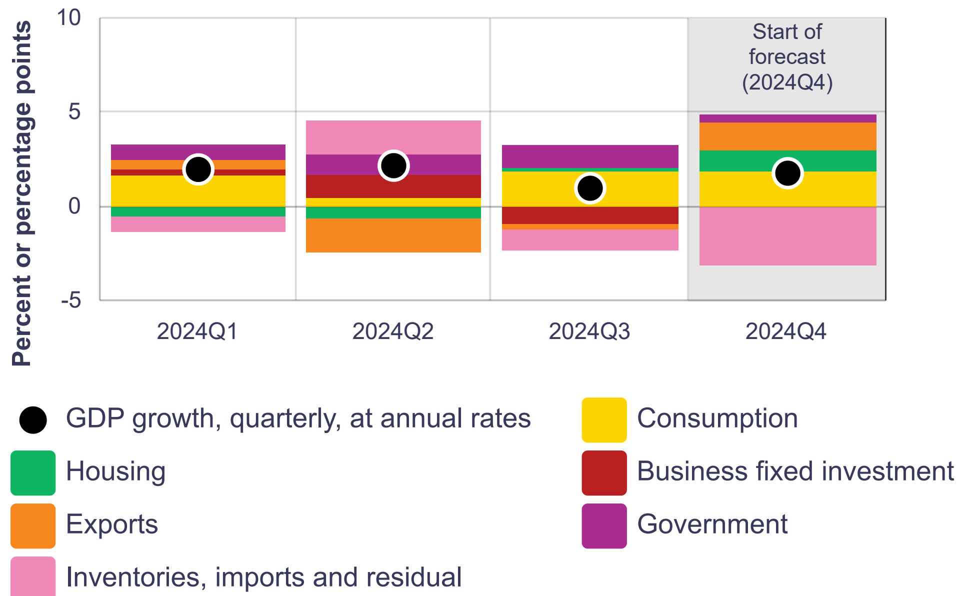
Consumer price index (CPI) inflation has remained around 2% in recent months, as expected in the October Report.

Economic activity

GDP growth slowed to 1% in the third quarter, weaker than anticipated at the time of the October Report. It is estimated to have increased modestly to around 1.8% in the fourth quarter (**Chart 1**).

Chart 1: GDP growth is estimated to be around 1.8% in the fourth quarter of 2024

Contributions to real GDP growth, quarterly data



Sources: Statistics Canada and Bank of Canada calculations and estimates
Last data plotted: 2024Q4

Growth in final domestic demand has been solid and is estimated to have climbed to about 3.5% in the fourth quarter. This recent strength reflects continued robust growth in consumer spending and a pickup in residential investment. In contrast, business investment remains weak.

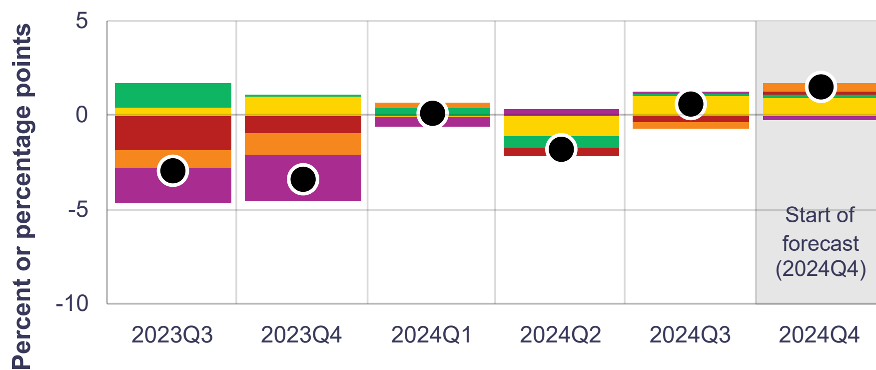
Uncertainty has risen in recent months because the new US administration has threatened to impose wide-ranging tariffs on Canada and many other major US trading partners. In Canada, there are signs that this uncertainty is weighing on consumer and business confidence and on investment intentions. The threat of new tariffs has also contributed to the recent decline in the Canadian dollar relative to the US dollar (see **In focus: Recent factors affecting the Canada-US exchange rate**).

Final domestic demand growth has been solid

The latest data available indicate that growth in final domestic demand was solid in the fourth quarter, led by growth in consumption per person and a surge in residential investment (**Chart 2**). This suggests that households are responding to lower interest rates. In contrast, growth in government spending has moderated, and business investment has remained flat.

Chart 2: Growth in consumer spending per person picked up in the second half of 2024

Contributions to growth in real consumption per person (aged 15 and older), quarterly data



- Growth in total consumption per person, quarterly, at annual rates
- Purchases of motor vehicles
- Expenditures by Canadians abroad
- Interest-rate-sensitive goods excluding purchases of motor vehicles
- Interest-rate-sensitive services excluding expenditures by Canadians abroad
- Other goods and services

Note: Data for the population aged 15 and older are from Statistics Canada's quarterly population estimates. For more information about what is included in the consumption categories, see T. Chernis and C. Luu, "Disaggregating Household Sensitivity to Monetary Policy by Expenditure Category," Bank of Canada Staff Analytical Note No. 2018-32 (October 2018).
Sources: Statistics Canada and Bank of Canada calculations and estimates
Last data plotted: 2024Q4

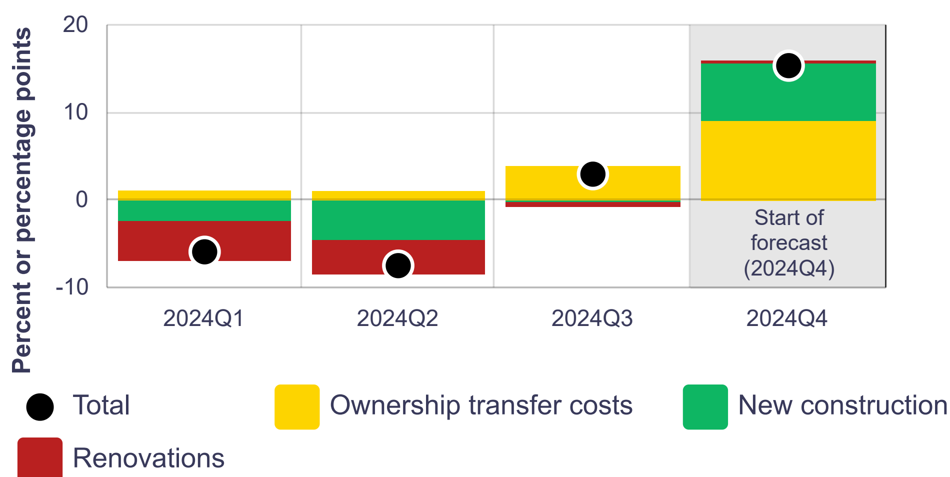
Growth in consumption per person turned positive in the third quarter of 2024, and it is estimated to have increased further to about 1.6% in the fourth quarter. This rise is supported by cuts made to the policy interest rate in 2024 and robust growth in disposable income per person.

Residential investment is estimated to have increased sharply by about 15% in the fourth quarter of 2024 (**Chart 3**). Continued strong growth in home resales—which boosts ownership transfer costs—and a substantial rise in new home construction were supported by lower interest rates and pent-up demand. In contrast, renovation activity remained soft.

Business investment has been weak and is estimated to have remained flat in the fourth quarter (**Chart 4**).

Chart 3: Residential investment is on track to strengthen in the fourth quarter of 2024

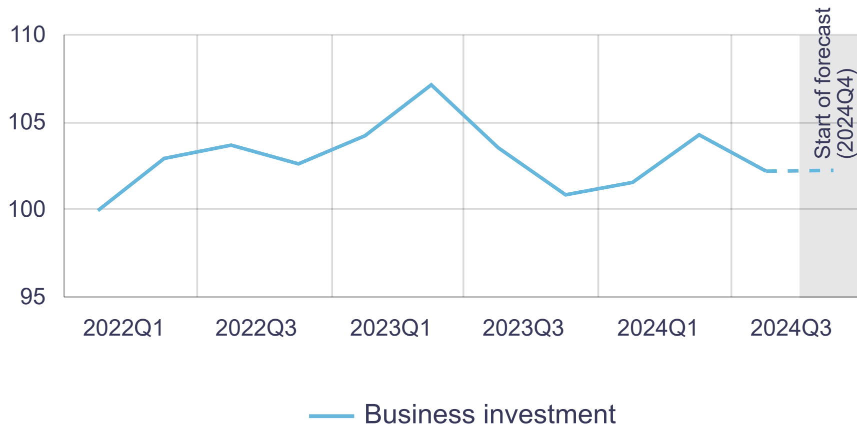
Quarterly growth, annualized



Note: Contributions to growth are an approximation and may not exactly sum to the total growth rate.
Sources: Statistics Canada and Bank of Canada calculations
Last data plotted: 2024Q4

Chart 4: Business investment remains subdued

Index: 2022Q1 = 100, quarterly data



Sources: Statistics Canada and Bank of Canada calculations
Last data plotted: 2024Q4

While government spending growth was strong through much of 2024, it is estimated to have eased in the fourth quarter, in line with plans laid out in federal and provincial budgets and fiscal updates.

Exports rise in the near term

Exports were weak over the first three quarters of 2024 despite the strength in foreign demand. While part of this weakness likely reflects ongoing competitiveness challenges, temporary factors are also at play. These include short-term shutdowns at some Canadian and US motor vehicle facilities.

Export growth is estimated to have risen sharply to around 4.6% in the fourth quarter, mostly reflecting a surge in the exports of gold and pharmaceuticals, which tend to be highly volatile. This recent pickup also reflects the re-opening of some motor vehicle facilities, and export growth in the fourth quarter is further supported by increased oil exports.

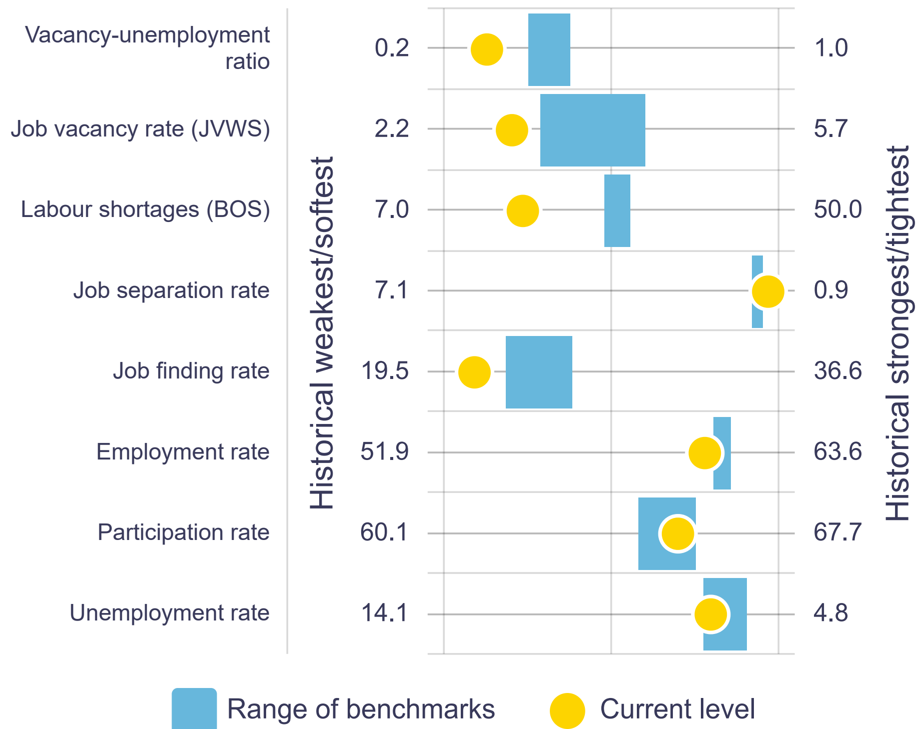
Import growth is estimated to have increased to about 2.9% in the fourth quarter. This reflects a rebound in motor vehicle imports, partially offset by weak imports of machinery and equipment, which are restrained by subdued business sentiment.

Capacity pressures

The Canadian economy continues to be in modest excess supply. The output gap is estimated to be between -1.25% and -0.25% in the fourth quarter, roughly unchanged from the third quarter. Due to upward revisions to the level of GDP, there is slightly less excess supply than at the time of the October Report (see **Changes to the projection** in the Projections section). A broad suite of labour market data indicate ongoing labour market softness (**Chart 5**).

Chart 5: The labour market remains soft

Selected labour market measures compared with their historical strongest/tightest and historical weakest/softest



Note: All variables are in percent other than the vacancy-unemployment ratio. This chart presents the current value of labour market indicators when compared with their historical worst and best values. The range of benchmarks are based on estimates of trend using different methodologies: the modified Hamilton filter; the Hodrick-Prescott filter; values of the indicator corresponding to a period when the labour input gap was closed (adjusted for demographic changes); and, for selected indicators, trend estimates produced by the Bank of Canada. Due to limitations from the short sample, the benchmark range for vacancy measures does not include the Hodrick-Prescott filter. Data for all series are from Statistics Canada's Labour Force Survey (LFS) unless otherwise noted. BOS is the Business Outlook Survey; JVWS is the Job Vacancy and Wage Survey. For more details, see E. Ens, A. Lam, K. See and G. Galassi, "Benchmarks for assessing labour market health: 2024 update," Staff Analytical Note No. 2024-8 (April 2024).

Sources: Statistics Canada, Bank of Canada and Bank of Canada calculations

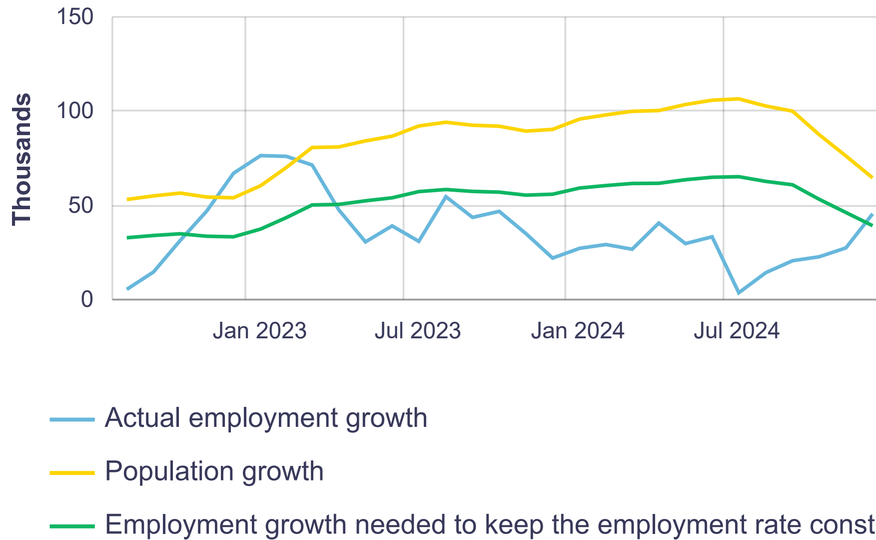
Last observations: LFS, December 2024; BOS, 2024Q4; JVWS, October 2024

The labour market remains soft

The unemployment rate is somewhat higher than it was at the time of the October Report, with youth and newcomers continuing to be the most affected. Employment gains picked up, while the rate of increase in the working-age population slowed (**Chart 6**). In recent months, average job gains were strong enough to maintain the ratio of employment to the working-age population.

