BANK OF CANADA
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Monetary Policy Report—July 2025

Overview

US tariffs are significantly higher than they were at the start of 2025, and US trade policy remains unpredictable. Inflation is near 2%, although underlying price pressures have picked up. With uncertainty about US trade policy still high, the outlook for the Canadian economy remains clouded.

The global trade conflict continues to evolve. Since the time of the April Report, extreme trade tensions between the United States and China have receded. The US administration has reached agreements on tariffs with some countries, which have raised US tariffs significantly from January levels. The United States has also doubled its tariffs on imports of steel and aluminum and has threatened high, broad-based tariffs on many other trading partners if agreements are not reached soon.

Economic scenarios for the outlook

At the beginning of 2025, shifting US trade policy increased uncertainty about the economic outlook.

This trade-related uncertainty has two layers. The first layer is around US trade policy. It is difficult to know what tariffs and countermeasures will be imposed, how long tariffs will last and how trade negotiations will play out. The second layer of uncertainty is about how households, businesses and governments will react and adapt to tariffs.

In the **April Report**, the Bank of Canada presented two illustrative scenarios that explored different paths for US trade policy. This was done to address the first layer of uncertainty. To address the second layer of uncertainty, the Risks section focused on how the economy would respond to a given level of tariffs.

Since April, the risk of a severe and escalating global trade conflict has diminished, and there is some clarity around what tariffs will look like. Nevertheless, how US trade policy will unfold remains highly uncertain. And while recent data have helped reduce some of the uncertainty around the impacts of tariffs, it is still too early to confidently project the effects of the tariffs on economic growth and inflation. In this environment of elevated uncertainty, scenarios continue to be a useful tool for considering potential outcomes.

Therefore, the July Report presents an economic scenario conditional on trade policies in place or agreed on as of July 27, 2025—the *current tariff scenario*—rather than a conventional forecast. This Report also includes two alternative scenarios, one in which tariffs are reduced and another in which they are substantially increased—the *de-escalation scenario* and the *escalation scenario*, respectively. Taken together, these scenarios encompass a range of paths for trade policy and the Canadian economy.

- For details on the scenarios, see the **Scenario assumptions** section.
- The economic outcomes of the *current tariff scenario* can be found in the **Outlook** and **Global economy** sections.
- The economic outcomes of the alternative scenarios are explored in **In focus: The path of US tariffs remains uncertain**.

Reflecting the high level of uncertainty, the information provided in this Report is somewhat less detailed than in a typical base-case projection. Table 2, Table 3 and Table 4 compare the *current tariff scenario* to the January Report, which was the last report to present a base-case projection.

As in the April Report, risks related to how businesses, households and governments will react and adapt to tariffs are examined in the **Risks** section. Other non-tariff risks are also discussed.

A summary of economic conditions

Consumer price index (CPI) inflation was 1.9% in June. Changes in indirect taxes, such as the HST/GST holiday and the removal of the consumer carbon tax, have impacted CPI inflation since late 2024. When indirect taxes are excluded, inflation rose to 2.5% in June 2025 from around 2% in the second half of 2024. This increase was mainly because inflation in non-energy goods prices rose, more than offsetting an easing in inflation in shelter services prices. Similarly, most measures of core inflation have picked up since late 2024. Overall, underlying inflation is now assessed to be around 2½%.

Growth in the Canadian economy in the first quarter of 2025 was stronger than expected at 2.2%, largely due to a temporary surge in exports in anticipation of US tariffs. Growth is estimated to have contracted in the second quarter. While exports and business investment have fallen, growth in consumer spending has been resilient, and spending by government has picked up.

In the *current tariff scenario*, Canada's economic growth is modest at 1% in the second half of 2025. Growth then rises, reaching 1.8% in 2027 as the effects of trade policy uncertainty fade and as global demand and exports increase modestly. Inflation remains close to 2% throughout the scenario horizon. The upside pressures and the downside pressures on inflation are roughly offsetting and dissipate over time.

In the *de-escalation scenario*, growth is stronger, excess supply is reduced and the direct upward pressure on inflation from tariffs is lower. In the *escalation scenario*, the Canadian economy contracts through the rest of 2025 and inflation rises temporarily above the 2% target due to the direct cost pressures from tariffs.