Chart 6: Employment growth has picked up, and population growth continues to weaken

3-month moving average, seasonally adjusted, monthly data



— Actual employment growth

— Population growth

— Employment growth needed to keep the employment rate constant

Note: Employment growth needed to keep the employment rate constant is calculated by multiplying the net monthly change in the size of the working-age population in the Labour Force Survey by the previous month's employment rate.

Sources: Statistics Canada and Bank of Canada calculations
Last observation: December 2024

While wage growth remains sticky, the most recent data show some signs that it has begun to moderate. The slowing is most evident in private-sector wage growth. All wage growth leads to higher demand and, because of this, has some effect on inflation. However, the cost of producing consumer goods and services is most affected by private sector wages. Measures of private sector wage growth based on data from the Labour Force Survey (LFS) have moved closer to growth in private sector compensation per hour in the national accounts (**Chart 7**). Growth in LFS private sector wages slowed to 3.4% in December, down from 4.6% at the time of the October Report. The microdata-based measure of LFS private sector wage growth, which adjusts for compositional changes, declined to 3.4% in December from 4% in September.

The moderation in wage growth has reduced the risk that inflation in some services could prove to be more persistent than expected (see the **Risks** section of the October 2024 *Monetary Policy Report*).

Chart 7: Wage growth shows some signs of moderating

Year-over-year percentage change, monthly and quarterly data

Note: LFS is the Labour Force Survey; SEPH is the Survey of Employment, Payrolls and Hours. *LFS, microdata* measures wage growth using LFS microdata to abstract from changes in worker characteristics, extracting a quality-adjusted price for labour. For more details, see F. Bounajm, T. Devakos and G. Galassi, “Beyond the averages: Measuring underlying wage growth using Labour Force Survey microdata,” Bank of Canada Staff Analytical Note No. 2024-23 (October 2024). All wage series are measured as compensation per hour except for SEPH, which is measured in terms of average weekly earnings. Private sector in SEPH excludes wages from public administration, education and health.

Source: Statistics Canada and Bank of Canada calculations

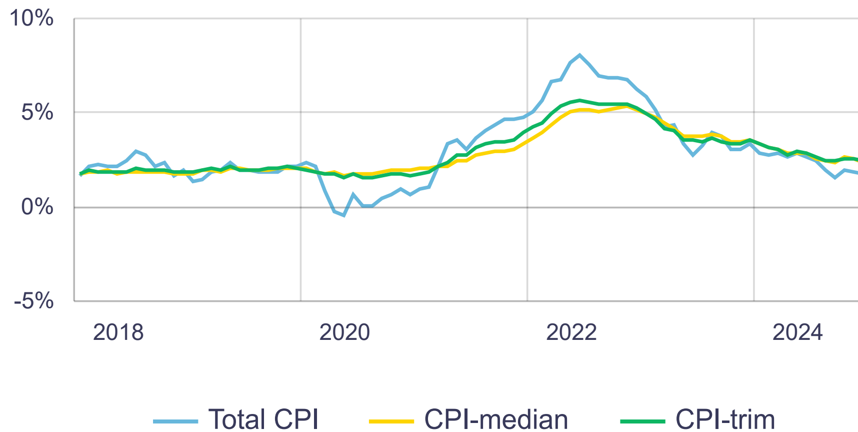
Last observations: LFS, December 2024; SEPH, October 2024; Compensation per hour worked, private sector, 2024Q3

Inflation

Inflation has remained close to the 2% target, as projected in the October Report (**Chart 8**). CPI inflation was 1.8% in December, and the Bank of Canada's preferred measures of core inflation, CPI-median and CPI-trim, were 2.4% and 2.5%, respectively.

Chart 8: Inflation has remained close to 2% since August 2024

Year-over-year percentage change, monthly data



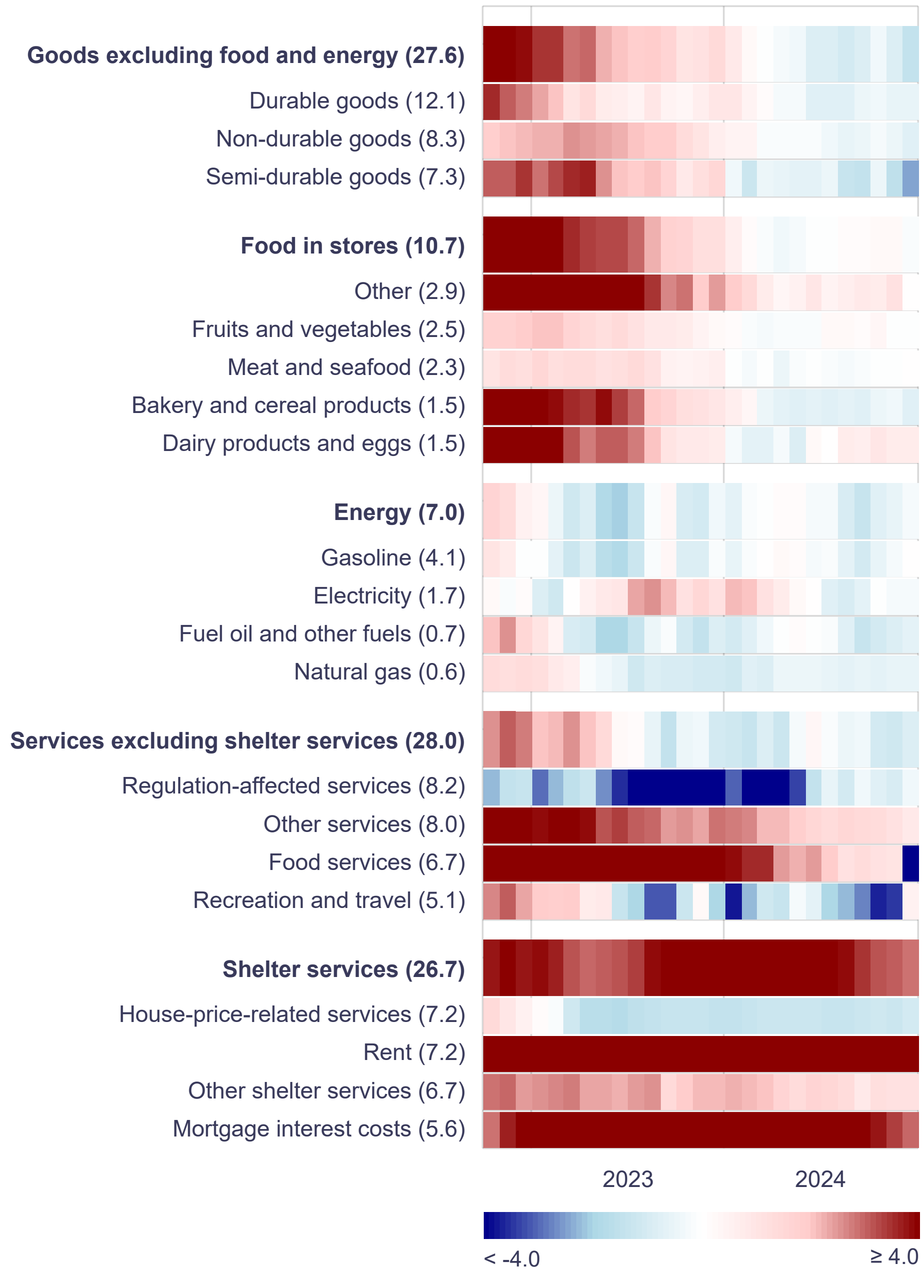
Sources: Statistics Canada and Bank of Canada calculations
Last observation: December 2024

The Bank judges that underlying inflation is close to 2%. There are no signs that inflationary pressures are broad-based. The share of CPI components rising by more than 3% is now below its historical average. Inflation expectations have largely returned to normal.

Inflation has remained around 2%

CPI inflation remains close to 2%. Shelter services price inflation is the only major component above its historical average (**Chart 9**). In particular, inflation remains elevated for rent and mortgage interest costs, but it has been easing.

Chart 9: Inflation in many CPI components continues to run below historical averages



Note: The heatmap shows the distance of each CPI component's year-over-year inflation rate from its historical average. The colour is white when a component's inflation rate is close to its average and is a varying shade of red (blue) when the rate is above (below) the average. Because the historical range of inflation varies widely across CPI components, each inflation rate plotted in the heatmap is standardized by subtracting its mean and dividing by its standard deviation. This standardization is conducted using data from 1996–2019, except for *Regulation-affected services* and *Other services*, where available data begin in 2004 and 2008, respectively. Note that *Regulation-affected services* includes prices that are affected by government regulations either directly (e.g., child care services) or indirectly (e.g., telephone services). Values in parentheses are CPI weights (in percent). Due to rounding, weights within categories may not sum to their respective totals. The components include the temporary GST/HST tax holiday (December 14, 2024, to February 15, 2025). This tax change impacts a wide range of goods and services, particularly semi-durable goods and food services.
Sources: Statistics Canada and Bank of Canada calculations
Last observation: December 2024

At the same time, inflation in other major CPI components has generally been below historical averages. In addition, the GST/HST holiday is pulling down inflation over the near term, particularly in categories such as food services and semi-durable goods. By March 2025, the tax holiday will have ended, and inflation in these categories will go back up.

Goods price inflation remains soft

Inflation in goods prices was -0.1% in December, in line with recent months. Excess supply and past easing in cost pressures continue to weigh on inflation for many goods prices. Moreover, the temporary GST/HST holiday reduced inflation in some goods, including food, alcohol, children's clothing and toys. These factors were partially offset by the recent depreciation of the Canadian dollar, which has had a small inflationary impact on the prices of imported goods.

Services price inflation has eased

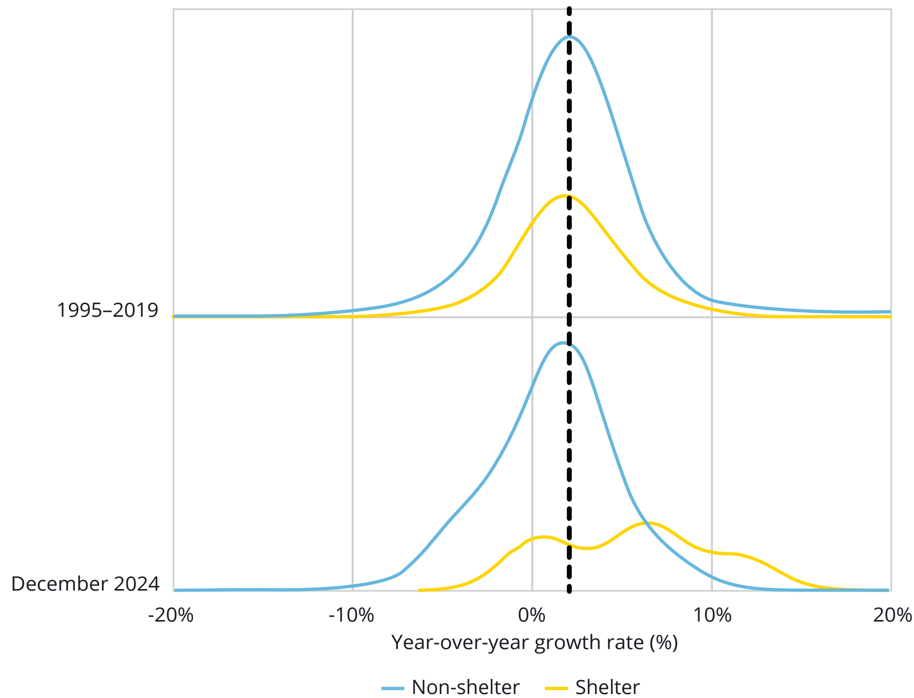
Inflation in services excluding shelter eased to 2% in December from 2.3% in September. The temporary GST/HST holiday pulled down inflation in services excluding shelter, especially food services.

Inflation in shelter services eased to 5.1% in December, down further from 5.8% in September. This easing has been driven by slower growth in rent and mortgage interest costs. While recent data suggest that the average asking price for rents declined in December, rent inflation remains persistently elevated. The persistence of rent inflation mostly reflects a gradual and ongoing adjustment to past increases in new rents (see **In focus: How the frequency of price changes affects inflation** in the October Report).

CPI-median and CPI-trim remain above 2% largely because of the impacts of persistently high shelter inflation on the distribution of price changes.[1] **Chart 10** shows the distribution of inflation in December 2024 compared with its historical norm (from 1995 to 2019). The distribution of non-shelter components (**Chart 10**, blue lines) has largely returned to its historical norm. In contrast, shelter price inflation (**Chart 10**, yellow lines) is still being pushed up more than usual by components that are well above 2%.

Chart 10: Shelter inflation remains unusually high and dispersed

Density of year-over-year percentage change, monthly data



Note: This distribution displays price changes to the 55 components in the CPI basket. CPI components are weighted by their respective basket weights. The dashed line indicates the 2% inflation target.
Sources: Statistics Canada and Bank of Canada calculations
Last observation: December 2024

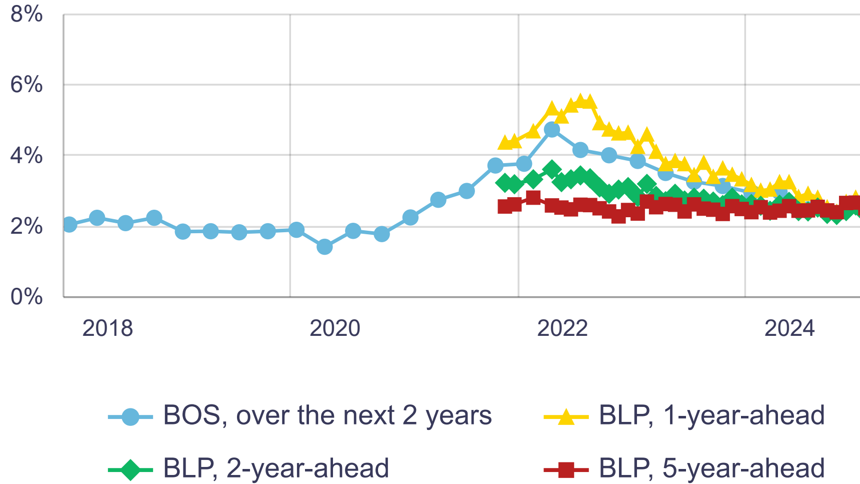
Inflation expectations have almost returned to normal

Inflation expectations of both consumers and businesses have almost returned to normal (**Chart 11**). Consumers' expectations eased further in the fourth quarter, and three-quarters of businesses now expect inflation to be between 1% and 3% at all horizons.

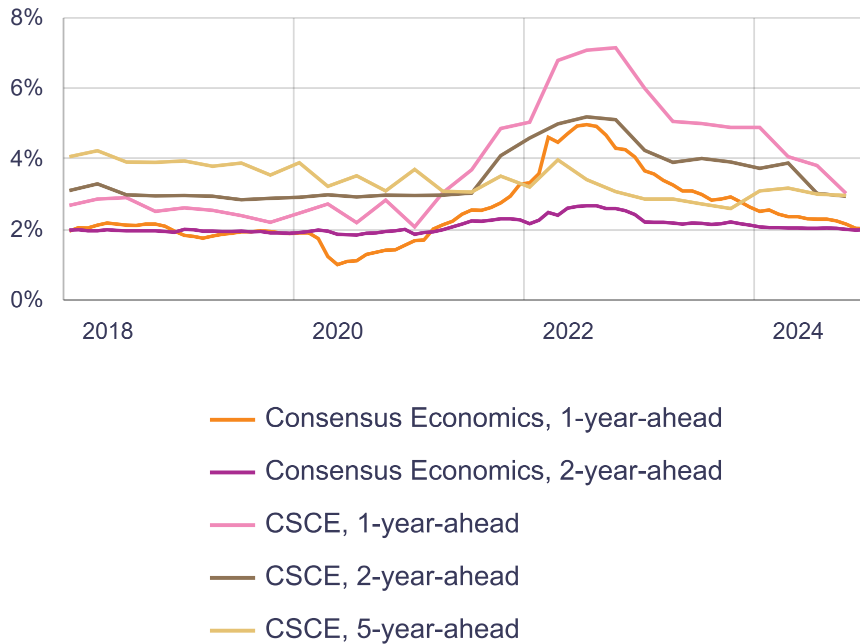
Chart 11: Inflation expectations have largely returned to normal

Quarterly and monthly data

a. Businesses



b. Consumers and professional forecasters



Note: CSCE is the Canadian Survey of Consumer Expectations; BOS is the Business Outlook Survey; BLP is the Business Leaders' Pulse. Consensus Economics' forecasts for the next year (based on monthly data) and the next two years (based on a combination of monthly and quarterly data releases) are transformed into fixed-horizon forecasts by the weighted average of fixed-date forecasts. *1-year-ahead* refers to inflation expectations for the next 12 months. *2-year-ahead* refers to inflation expectations for the period 12 to 24 months from now. *5-year-ahead* refers to inflation expectations for the period 48 to 60 months from now. This question was not asked in the January or March 2022 BLP.
Sources: Consensus Economics, Bank of Canada and Bank of Canada calculations
Last observations: Consensus Economics, December 2024; CSCE and BOS, 2024Q4; BLP, January 23, 2025

Endnotes

1. For example, mortgage interest cost, which comprises 5.6% of the CPI basket, has been excluded from CPI-trim for much of the past two years. This persistent exclusion of a high-weight category limits the extent to which CPI-trim can symmetrically exclude volatile price movements in other categories each month. In this way, mortgage interest cost can contribute indirectly to CPI-trim despite being excluded from the measure. This indirect effect became increasingly large through 2024. In addition, other shelter components, such as rent, have often been included in CPI-trim, contributing directly to some of the remaining strength in the measure. [←]

Outlook

Economic growth in Canada is projected to rise to around 1.8% in 2025 and 2026, outpacing potential output, and excess supply is gradually absorbed. Inflation is expected to remain close to the Bank of Canada's 2% target.

The economic outlook depends on several key assumptions (see **Key inputs to the projection** in the Projections section). Importantly, the projection does not incorporate any wide-ranging US tariffs. New tariffs could significantly affect the outlooks for growth and inflation (see **In focus: Evaluating the potential impacts of US tariffs**). Reflecting an increase in uncertainty about US trade policy, the projection includes a modest negative impact on Canadian business investment.

The easing of monetary policy contributes to the increase in economic activity by stimulating household and business spending. At the same time, exports are supported by new transportation capacity for oil and gas, along with the continued strength of the US economy.

The outlook for growth in Canada has been revised down since the October Report because of new government policies designed to slow immigration and updated assumptions related to outflows of non-permanent residents. Fewer newcomers lead to both fewer new consumers and fewer new workers, with little net impact on inflation (see **Canadian outlook** in the Projections section).

Economic activity

As the impacts of monetary policy easing continue to work through the economy, growth in gross domestic product (GDP) is projected to increase from about 1.3% in 2024 to around 1.8% in 2025 and 2026 (see **Table 1** in the Projections section). Quarterly growth slows near the end of the projection to be more in line with potential output growth as the effects of monetary policy easing fade.

GDP growth is forecast to pick up

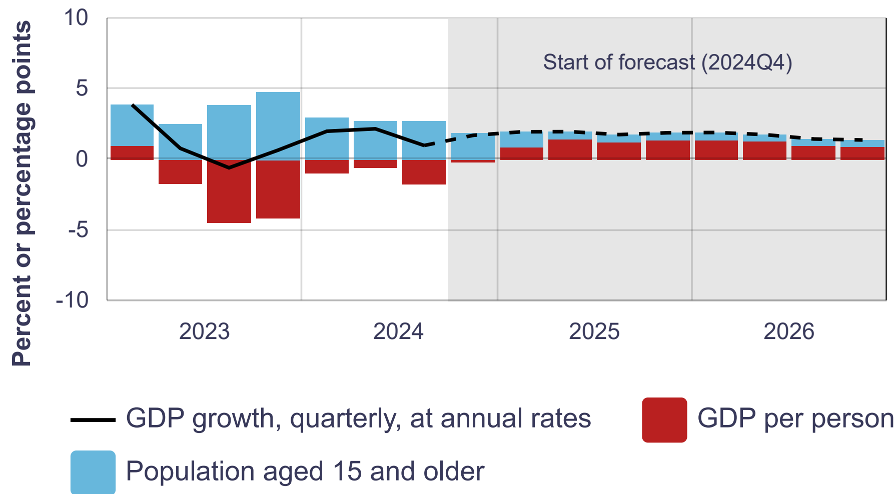
The path for economic growth over the projection reflects the net impact of two opposing forces (**Chart 12**).

- On one hand, growth in GDP per person strengthens in 2025. Per-person household spending is the main factor behind this strengthening, reflecting the effects of lower interest rates as well as rising incomes and household wealth. It also reflects one-time government measures designed to support consumption in the first part of 2025. Export growth and business investment also increase.
- On the other hand, population growth is assumed to slow. After reaching about 2.3% in the second half of 2024, population growth is assumed to decline to 0.5% in the second quarter of 2025, and it is assumed to remain at that pace over the rest of the projection.

On a quarterly basis, GDP growth slows near the end of the projection horizon to be more in line with potential output growth as the effects of monetary policy easing fade.

Chart 12: Growth of GDP per person is expected to pick up in 2025

Contributions to growth in real GDP per person (aged 15 and older), quarterly data



Note: Data for the population aged 15 and older are from Statistics Canada's quarterly population estimates.

Sources: Statistics Canada and Bank of Canada calculations, estimates and projections
Last data plotted: 2026Q4

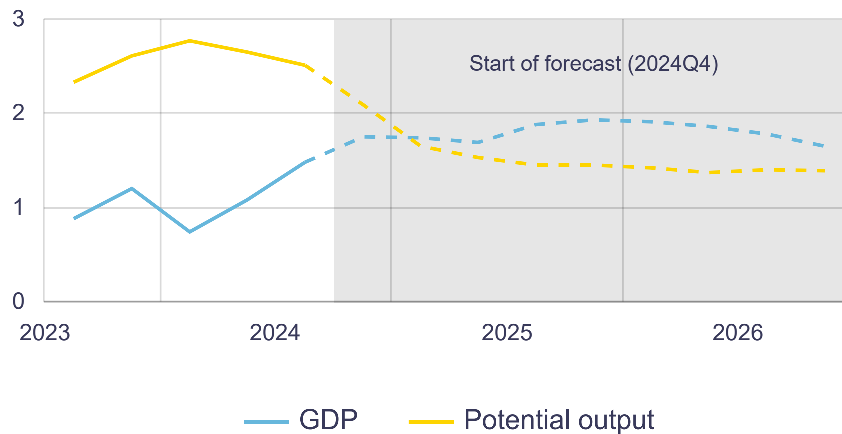
Excess supply is projected to be gradually absorbed

Growth in potential output is projected to slow from 2.5% in 2024 to roughly 1.5% in 2025 and 2026. The assumed slower pace of population growth over the projection pulls down potential output growth (see **Key inputs to the projection** in the Projections section). This is partially offset by an expected rise in growth in trend labour productivity.

GDP growth is anticipated to outpace growth in potential output in 2025 and 2026, resulting in excess supply being absorbed (**Chart 13**).

Chart 13: GDP growth is projected to rise above potential output growth

Year-over-year percentage change, quarterly data



Sources: Statistics Canada and Bank of Canada calculations, estimates and projections
Last data plotted: 2026Q4

Growth in consumption per person is expected to increase

Consumption growth is expected to ease over the projection horizon, in line with slower population growth.

On a per-person basis, however, growth in consumption is projected to pick up and average around 1% in 2025 and 2026, supported by past cuts in policy interest rates, solid income growth and increases in household wealth from rising house prices. Consistent with this outlook, respondents to the Bank's most recent Canadian Survey of Consumer Expectations signalled their intent to increase spending on discretionary items over the next 12 months (**Chart 14**).

Chart 14: Consumers plan to increase their spending

Balance of opinion, Canadian Survey of Consumer Expectations (CSCE), quarterly data

2024Q3 CSCE 2024Q4 CSCE

Note: Balance of opinion is the percentage of respondents expecting their spending to increase minus the percentage expecting their spending to decrease. Responses of *decrease significantly* and *increase significantly* are given twice the weight of responses of *decrease slightly* and *increase slightly*. The range of potential outcomes of this double-weighted balance of opinion is -200% to 200%.
Source: Bank of Canada
Last observation: 2024Q4

Residential investment growth is forecast to be robust in 2025

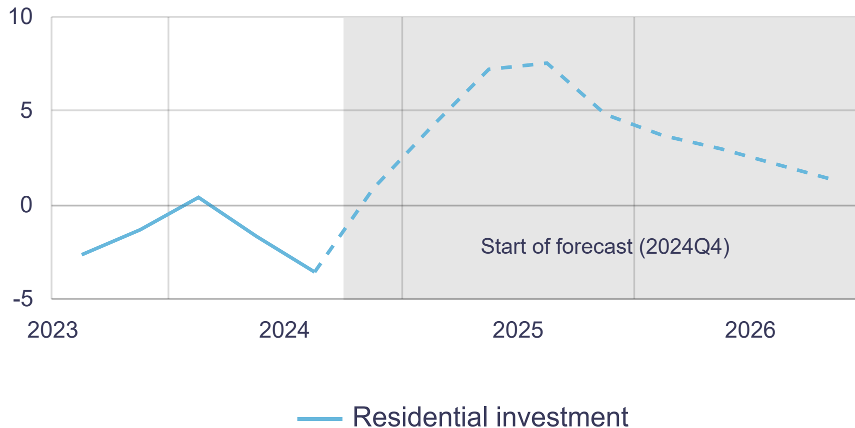
Residential investment growth is expected to be robust, at about 6%, in 2025 (**Chart 15**).

- Declines in mortgage rates strengthen growth in resales. Recent rule changes for mortgage insurance are also expected to boost resales.
- Pent-up demand for housing supports new construction, but constraints will limit supply growth in the short term. These constraints include the amount of land available for new homes, zoning restrictions and a lack of skilled workers.

Growth in residential investment is projected to moderate to about 2.6% in 2026. The housing vacancy rate is anticipated to gradually rise as population growth slows and more homes are built. However, the vacancy rate is expected to remain relatively low.

Chart 15: Growth in residential investment is expected to strengthen in 2025

Year-over-year growth, quarterly data



Residential investment

Sources: Statistics Canada and Bank of Canada estimates and projections
Last data plotted: 2026Q4

Growth in business investment is expected to remain modest

Growth in business investment is expected to increase but remain modest, averaging 1.6% over the projection horizon. Stronger demand growth and past declines in interest rates strengthen business investment. Increased export capacity is projected to encourage investment in the energy sector. At the same time, the rise in trade-related uncertainty will weigh on businesses' investment plans. Moreover, the recent depreciation of the Canadian dollar has made imported machinery and equipment more expensive.

Growth in government spending is assumed to slow in line with federal and provincial budgets and fiscal updates.

Export growth is supported by new transportation capacity for oil and gas

Export growth is projected to increase to about 2.2% on average. It is bolstered by the increased transport capacity provided by the Trans Mountain pipeline, along with new export capacity for liquefied natural gas that is expected to come online in mid-2025. Non-commodity exports grow slowly over the projection despite strong foreign demand.

Import growth is projected to pick up to about 2.4% on average in 2025 and 2026, broadly in line with growth in domestic demand.

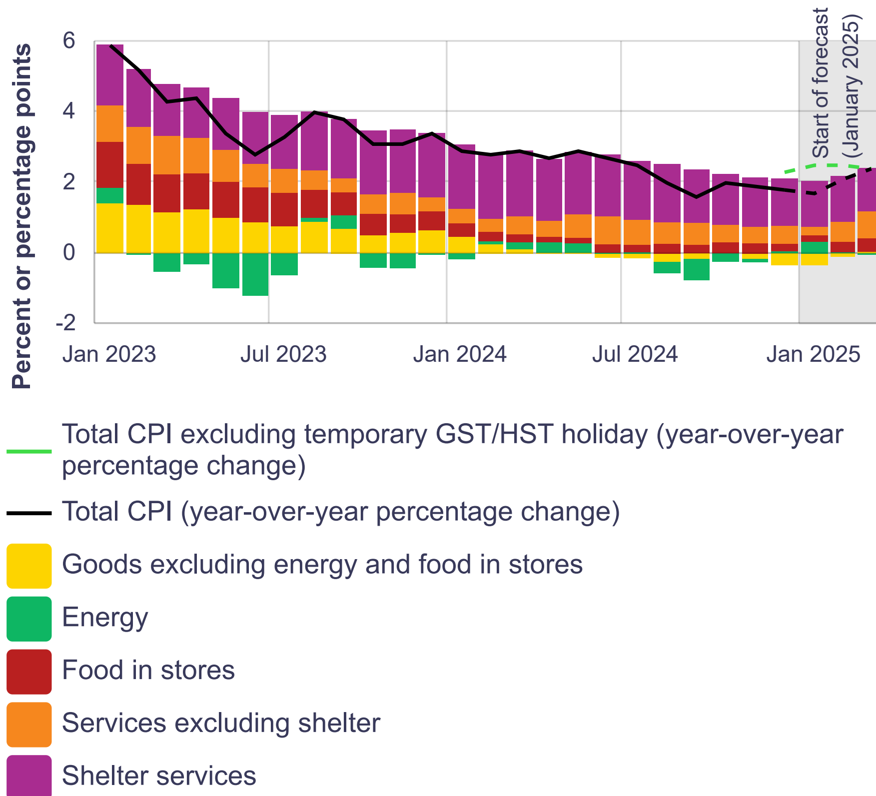
Inflation outlook

Consumer price index (CPI) inflation is expected to remain close to target over the projection. The Bank's preferred core measures of inflation are projected to gradually ease toward 2% as shelter inflation continues to decline (see **Table 2** in the Projections section).

The temporary GST/HST holiday on some goods and services will continue to add volatility to inflation in the coming months. After reducing year-over-year inflation by 0.5 percentage points in December, the tax holiday will likely lower inflation by about 0.8 percentage points in January and by around 0.4 percentage points in February (**Chart 16**). By March, the tax holiday will have ended, and inflation will edge up. The impact of the tax holiday is concentrated in prices for food and alcohol at restaurants (**Chart 16**, included in orange bars).

Chart 16: The GST/HST holiday is adding volatility to near-term inflation

Contributions to CPI inflation, monthly data



Sources: Statistics Canada and Bank of Canada calculations, estimates and projections
Last data plotted: March 2025

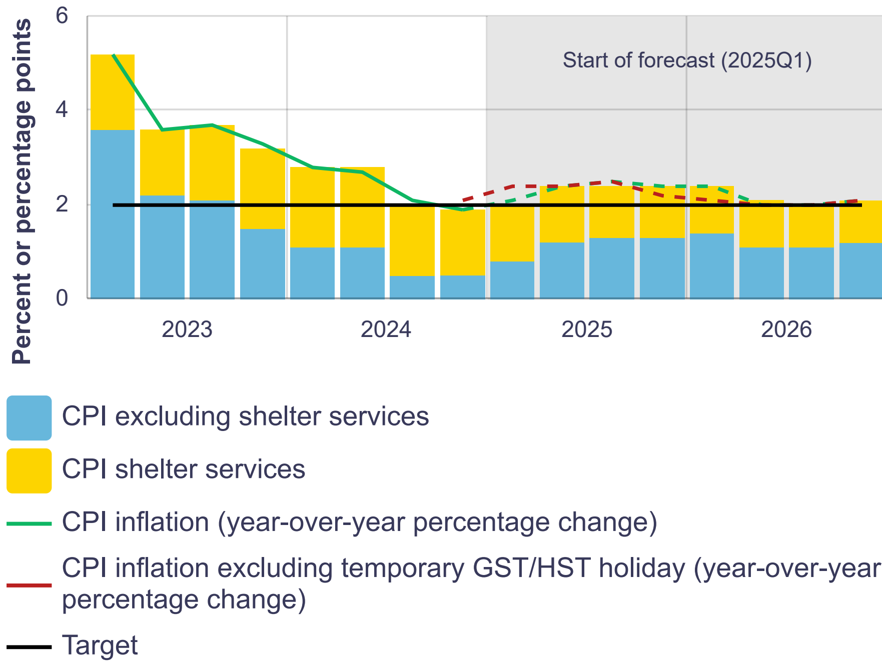
Over the projection, inflation is anticipated to remain close to the 2% target (**Chart 17**).

Inflation in shelter prices is expected to continue to ease but remain above its historical average. Past declines in interest rates will continue to be reflected in slower inflation in mortgage interest costs. With asking rents falling for the first time in several years and population growth assumed to continue slowing, inflation in rent is anticipated to moderate further.[1]

In contrast, inflation in non-shelter components is projected to rise but remain somewhat below its historical average over the projection horizon. The increase comes about as excess supply dissipates and the recent depreciation of the Canadian dollar lifts inflation in the prices of imported goods.

Chart 17: CPI inflation is projected to remain close to 2%

Contributions to CPI inflation, quarterly data



Sources: Statistics Canada and Bank of Canada calculations, estimates and projections
Last data plotted: 2026Q4

Endnotes

1. CPI-rent reflects the quality-adjusted rent price for all units in Canada. Asking rents reflect the going market rate for new rental unit contracts.[←]

Global economy

Global economic growth remains near 3%, and headline inflation is close to central bank targets in many countries. However, uncertainty has increased amid political and trade tensions. The outlook does not incorporate new tariffs threatened by the United States.

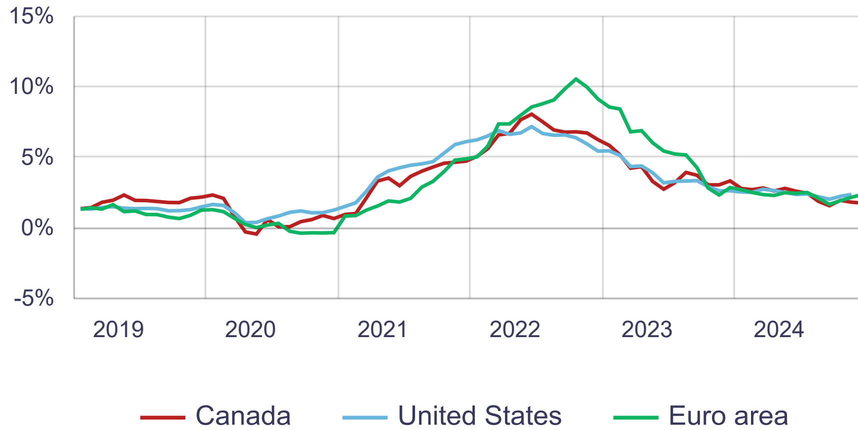
The outlooks for inflation and global growth are broadly in line with the October Report (**Chart 18**; **Table 3** in the Projections section). However, these outlooks are subject to greater uncertainty than normal. This uncertainty is due to US President Donald Trump's threat to impose significant import tariffs (**Chart 19**). As well, several major economies are experiencing heightened political uncertainty.

In this context, developments in financial conditions have been mixed across countries. Markets expect fewer US policy rate cuts, and long-term US interest rates have edged up. Many advanced economies have seen their currencies depreciate against the US dollar.

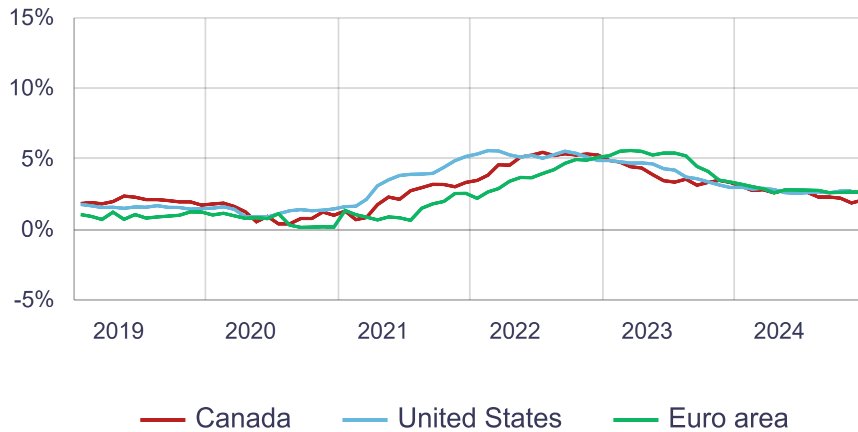
Chart 18: Total inflation is near target, but inflation excluding food and energy remains elevated in many major economies

Year-over-year percentage change, monthly data

a. Total inflation



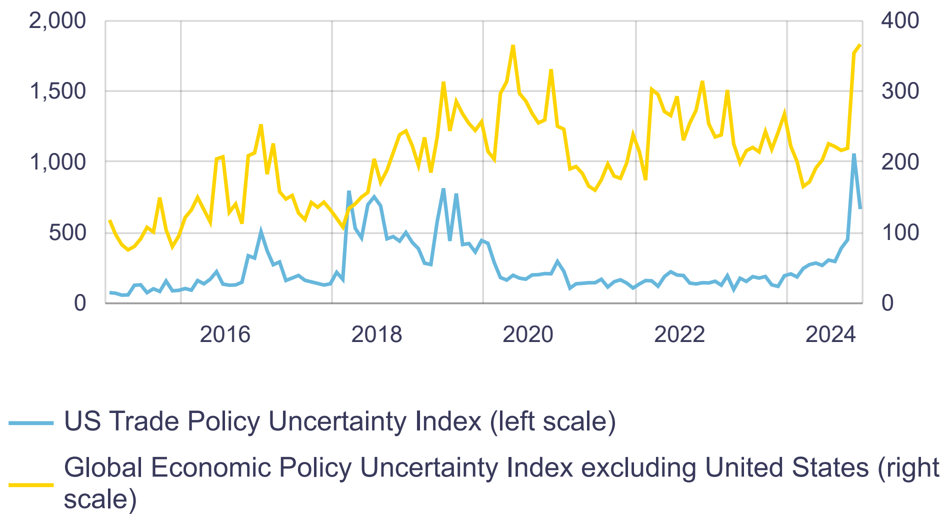
b. Inflation excluding food and energy



Note: Inflation rate calculations are based on the Harmonised Index of Consumer Prices for the euro area, the personal consumption expenditures price index for the United States and the consumer price index for Canada.
Sources: Statistics Canada, US Bureau of Economic Analysis and Eurostat via Haver Analytics, and Bank of Canada calculations
Last observations: United States, November 2024; others, December 2024

Chart 19: Policy uncertainty is elevated

Index: 2015 = 100, monthly data



— US Trade Policy Uncertainty Index (left scale)

— Global Economic Policy Uncertainty Index excluding United States (right scale)

Note: The US Trade Policy Uncertainty Index counts the monthly frequency of articles in major newspapers that discuss trade policy uncertainty. This index was developed in D. Caldara, M. Iacoviello, P. Molligo, A. Pretipino and A. Raffo, "The Effects of Trade Policy Uncertainty," *Journal of Monetary Economics*, 109 (2020): 38–59. The Global Economic Policy Uncertainty Index is a GDP weighted average of the indices from 21 countries. These indexes are available at policyuncertainty.com.

Sources: policyuncertainty.com and International Monetary Fund via Haver Analytics and Bank of Canada calculations

Last observation: December 2024

United States

US economic growth is expected to remain robust in 2025 and to moderate in 2026. Solid growth in labour income and past increases in financial wealth continue to boost consumer spending. Inflationary pressures in core services are persisting, and inflation in the United States has ticked up slightly, although it is expected to ease in 2025.

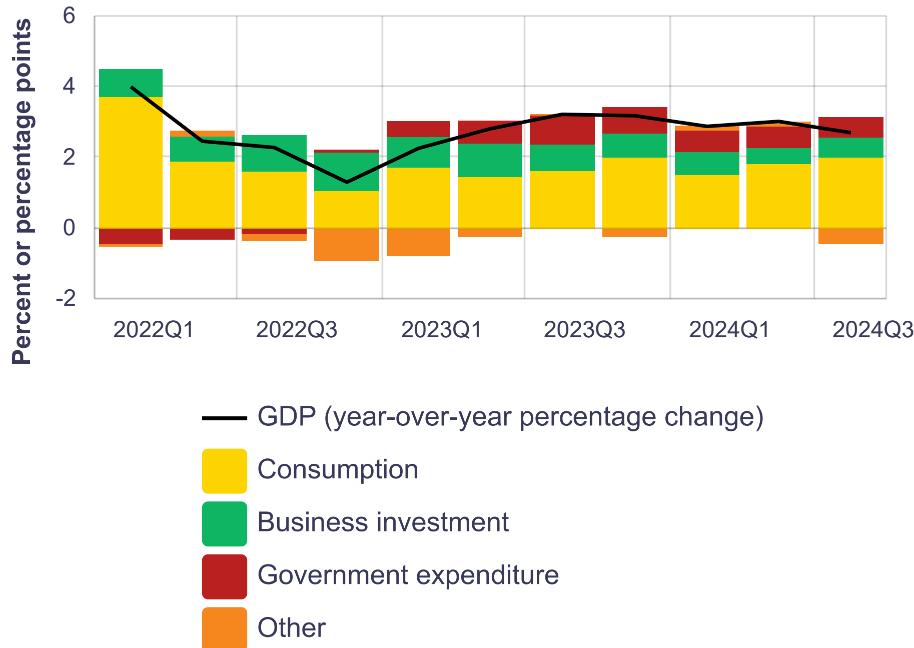
The projection assumes that the *Tax Cuts and Jobs Act* will be extended. Other assumptions about US fiscal policy remain unchanged.

US growth is strong but expected to moderate

US growth is estimated to have averaged 2.9% in the second half of 2024 and is expected to decline gradually to a still-solid pace of around 2.3% in 2026. Consumer spending, which has been surprisingly strong, is underpinning growth (**Chart 20**).

Chart 20: US growth continues to be strong

Contributions to real GDP growth, seasonally adjusted, quarterly data



Note: *Other* includes residential investment, net exports and inventories.
Sources: US Bureau of Economic Analysis via Haver Analytics and Bank of Canada calculations
Last observation: 2024Q3

Solid growth in household income and past gains in financial wealth continue to support consumer spending in 2025. The anticipated extension of provisions of the *Tax Cuts and Jobs Act* is expected to boost household spending into 2026. By the end of the projection, the pace of consumption growth is forecast to soften slightly to about 2.2%.

Growth is anticipated to slow over the projection for state and local government spending as well as for business infrastructure investment due to the fading effect of past federal incentives.

The US economic outlook is subject to greater uncertainty than usual. The new US administration has proposed lower personal and corporate income taxes, changes to regulatory and immigration policies, and wide-ranging tariffs. (See **In focus: Evaluating the potential impacts of US tariffs**.)

US services price inflation remains elevated and declines only gradually

US inflation, measured by the personal consumption expenditures price index, is estimated to have edged up in the fourth quarter of 2024 to about 2.4%. This rise is mainly due to additional upward pressure from inflation in prices for core services (**Chart 21**). Over the projection, inflation gradually eases as demand growth slows and shelter price inflation subsides.

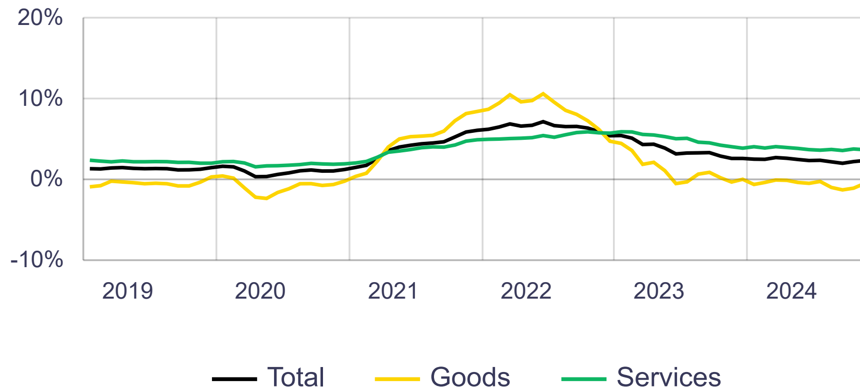
Inflation in services prices is estimated to have remained elevated at about 3.8% in the fourth quarter of 2024 due to strong consumer demand and because some prices have been slow to adjust to past cost increases. As these prices adjust and domestic demand growth slows, inflation in services prices is expected to come down. In addition, easing growth in house prices and recent declines in new tenant rents are expected to reduce shelter inflation over time. Inflation in goods prices is expected to rise from its low level as the impact of past declines in prices for durables fades.

Further into the projection, inflation in the United States moves close to target, with the economy growing at a pace broadly in line with potential output.

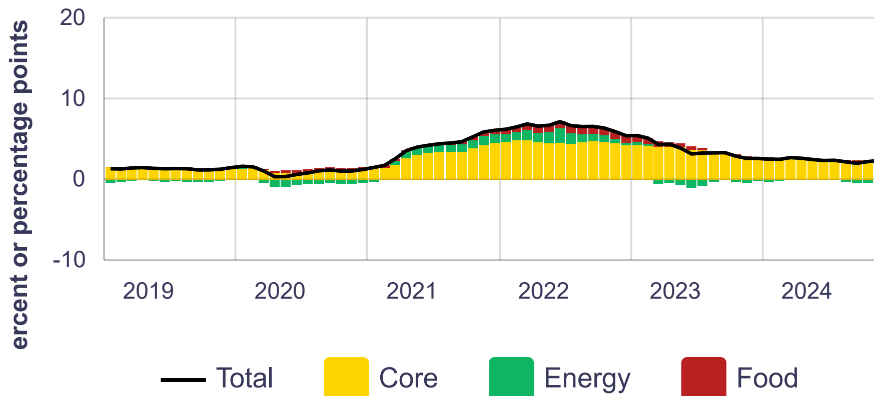
Chart 21: PCE Inflation in services prices remains above pre-pandemic levels

US PCE inflation, year-over-year percentage change, monthly data

a. US inflation components



b. Contributions to US inflation



Note: PCE is the personal consumption expenditures price index.
Sources: US Bureau of Economic Analysis via Haver Analytics and Bank of Canada calculations
Last observation: November 2024

Euro area

Euro area gross domestic product is expected to grow at a subdued pace of around 0.8% in 2025 before gradually strengthening to about 1.3% in 2026. Economic growth is expected to be weighed down by ongoing weakness in manufacturing. The manufacturing sector is struggling to adjust to structural challenges, such as a lack of infrastructure investment and relatively high energy prices, along with persistent competitiveness pressures.

Financial markets expect the European Central Bank (ECB) to further reduce its policy interest rates. This policy easing should support domestic demand and boost consumer and business sentiment.

Inflation in the euro area is expected to be close to the ECB's target of 2% over the projection. In particular, inflation in core services is projected to ease, reflecting modest growth in consumer demand, slowing wage growth and the dissipation of temporary effects related to sporting and cultural events in 2024.

China

Growth in domestic demand in China is projected to rise in the near term, bolstered by recent policy announcements. These announcements include spending vouchers for households, debt support for local governments and policies to stabilize the property sector. Exports grew at a rapid pace in 2024, mostly due to rising production capacity and falling prices for China's manufactured goods. The prices of manufactured export goods are expected to stabilize, leading export growth to slow in 2025.

Later in the projection, economic activity eases as the impact of cyclical policy measures fades and structural challenges, such as an aging population, hold back growth.

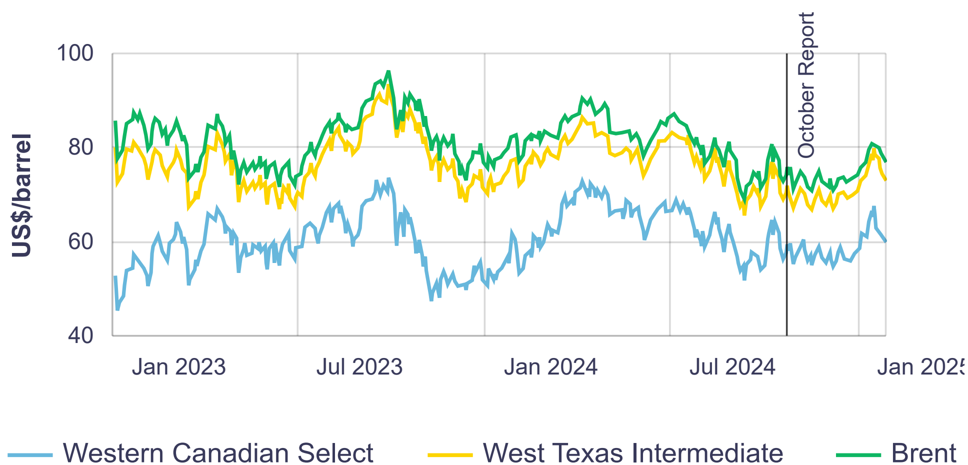
Commodities

Oil prices have risen in response to tightened sanctions on Russian oil amid low global inventories (**Chart 22**). In addition, the Organization of the Petroleum Exporting Countries (OPEC) and OPEC+ members (OPEC plus some non-OPEC oil producers) have again delayed unwinding voluntary production cuts. Brent oil is assumed to average US$80 over the projection, higher than expected in the October Report.

The Bank of Canada's commodity price index excluding energy is largely unchanged (see **Changes to the projection** in the Projections section).

Chart 22: Oil prices have risen since the October Report

Daily data



Western Canadian Select — West Texas Intermediate — Brent

Sources: Kalibrate Canada Inc., NYMEX and Intercontinental Exchange via Haver Analytics

Last observation: January 27, 2025

Financial conditions

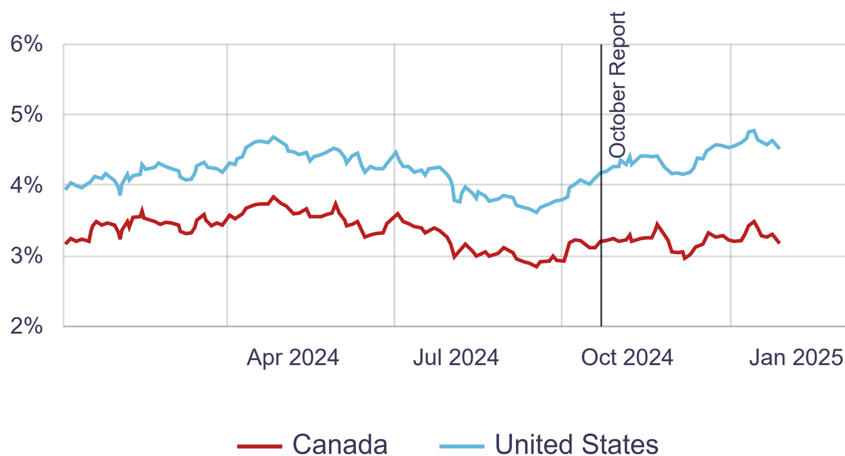
Many global central banks have continued to reduce their policy interest rates as inflation has moved toward their targets. However, recent data and possible policy changes under the new US administration have led market participants to expect greater divergence in economic outlooks across countries.

In this context, changes in financial conditions have differed across countries. In the United States, markets now anticipate fewer policy rate cuts and that those cuts will come later than previously expected. This is partly due to ongoing strength in the economy and persistent inflation. In addition, market participants have begun to place some weight on potential policy changes under the new administration and their likely economic implications. These factors have supported a strong rise in US sovereign bond yields. Bond yields in most other advanced economies have either modestly declined since October, as in Canada (**Chart 23**), or have risen by less than in the United States, reflecting weaker growth and inflation prospects.

Chart 23: US bond yields have risen whereas Canadian bond yields have modestly declined since the October Report

a. 2-year government bond yield, daily data

b. 10-year government bond yield, daily data



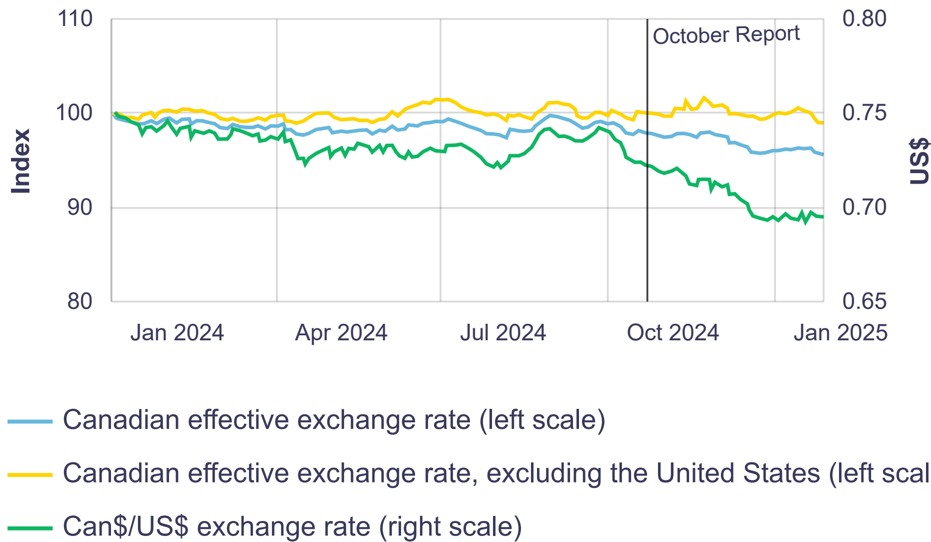
Sources: US Treasury via Haver Analytics and Bank of Canada
Last observation: January 27, 2025

Equity market valuations in advanced economies have continued to rise. Measures of risk appetite have generally remained strong, with equity risk premiums and corporate credit spreads still low relative to historical levels.

The US dollar has continued to appreciate against most other currencies and recently hit an all-time high on a nominal trade-weighted basis. The value of the Canadian dollar has fallen against the US dollar to about 70 cents US but has remained more stable against a basket of other currencies (**Chart 24**).

Chart 24: The Canadian dollar has depreciated against the US dollar but has remained more stable relative to other currencies

Canadian exchange rate and indexes: January 1, 2024 = 100, daily data



Note: The Canadian effective exchange rate index is a weighted average of bilateral exchange rates for the Canadian dollar against the currencies of Canada's major trading partners.
Source: Bank of Canada
Last observation: January 27, 2025

Most of the recent strength in the US dollar appears to be due to an increase in the foreign exchange risk premium associated with holding non-US currencies. While the spread between US and Canadian policy rates has increased, Bank models suggest this has had only a modest impact on the Canada-US exchange rate. (See **In focus: Recent drivers of the Canada-US exchange rate**.)

Projections

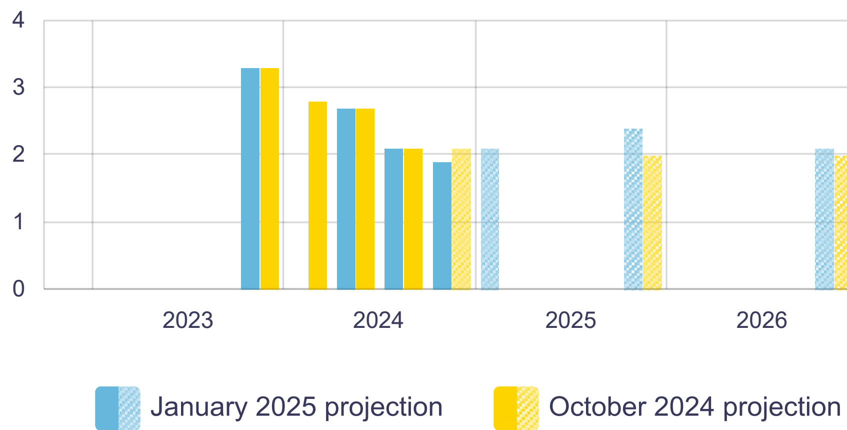
Economic growth in Canada is expected to pick up, supported by past interest rate cuts, and inflation is projected to remain close to the 2% target.

The projection does not incorporate any new US tariffs (see **In focus: Evaluating the potential impacts of US tariffs**). Reflecting increased uncertainty about US trade policy, the outlook embeds a modest negative impact on business investment.

Compare recent Bank projections

Chart 25: The January 2025 and October 2024 Monetary Policy Report projections

CPI inflation (year-over-year percentage change)



Canadian projection

Growth in gross domestic product (GDP) is expected to average 1.8% over the projection horizon.

Table 1: Contributions to average annual real GDP growth Percentage points*†

	2023	2024	2025	2026
Consumption	1.0 (0.9)	1.1 (1.2)	1.3 (0.7)	0.9 (1.1)
Housing	-0.7 (-0.9)	-0.1 (0.0)	0.5 (0.5)	0.2 (0.5)
Government	0.6 (0.5)	0.7 (0.7)	0.5 (0.6)	0.4 (0.4)
Business fixed investment	0.2 (-0.1)	-0.1 (-0.1)	0.1 (0.4)	0.2 (0.5)
Subtotal: final domestic demand	1.1 (0.5)	1.6 (1.8)	2.4 (2.2)	1.7 (2.5)
Exports	1.6 (1.8)	0.3 (0.4)	0.6 (1.5)	0.8 (1.0)
Imports	-0.1 (-0.3)	-0.2 (-0.2)	-0.7 (-1.1)	-0.8 (-1.2)
Inventories	-1.1 (-0.8)	-0.4 (-0.8)	-0.5 (-0.5)	0.1 (0.0)
GDP	1.5 (1.2)	1.3 (1.2)	1.8 (2.1)	1.8 (2.3)
Memo items (percentage change):				
Range for potential output	1.4–3.2 (1.4–3.2)	2.1–2.8 (2.1–2.8)	1.1–2.4 (1.1–2.4)	0.9–2.2 (0.9–2.2)
CPI inflation	3.9 (3.9)	2.4 (2.5)	2.3 (2.2)	2.1 (2.0)

* Numbers in parentheses are from the projection in the previous Report.

† Numbers may not add to total due to rounding.

Sources: Statistics Canada and Bank of Canada calculations and projections

Quarterly projection

Inflation is forecast to stay close to the 2% target over the projection.

Table 2: Summary of the quarterly projection for Canada*

	2024			2025	2023	2024	2025	2026
	Q2	Q3	Q4	Q1	Q4	Q4	Q4	Q4
CPI inflation (year-over-year percentage change)	2.7 (2.7)	2.1 (2.1)	1.9 (2.1)	2.1	3.3 (3.3)	1.9 (2.1)	2.4 (2.0)	2.1 (2.0)
Core inflation (year-over-year percentage change)†	2.9 (2.8)	2.5 (2.5)	2.6 (2.3)	2.5	3.5 (3.4)	2.6 (2.3)	2.1 (2.1)	2.1 (2.0)
Real GDP (year-over-year percentage change)	1.1 (0.9)	1.5 (1.4)	1.8 (1.8)	1.7	1.2 (1.0)	1.8 (1.8)	1.9 (2.3)	1.7 (2.3)
Real GDP (quarter-over-quarter percentage change at annual rates)‡	2.2 (2.1)	1.0 (1.5)	1.8 (2.0)	2.0				

* See details on the **key inputs to the projection**. Numbers in parentheses are from the projection in the previous Report.

† Core inflation is the average of CPI-trim and CPI-median.

‡ At the time the projection was conducted, 2024Q4 and 2025Q1 are the only quarters over the projection horizon where indicators exist to help inform real GDP growth. For longer horizons, fourth-quarter-over-fourth-quarter percentage changes are presented. They show the Bank's projected growth rates of CPI and real GDP within a given year. As such, they can differ from the growth rates of annual averages shown in **Table 1**.

Sources: Statistics Canada and Bank of Canada calculations and projections

Global projection

The global economy is forecast to grow at around 3% in 2025 and 2026 (**Chart 26**).

Table 3: Projection for global economic growth

		Projected growth* (%)			
	Share of real global GDP† (%)	**2023**	**2024**	**2025**	**2026**
United States	15	2.9 (2.9)	2.8 (2.8)	2.6 (2.4)	2.3 (2.2)
Euro area	12	0.5 (0.5)	0.7 (0.7)	0.8 (1.2)	1.3 (1.6)
Japan	3	1.5 (1.7)	-0.2 (-0.1)	1.2 (1.3)	1.1 (1.0)
China	19	5.2 (5.2)	5.0 (4.6)	4.9 (4.3)	4.1 (4.1)
Oil-importing EMEs‡	34	4.0 (3.9)	3.7 (3.7)	3.8 (4.0)	4.1 (4.0)
Rest of the world§	17	1.6 (1.4)	2.1 (2.0)	2.1 (2.2)	2.5 (2.2)
World	100	3.2 (3.2)	3.1 (3.0)	3.1 (3.1)	3.1 (3.0)

* Numbers in parentheses are projections used in the previous Report.

† Shares of gross domestic product (GDP) are based on International Monetary Fund (IMF) estimates of the purchasing-power-parity valuation of country GDPs for 2023 from the IMF's October 2024 *World Economic Outlook*. The individual shares may not add up to 100 due to rounding.

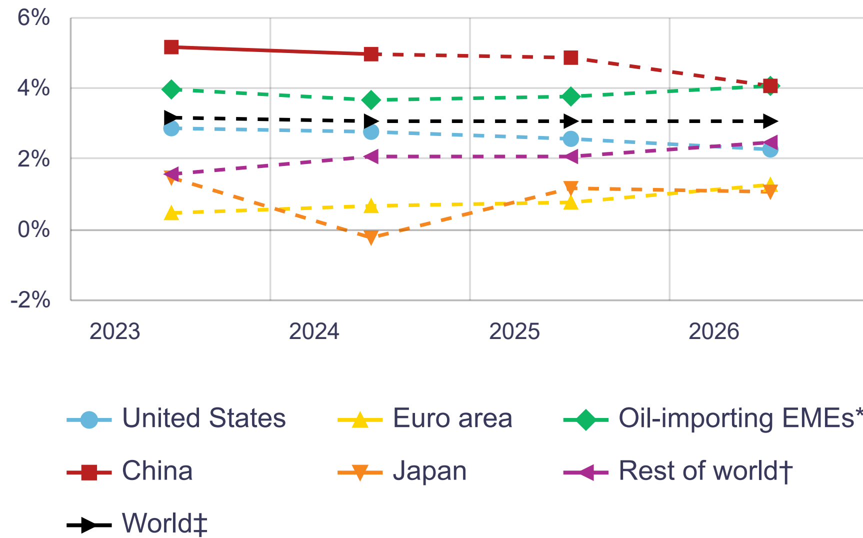
‡ The oil-importing emerging-market economies (EMEs) grouping excludes China. It is composed of large EMEs from Asia, Latin America, the Middle East, Europe and Africa (such as India, Brazil and South Africa) as well as newly industrialized economies (such as South Korea)

§ *Rest of the world* is a grouping of other economies not included in the first five regions. It is composed of oil-exporting EMEs (such as Russia, Nigeria and Saudi Arabia) and other advanced economies (such as Canada, the United Kingdom and Australia).

Sources: National sources via Haver Analytics, and Bank of Canada calculations and projections

Chart 26: Projection for global economic growth

Year-over-year percentage change



* The oil-importing emerging-market economies (EMEs) grouping excludes China. It is composed of large EMEs from Asia, Latin America, the Middle East, Europe and Africa (such as India, Brazil and South Africa) as well as newly industrialized economies (such as South Korea).

† *Rest of the world* is a grouping of other economies not included in the first five regions. It is composed of oil-exporting EMEs (such as Russia, Nigeria and Saudi Arabia) and other advanced economies (such as Canada, the United Kingdom and Australia).

‡ World GDP is calculated as a weighted average based on International Monetary Fund (IMF) estimates of the purchasing-power-parity valuation of country GDPs for 2023 from the IMF's October 2024 *World Economic Outlook*.

Sources: National sources via Haver Analytics, and Bank of Canada calculations and projections

Changes to the projection

The following changes have been made to the Canadian and global economic projections, reflecting new information since the October Report.

Global outlook

The outlook for global growth is broadly in line with the October Report, although the composition has changed. Growth in the United States and China is revised up, while it is revised down in the euro area and some emerging-market economies.

- Growth in US GDP is revised up in 2025 and 2026, partly due to the net impact of:
    - stronger momentum in consumption and government spending;
    - the assumed extension of expiring provisions of the *Tax Cuts and Jobs Act*; and
    - tighter US financial conditions, which restrain growth.
- The outlook for China is also revised up over the near term due to a stronger starting point for exports.
- For the euro area, growth is revised down due to both weaker productivity and competitiveness challenges in the manufacturing sector.

Canadian outlook

The outlook for growth in Canada is revised down compared with the October Report.

- Growth in the third quarter of 2024 was 0.5 percentage points lower than projected, driven by weaker-than-expected contributions from inventory investment, exports and business investment. This weakness was partially offset by stronger-than-expected growth in consumption and government spending.
- Growth in GDP in 2025 and 2026 is projected to be lower by about 0.3 percentage points and 0.5 percentage points, respectively. This is primarily due to a downward revision to population growth resulting from new federal immigration policies and updated assumptions related to outflows of non-permanent residents.
    - Consumption growth is revised up by 0.9 percentage points in 2025. Stronger growth in consumption per person reflects a slower decline in wage growth than previously forecast. Consumption growth is revised down by 0.5 percentage points in 2026 as a result of slower population growth.
    - Growth in business investment is lower than projected by 2.8 percentage points on average, primarily reflecting weaker demand.
        - Heightened uncertainty surrounding US trade policy reduces the level of investment by 0.5% by the end of 2026.
        - The lower value of the Canadian dollar, which increases the cost of imported machinery and equipment, is also expected to reduce investment by about 1% by the end of 2026.
    - Growth in exports is also revised down by 1.8 percentage points on average in 2025 and 2026. This reflects unexpected past weakness in exports relative to foreign demand growth that is expected to persist.
    - Growth in imports is revised down by about 1 percentage point on average over the forecast with slower domestic demand.
- Excess capacity is revised down.
    - Revisions to historical data indicate that the levels of economic activity beginning in 2021 were higher than in the October Report.[1] The largest revisions were to business investment and consumer spending.

    - The upward revisions to the level of potential output were also substantial but not as large as those to economic activity.[2]
    - As a result, the economy has somewhat less excess supply than estimated in the October Report. The output gap is estimated to be about 0.3 percentage points narrower than it was before the upward revisions to historical data.
- Growth in potential output in 2025 and 2026 is about 0.3 percentage points and 0.6 percentage points, respectively, lower than previously estimated. Growth in trend labour input is expected to moderate due to slower population growth. This is partially offset by stronger growth in trend labour productivity, reflecting a higher ratio of capital to labour associated with the anticipated slower growth in labour input.

The temporary GST/HST holiday leads consumer price index inflation to be revised below and then above the October outlook. Looking through this effect, the projection for inflation is expected to be slightly higher.

- Lower-than-expected inflation in the fourth quarter of 2024 and the downward revision to the first quarter of 2025 are mostly due to the federal government's temporary GST/HST holiday on some goods and services. Similarly, the outlook for inflation in the first quarter of 2026 has been revised up, reflecting the base year effect on inflation coming from the temporary tax cut.
- Setting aside the impact of the tax holiday, inflation is revised up slightly. This revision is due to less excess supply, stronger oil prices, and higher import prices resulting from the lower Canadian dollar. The upward pressures are partially offset by a weaker starting point for inflation and lower inflation in shelter prices.

Key inputs to the projection

The Bank of Canada's projection is conditional on several key inputs and assumptions. The Bank regularly reviews these inputs and assumptions and adjusts the economic projection accordingly.

- The projection assumes that there are no new US tariffs. However, it does include a modest downward revision to business investment resulting from the increase in policy uncertainty.
- Population growth of people aged 15 and over is assumed to be 3.3% in 2024. Population growth is assumed to decline to 0.5% by 2026, 1.0 percentage points lower than forecast in the October Report. This revision reflects two factors:
    - lower permanent resident targets in the federal government's 2025–27 Immigration Levels Plan, which was announced on October 24, 2024
    - downward revisions to the outlook for net flows of non-permanent residents, reflecting new information related to the duration of temporary permits
- Growth of potential output in Canada is expected to slow from about 2.5% in 2024 to around 1.5% on average over 2025 and 2026.
- The Bank estimates that the output gap is between -1.25% and -0.25% in the fourth quarter of 2024.
- The projection incorporates information from published federal and provincial budgets and recent fiscal updates that have been tabled at the time of writing.
- Over the projection horizon, the per-barrel prices for oil are assumed to be US$80 for Brent, US$75 for West Texas Intermediate and US$60 for Western Canadian Select. These prices are US$5 higher than in the October Report.
- By convention, the Bank does not forecast the exchange rate in the *Monetary Policy Report*. The Canadian dollar is assumed to remain at 70 cents US over the projection horizon, 3 cents lower than in the October Report.
- The nominal neutral interest rate in Canada is estimated to be in the range of 2.25% to 3.25%. The economic projection assumes that the neutral rate is at the midpoint of this range. The neutral rate is the rate to which the policy rate would converge in the long run, when output is sustainably at its potential and inflation is at target (i.e., after all cyclical shocks have

dissipated). It is a medium- to long-term equilibrium concept. The Bank re-examines estimates of the neutral rate each year in April.

Endnotes

1. Since the release of the October Report, historical revisions to Statistics Canada's National Economic Accounts data from the first quarter of 2021 to the second quarter of 2024 were released together with the data for the third quarter of 2024.[←]

2. For more detail on the potential output framework, see T. Devakos, C. Hajzler, S. Houle, C. Johnston, A. Poulin-Moore, R. Rautu and T. Taskin, "**Potential output in Canada: 2024 assessment**," Bank of Canada Staff Analytical Note No. 2014-11 (April 2024).[←]

Risks

The prospect of wide-ranging US import tariffs is the most important risk to the outlook. Given the fast-evolving situation and the high degree of uncertainty, the Bank has chosen not to include new tariffs in the projection.

Risk of tariffs

US President Donald Trump has threatened to impose tariffs on major US trading partners, including a 25% tariff on imports from Canada and Mexico. Affected countries, including Canada, could respond with tariffs of their own. The scale, breadth and duration of a potential trade war is uncertain. Even if all these details were known, it would be difficult to predict with precision how the effects would flow through the economy. The magnitude and timing of the impacts will depend importantly on how businesses and households respond to higher prices for inputs and final goods.

A permanent—or at least prolonged—broad-based and significant increase in tariffs, together with retaliation, would have a substantial negative impact on economic activity in Canada. At the same time, inflation would likely increase, due to higher costs for imported final and intermediate goods. In the face of a trade conflict, the response of monetary policy must balance the downward pressure on inflation from excess supply in the economy with the upward pressure on inflation from new tariffs on imports.

A detailed discussion of the channels through which the Canadian economy would be affected by tariffs, including an illustrative scenario, can be found in the section **In Focus: Evaluating the potential impacts of US tariffs**.

Apart from the imposition of wide-ranging tariffs, the Bank's outlook for inflation is subject to several upside and downside risks. Overall, the Bank views these risks to inflation as roughly balanced.

Main upside risks

There are two main upside risks: shelter price inflation could be more persistent than in the projection, and consumer spending could be stronger than anticipated.

Shelter price inflation could persist

Inflation in shelter prices is expected to slow gradually. However, because the housing vacancy rate is near a record low, past interest rate cuts and the recent changes in mortgage rules could lead to higher-than-anticipated house prices and rents. As a result, shelter price inflation and total inflation may slow more gradually than anticipated.

Consumer spending could be stronger

Canadians are saving a relatively higher share of their income than they typically did over the past two decades. With interest rates falling, however, the savings rate could return closer to historical levels. This could result in consumer spending that is significantly stronger than anticipated. If this risk were to materialize, it would create additional demand in the economy and place upward pressure on inflation.

Main downside risks

Even if no new tariffs are imposed, the threat of tariffs is creating uncertainty, which is already having a negative impact on the Canadian economy. The effect of this uncertainty could be bigger than expected. Another downside risk is that global financial conditions could be tighter than anticipated.

Trade uncertainty could weigh more on the economy

Responses to several surveys show that, even without tariffs being imposed, the uncertainty about trade policy is restraining business investment intentions. Reflecting this development, the outlook includes a modest negative impact on business investment.

There is a risk, however, that the impact of uncertainty could be larger than currently embedded in the projection. The longer this uncertainty persists, the more it would negatively impact investment. Businesses could also cut back on hiring, which would weigh on labour income and consumer confidence. Consequently, domestic demand would slow, exerting downward pressure on inflation.

Global financial conditions could be tighter

The new US administration has proposed additional personal and corporate tax cuts that are not included in the projection. Given the high level of US debt and deficits, an increase in US government borrowing could lead to higher-than-anticipated yields. Higher yields in the United States could, in turn, spill over into higher borrowing costs for Canadian households and businesses. This would lead to weaker Canadian domestic demand and add downward pressure on Canadian inflation.

Evaluating the potential impacts of US tariffs

The new US administration is considering sweeping tariffs on imports. While many important elements are unknown, these measures could be highly disruptive to the Canadian and US economies.

US President Donald Trump has said his government would impose tariffs of 25% on goods from Canada and Mexico. He has also threatened tariffs on goods imported from other countries. This could lead to countermeasures by the United States' trading partners, including retaliatory tariffs.

Tariffs are taxes on imports that increase the price consumers and businesses pay for goods and services.[1] Tariffs affect spending, trade flows, government revenue, exchange rates, employment, gross domestic product (GDP) and inflation. They could substantially disrupt supply chains in Canada, the United States and elsewhere around the world.

In general, the economic impacts for a country imposing import tariffs depend critically on how easily businesses and households can find non-tariffed substitutes. When substitutes do not exist or cannot easily be produced in higher quantities due to capacity constraints, tariffs are more disruptive to the real economy and lead to higher inflation. In contrast, the effects are more muted when close substitutes are readily available.

At a minimum, a permanent tariff will cause a one-time, permanent increase in price levels. Whether tariffs lead to ongoing inflation will mostly depend on how household and business expectations for inflation respond to tariff-related price level increases. When expectations are well anchored to the inflation target, tariff-related price increases will have less of an effect on other prices and wages. The increase to consumer price index (CPI) inflation will therefore be temporary.

The ultimate scale, breadth, timing and duration of any US tariffs remain highly uncertain. It is also unclear how affected countries, including Canada, will react.

An illustrative tariff scenario

Given the uncertainty around future global tariff policies at this time, the Bank has chosen a simple scenario to illustrate how the global and Canadian economies could be affected by a trade conflict. This is not a forecast, but rather a hypothetical scenario that makes the following important assumptions:

- The United States imposes permanent tariffs of 25% on all the goods it imports, including from Canada.
- In response, the United States' trading partners, including Canada, impose retaliatory tariffs of 25% on their imports of goods from the United States.
- The pass-through of tariffs to prices for final goods is initially low but increases gradually over time. In the meantime, businesses' profit margins are reduced because they absorb part of the increase in costs.
- Half of the tariff revenue raised by each country, including Canada, is transferred back to households, while the remainder is used to pay down debt.

Lower GDP growth and higher inflation in both Canada and the United States

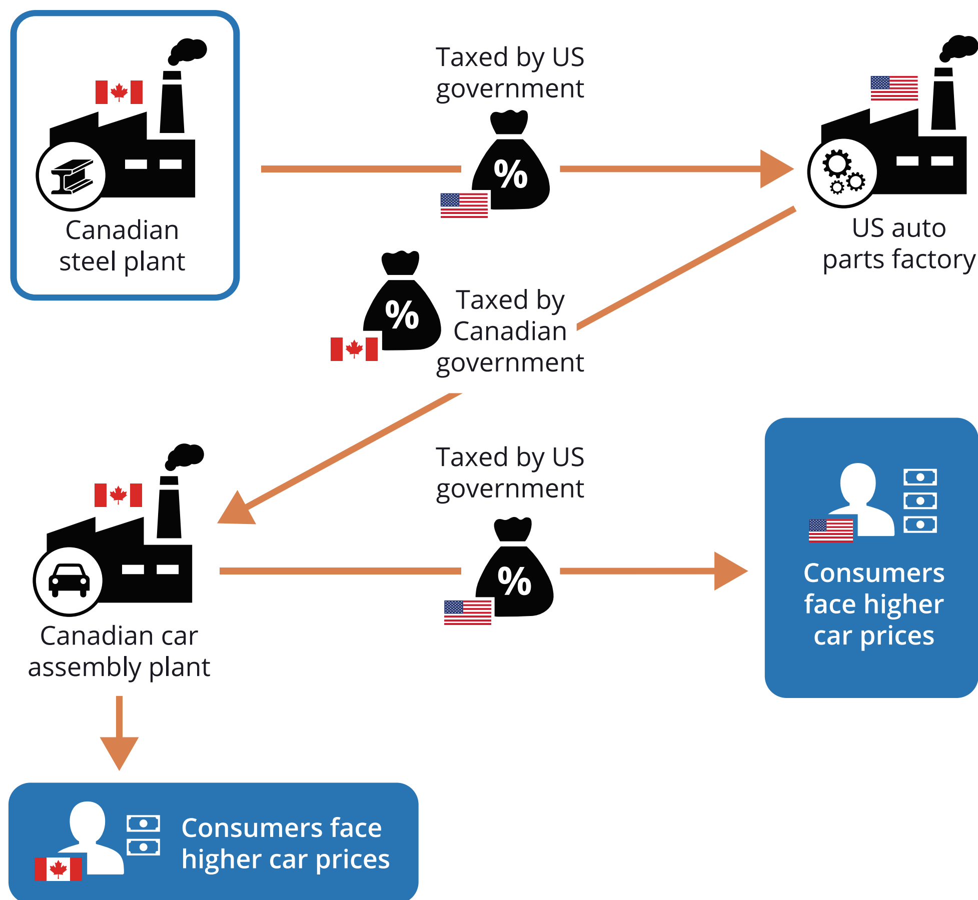
In the United States:

- US tariffs increase the prices US consumers pay for imported goods, leading to higher inflation. A stronger US dollar provides a partial offset.
- US GDP growth slows because retaliatory tariffs imposed by other countries, including Canada, lead to a significant substitution away from US exports.[2]

Tariffs also increase costs for US businesses that import intermediate inputs used to produce final goods. These higher costs are typically passed on to consumers. This is particularly problematic for industries with highly integrated international supply chains, such as the motor vehicle sector, and for industries that cannot easily substitute to domestically produced inputs.

For example, in the process of making a car, parts and components of motor vehicles cross the Canada-US border several times. If these components are taxed each time, it would amplify the increase in production costs and increase the prices paid by consumers on both sides of the border (**Figure 1**).

Figure 1: Tariffs on intermediate goods amplify the impacts of tariffs on production costs and prices



In Canada, a trade conflict would negatively affect both exports and imports:

- US tariffs make Canada's exports to the United States—its largest trading partner—less competitive, leading to a significant decline in the volume of exports.
- Because US tariffs are applied to goods from all its trading partners, global exports and GDP decline. Lower global demand in turn reduces commodity prices, including the price of oil—one of Canada's major exports.
- Lower global activity further reduces demand for Canadian exports.
- Canadian imports decline because of Canada's retaliatory tariffs on US goods. This leads Canadian households and businesses to substitute US goods for goods that are not subject to tariffs.

On the whole, Canada's trade balance worsens. Together, lower net export volumes and weaker terms of trade lead to a depreciation of the Canadian dollar.

Canadian business investment also declines significantly due to a combination of weaker export activity and an increase in the cost of imported investment goods from the United States.

- The cost of machinery and equipment imported from the United States rises in response to Canada's retaliatory tariffs and the depreciation of the Canadian dollar. Imports from the United States comprise about half of overall business investment in machinery and equipment in Canada.
- Lower business profits also weigh on business investment during the period when businesses partially absorb cost increases associated with Canadian tariffs.

Faced with less demand, Canadian exporters lower production and lay off workers. This, in turn, negatively affects the rest of the economy by reducing demand for goods and services that are not traded, such as housing and dining in restaurants. An increase in government transfers to households financed by tariff revenues provides a partial offset.

Over time, the decline in business investment significantly reduces potential GDP in Canada, leading to a permanent decline in GDP.

Inflation generally rises, reflecting the net impacts of two offsetting factors:

- GDP declines because of weaker net exports and weaker domestic demand, resulting in significant excess supply in the short run. Commodity prices also decline. Together, these factors weigh on CPI inflation.
- Canada's retaliatory tariffs on all goods imported from the United States have a direct and indirect impact on consumer prices.
    - Imports from the United States of final consumer goods and intermediate inputs used to produce final goods make up about 13% of the CPI basket in Canada.
    - Prices paid by consumer-oriented businesses for other production inputs, such as equipment and machinery, also increase in response to tariffs.
    - Together with the depreciation of the Canadian dollar, these direct and indirect pass-through effects more than offset the drag from excess supply and lower commodity prices, leading to an increase in CPI inflation.

A quantitative example

Models can be very helpful for understanding the many ways tariffs could affect growth and inflation. To create the hypothetical tariff scenario, the Bank used its standard global and Canadian projection models in conjunction with a specialized trade model.[3] This multi-model approach helps to better capture how tariffs on many different goods and countries affect key macroeconomic variables.

The absence of large, broad-based tariffs in the past makes it difficult to quantify with precision how their effects would flow through the economy. Therefore, in addition to the benchmark calibration, the Bank has produced a number of variations using different assumptions about how households and businesses respond to tariffs. However, the trade scenario is the same across each variation. In all cases, it is assumed that the United States increases tariffs on all imported goods to 25%, and its trading partners respond by increasing tariffs on imported goods from the United States to 25%. All results are presented relative to a no-tariff scenario.

Benchmark calibration

The benchmark calibration assumes the historical averages for:

- the response of US demand for Canadian exports to price changes.
- the amount of time it takes for cost changes to be fully passed through to the Canadian CPI (three years)

In the benchmark calibration, average annual GDP growth in the first year is about 2.5 percentage points lower than it would otherwise be (**Chart 27**, red bars). In the second year, it is about 1.5 percentage points lower. By the third year, GDP growth has roughly returned to normal. In other words, if annual average growth were projected to be 2% in years 1 and 2 with no new tariffs, then the growth forecast would be about -0.5% in year 1 and 0.5% in year 2 with the new tariffs.

While the effect of tariffs on the rate of growth is temporary, the level of GDP is permanently lower, reflecting a decline in the long-run level of Canadian productivity due to the distortionary effects of tariffs.

Because cost increases associated with Canada's retaliatory tariffs are assumed to be gradually passed on to consumer prices over three years, CPI inflation is subject to sustained upward pressure over this period (**Chart 28**, red bars). Considerable excess supply and declining commodity prices largely offset the direct impact of tariffs in the first year, but inflation rises as excess supply is gradually absorbed in subsequent years.

Sensitivity analysis around the benchmark calibration

The assumption of wide-ranging 25% US tariffs and full retaliation represents a significant relative price shock for an economy like Canada with strong trade links to the United States. Tariffs affect supply and demand in complex ways, and some prices are more affected than others. Wages and other business costs also adjust. In turn, businesses are likely to change what they produce and how they produce it, while consumers substitute away from some goods and services in favour of others. Gauging the net impact on economic slack and inflation is difficult. In particular, the relative strength of the various forces acting on inflation depends critically on:

- how much Canadian export volumes decline and the related spillover effects to business investment
- how sensitive Canadian inflation is to tariffs on US exports to Canada, particularly for consumer goods

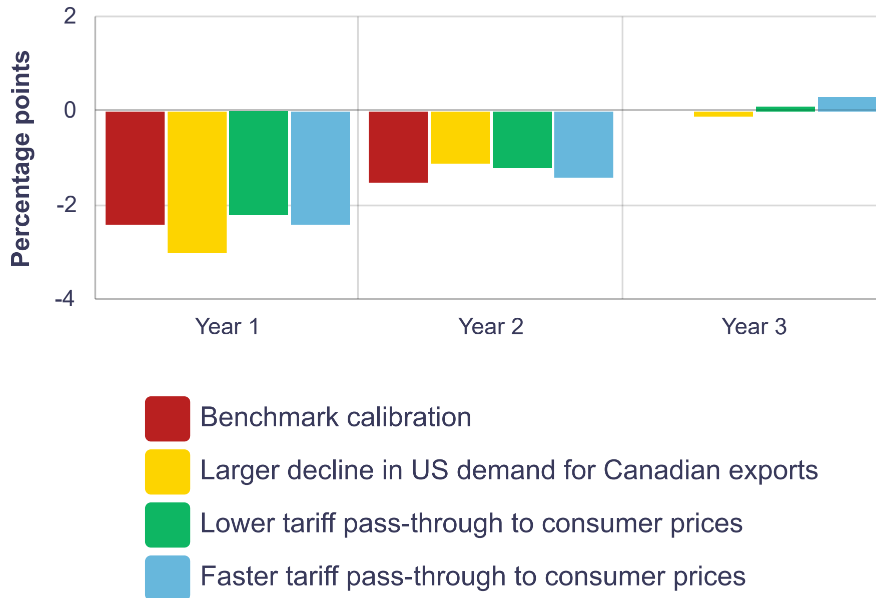
To illustrate these sensitivities, the Bank has created a number of variations on the benchmark calibration (**Table 4**). How these variations impact GDP growth and inflation is shown in **Chart 27** and **Chart 28**.

Table 4: Details on variations of trade conflict scenario

Variation	Export assumption	Pass-through assumption
Benchmark calibration	Canadian exports react to price changes in line with what has typically been seen over history	The cost of tariffs is assumed to fully pass through into consumer prices over three years
Larger decline in US demand for Canadian exports	The decline in US demand for Canadian exports is about **40% larger** than the historical average	Same as benchmark calibration
Lower tariff pass-through to consumer prices	Same as benchmark calibration	**Half** of the cost of tariffs pass through into consumer prices over three years
Faster tariff pass-through to consumer prices	Same as benchmark calibration	The cost of tariffs is assumed to fully pass through into consumer prices over **one and a half years**

Chart 27: A global trade conflict reduces Canadian GDP growth

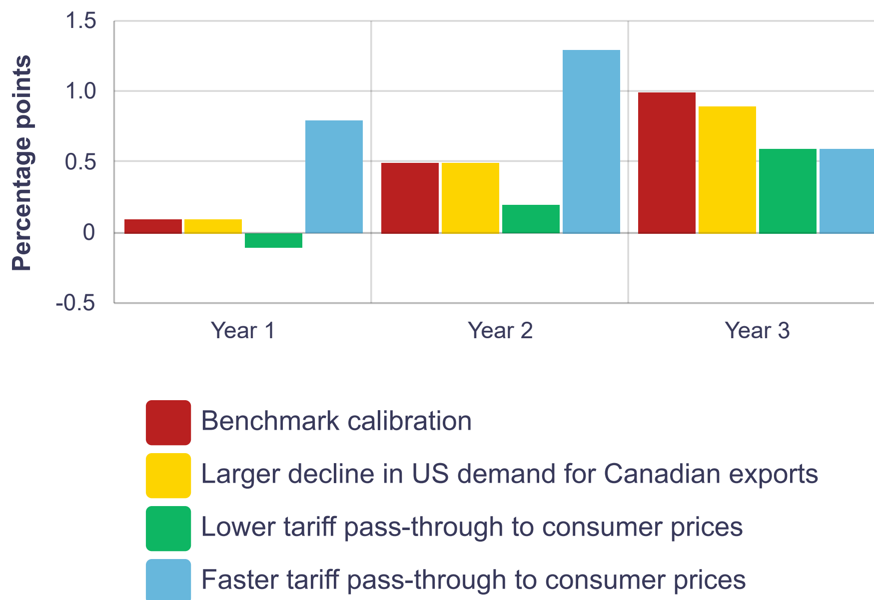
Impact on real GDP growth relative to a no-tariff scenario, annual average growth



Sources: Bank of Canada calculations, estimates and projections

Chart 28: A global trade conflict increases Canadian inflation

Impact on total CPI inflation relative to a no-tariff scenario, annual average inflation



Sources: Bank of Canada calculations, estimates and projections

Larger decline in US demand for Canadian exports

Estimates of the sensitivity of Canadian exports to price changes are based on historical data and are found to be quite low. However, in the case of such a large shock, it is possible that exports could fall by considerably more than predicted by the Bank's projection models. Increasing the sensitivity for both commodity and non-commodity exports to US tariffs results in a more significant decline in exports and business investment and, as a result, weaker GDP growth (**Chart 27**, yellow bars). It also leads to a more significant depreciation of the Canadian dollar because Canada's trade balance worsens by more than with the benchmark calibration.

The impact of weaker demand and a weaker dollar have partially offsetting effects on consumer prices. As a result, CPI inflation is only modestly lower than in the benchmark calibration (**Chart 28**, yellow bars).

Lower tariff pass-through to consumer prices

In the benchmark calibration, it is assumed that the increased costs associated with tariffs are fully passed on to consumer prices after three years, meaning that businesses no longer absorb any of the cost increase after that point. If instead only 50% of the cost increase associated with tariffs is passed on to consumers after three years, inflation declines in the first year. This decline occurs because the drag on inflation from excess supply and falling commodity prices now outweigh the effect of tariff-related price increases (**Chart 28**, green bars). In subsequent years, inflationary pressures are also lower than with the benchmark calibration.

GDP growth does not decline by as much as it does in the benchmark calibration (**Chart 27**, green bars) because prices rise by less and, as a result, consumer purchasing power declines by less.

Faster tariff pass-through to consumer prices

Since the adoption of inflation targeting in Canada, changes to input costs have not usually led to significant increases in inflation. This suggests that a large portion of input cost changes are initially absorbed in businesses' profit margins. However, it became clear in the pandemic that large cost changes can be passed through to prices much more quickly. Because a 25% tariff would lead to a significant increase in costs for businesses, they may adjust their prices more quickly relative to the historical average. In this variation, the time it takes for businesses to fully pass through the costs of Canadian import tariffs is reduced from three years to one and a half years (**Chart 28**, blue bars).

With faster pass-through, inflation initially increases by more, but also comes back down more quickly relative to the benchmark calibration. The implications for GDP growth, relative to the benchmark calibration, are small (**Chart 27**, blue bars).

Endnotes

1. Specialization and trade between countries can increase incomes and provide consumers with a greater selection of goods and services at lower prices. The introduction of tariffs distorts trade patterns, reducing these benefits. For a discussion, see S. Murchison and A. Chernoff, "**The benefits of freer trade**," Bank of Canada *The Economy, Plain and Simple* (September 28, 2018).[←]

2. Retaliatory tariffs imposed by the United States' trading partners only affect their imports from the United States. Other countries can potentially avoid some of the tariff impact by importing less from the United States and more from other countries. This would contribute to a further decline in US exports. US consumers and businesses would not be able to avoid tariffs in the same way because US tariffs would be applied to products imported from all countries.[←]

3. To simulate the impacts of tariffs on trade between countries, the Bank uses a version of the multi-sector, multi-country model developed by Baqaee and Farhi in D. R. Baqaee and E. Farhi, "**Networks, Barriers, and Trade**," *Econometrica* 92, no. 2 (March 2024): 505–541.[←]

Recent factors affecting the Canada-US exchange rate

The Canadian dollar has declined against the US dollar since October 2024, mostly due to rising uncertainty around trade policies. A widening differential in policy interest rates between the two countries has also played a modest role.

In recent months, the rising uncertainty and the widening interest rate differential have both played a role in the depreciation of the Canadian dollar. The relative contribution of each component can be better understood by examining how they influence the exchange rate.[1]

To what degree do interest rate differentials affect the exchange rate?

The widening differential between interest rates in Canada and the United States is one reason for the recent depreciation in the Canadian dollar. But how large of a role has it played?

The following example helps gauge the impact. Consider an investment in one-year treasury bills in Canada and in the United States. Both offer guaranteed returns after one year. If the return on the Canadian treasury bills decreases to 1 percentage point below the return offered by US Treasury bills, then investing in the United States becomes relatively more attractive. In this case, investor demand for Canadian dollars declines, and the market value of the Canadian dollar temporarily depreciates below its long-term value by about 1%. Because of this depreciation, investors now have reason to expect that the Canadian dollar will appreciate by 1% over the next year, which offsets the 1-percentage-point difference in returns between the bills.[2]

The above example roughly matches what has happened since October 2024. The widening differential between Canadian and US interest rates of about 1 percentage point has contributed to a roughly 1% depreciation in the Canadian dollar. This leaves most of the remaining observed depreciation since October 2024 unaccounted for.

Exchange rate risk can also affect the value of the Canadian dollar

Exchange rate risk also plays an important role in investors' decisions and therefore affects the exchange rates between currencies.

Continuing with the above example, when foreign investors buy Canadian treasury bills, they bear the risk of unexpected changes in the value of the Canadian dollar while the asset is held.

During periods of heightened uncertainty, investors typically demand a premium to compensate them for the additional exchange rate risk or to cover the cost of purchasing insurance in the form of options or futures contracts. This premium is known as the *foreign exchange rate risk premium*, and an increase in its value is associated with a depreciation of the exchange rate.[3]

The risks around the Canadian dollar and other currencies have been amplified since the US election, partly due to the uncertainty caused by the threat of US tariffs (**Chart 29**). Activity in markets for options and futures contracts reveals the increased concerns that the Canadian dollar could depreciate further (**Chart 30**). For example:

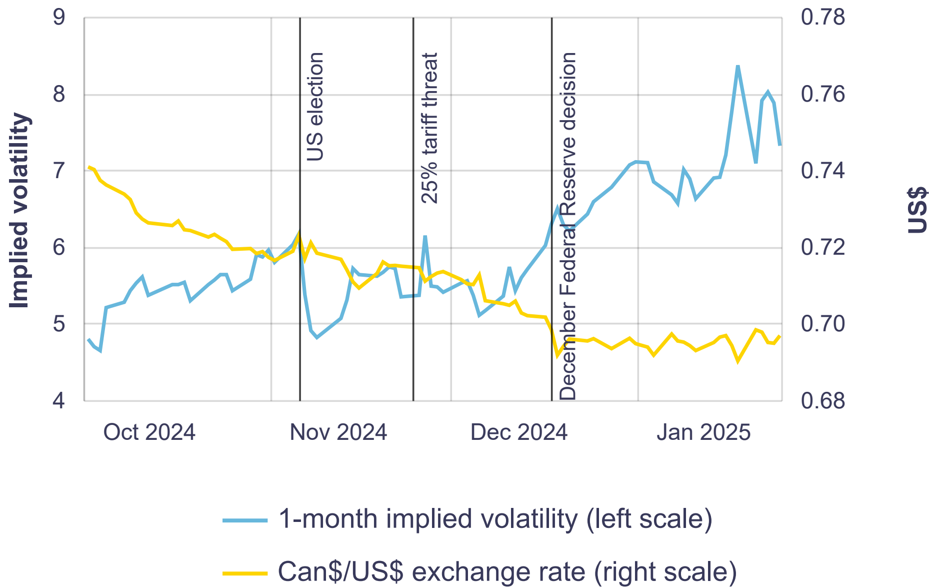
- Asset managers have increased their short positions in currency futures, which protect against devaluation of the Canadian dollar.

- Prices have risen for other derivatives contracts, including options contracts, which are used to insure against a depreciation of the Canadian dollar.

These increased concerns have added to the foreign exchange rate risk premium and have contributed to the depreciation of the Canadian dollar.

Chart 29: Since October, uncertainty has increased and the Canadian dollar has depreciated

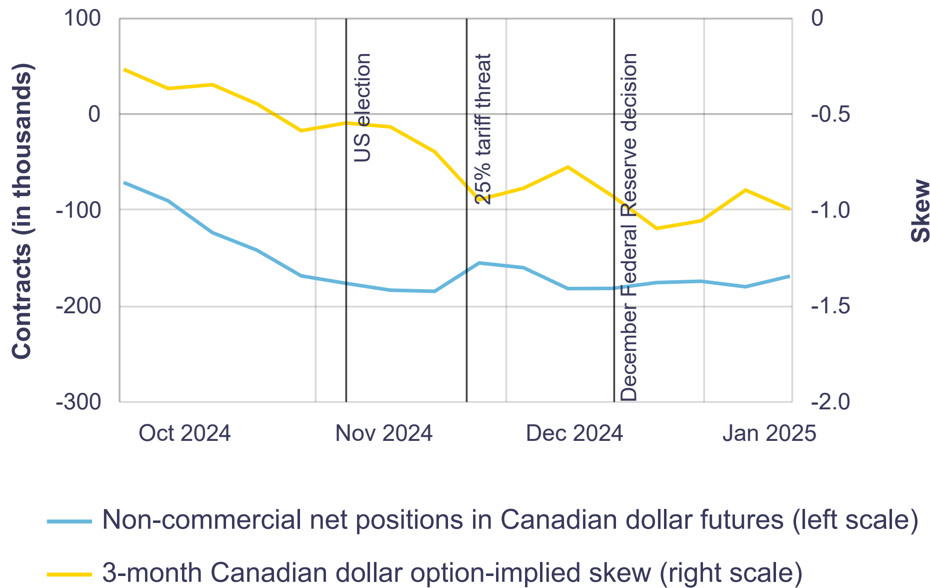
Daily data



Note: A higher degree of option-implied volatility suggests greater uncertainty around the future value of the Canada-US exchange rate. Source: Bloomberg Finance L.P.
Last observation: January 24, 2025

Chart 30: Options and futures markets show increased concerns of future depreciation of the Canadian dollar

Weekly data



Non-commercial net positions in Canadian dollar futures (left scale)

3-month Canadian dollar option-implied skew (right scale)

Note: A negative (short) position will earn a profit if the value of the Canadian dollar depreciates over the life of the futures contract. A negative skew indicates a higher cost of insuring against a depreciation of the Canadian dollar, relative to the cost of insuring against an appreciation.
Source: Bloomberg Finance L.P.
Last observation: January 14, 2025

How does each factor contribute to the change in the exchange rate?

The relative contributions from the interest rate differential and the foreign exchange rate risk premium on the recent depreciation in the Canadian dollar can be estimated.[4] Bank of Canada staff find that:

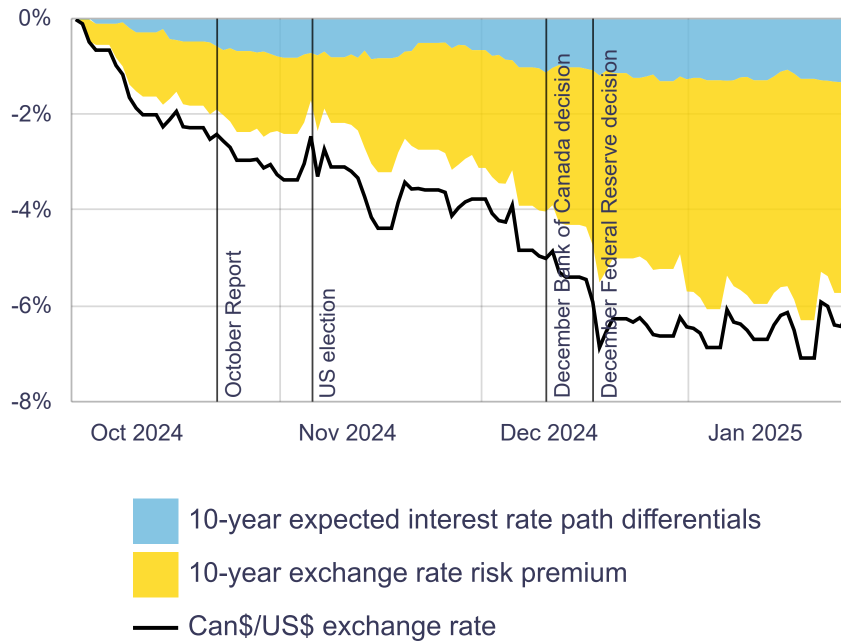
- The widening interest rate differential is estimated to account for a relatively modest share of the overall depreciation.
- Most of the depreciation is explained by the foreign exchange rate risk premium (**Chart 31**).

Bank staff also find that most of the depreciation in the currencies of other advanced economies relative to the US dollar is explained by the changes in their foreign exchange rate risk premium. Indeed, these depreciations all share common timing and patterns (**Chart 32**).

The foreign exchange rate risk premium increases when uncertainty is heightened. While there are many reasons why uncertainty has risen in recent months, much is due to US President Donald Trump's threat of import tariffs. In practice, it is very difficult to distinguish between exchange rate depreciations that reflect pure uncertainty effects and changes in market expectations about the long-run value of the exchange rate.

Chart 31: The Canadian dollar depreciated mainly due to an increased foreign exchange rate risk premium

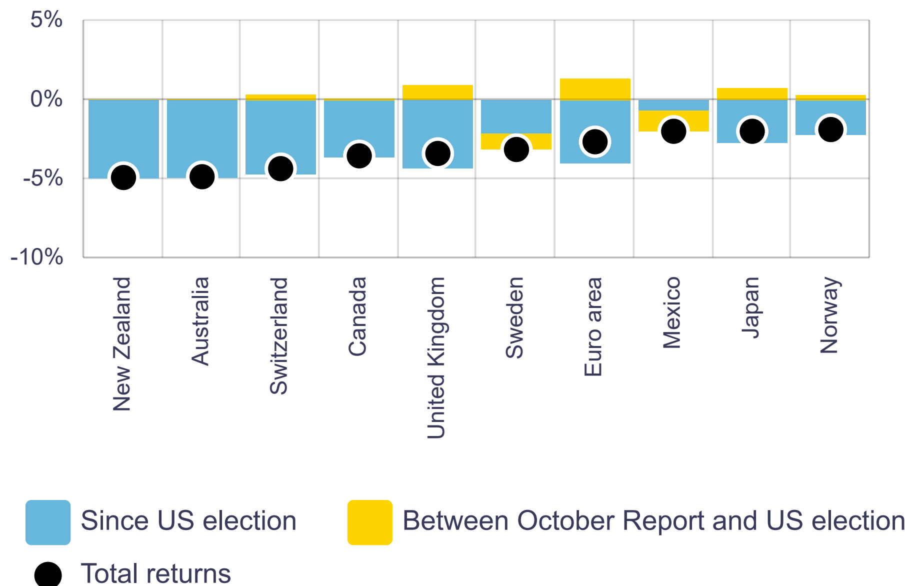
Decomposition of cumulative change in model components since October 2024, daily data



Source: Feunou, Fontaine and Krohn (2022)
Last observation: January 24, 2025

Chart 32: Depreciation against the US dollar was broad-based

Exchange rate against US dollar



Source: Bloomberg Finance L.P.
Last observation: January 24, 2025

Endnotes

1. For additional analysis and background information, see J.-S. Fontaine, I. Krohn, J. Kyeong and K. Zmitrowicz, "Monetary policy, interest rates and the Canadian dollar," Bank of Canada Staff Analytical Note (forthcoming). [←]

2. This equalization of expected returns does not determine the level of the exchange rate; rather, it determines the expected future change required to match the expected returns across the border when expressed in the same currency.[←]

3. The foreign exchange rate risk premium has a counterpart in the valuation of equities. Stocks that tend to fall by more than the average in market declines are seen as risky, so their value is discounted. That discount is the *equity risk premium*. The equity risk premium and the foreign exchange rate risk premium are closely related. For more detail, see E. Djeutem and G. R. Dunbar, "**Uncovered Return Parity: Equity Returns and Currency Returns**," Bank of Canada Staff Working Paper No. 2018-22 (May 2018).[←]

4. See B. Feunou, J.-S. Fontaine and I. Krohn, "**Real Exchange Rate Decompositions**," Bank of Canada Staff Discussion Paper No. 2022-6 (March 2022).[←]