Current conditions

Canadian economic activity has slowed considerably because of the trade conflict but is showing signs of resilience. While inflation is close to 2%, underlying inflation has risen to about 2½%.

The trade conflict disrupted the Canadian economy in the first half of 2025. In the first quarter, trade was pulled forward in anticipation of tariffs, and exports grew rapidly. As a result, Canada's gross domestic product (GDP) rose by 2.2%. At the same time, growth in final domestic demand stalled as uncertainty about the trade environment began to weigh on business and household spending.

The impact of tariffs on economic activity continued to play out in the second quarter; GDP is estimated to have fallen by 1.5%.

- Exports fell because trade activity brought forward in the two previous quarters was reversed and tariffs were imposed.
- Heightened uncertainty weighed on spending by businesses and households.
- Job losses were concentrated in sectors that rely on trade. Employment in the rest of the economy continued to grow modestly.

Consumer price index (CPI) inflation was 1.9% in June. CPI inflation excluding indirect taxes rose from about 2% in the second half of 2024 to 2.5% in June. This is largely due to higher inflation in prices for non-energy goods. Price increases in shelter services are holding inflation up but have continued to ease as expected.

Tariffs have had only a limited effect on inflation to date. Household inflation expectations remain elevated, while businesses' inflation expectations have moderated. Some businesses, however, report that the shifts in global trade are imposing new costs on their operations.

Economic activity

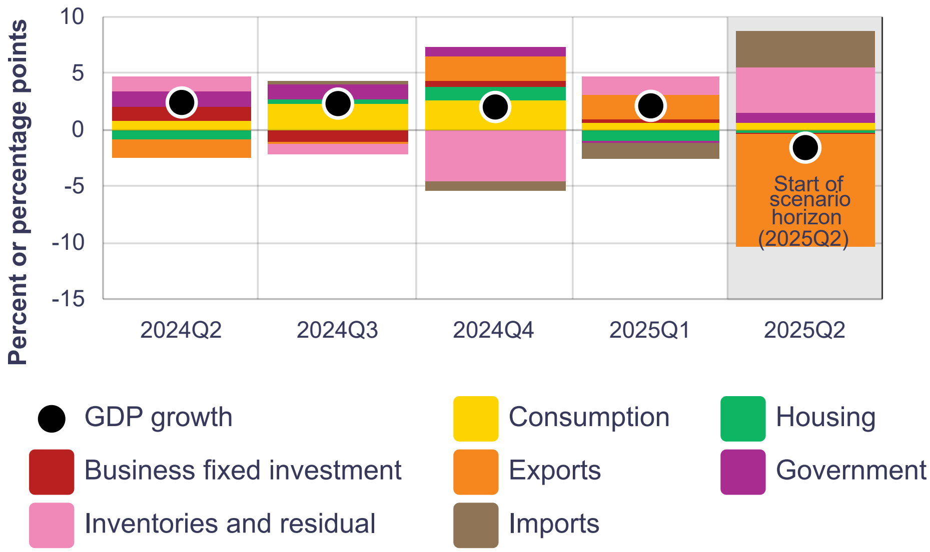
GDP growth for the first quarter of 2025 was stronger than expected at 2.2%. Trade activity was brought forward ahead of anticipated tariffs, boosting growth. Exports surged, and the drag from higher imports was offset by a strong pick-up in inventories.

In contrast, final domestic demand was flat in the first quarter. Residential investment fell, led by a steep decline in housing resale activity. Government spending was pulled down by shipments of military aid to Ukraine.[1] Growth in consumption and business investment slowed because of heightened uncertainty about US trade policy, along with a pullback after strong growth in the fourth quarter of 2024.

In the second quarter of 2025, GDP is estimated to have contracted by 1.5%, primarily due to a sharp drop in exports after tariffs were imposed (**Chart 1**). The effects of tariffs and trade uncertainty also continued to weigh on household spending and business investment. A rebound in government spending after weakness in the first quarter provided a partial offset.

Chart 1: GDP is estimated to have contracted in the second quarter of 2025

Contributions to real GDP growth, annualized, quarterly data



Sources: Statistics Canada and Bank of Canada calculations and estimates
Last data plotted: 2025Q2

Trade has fallen sharply

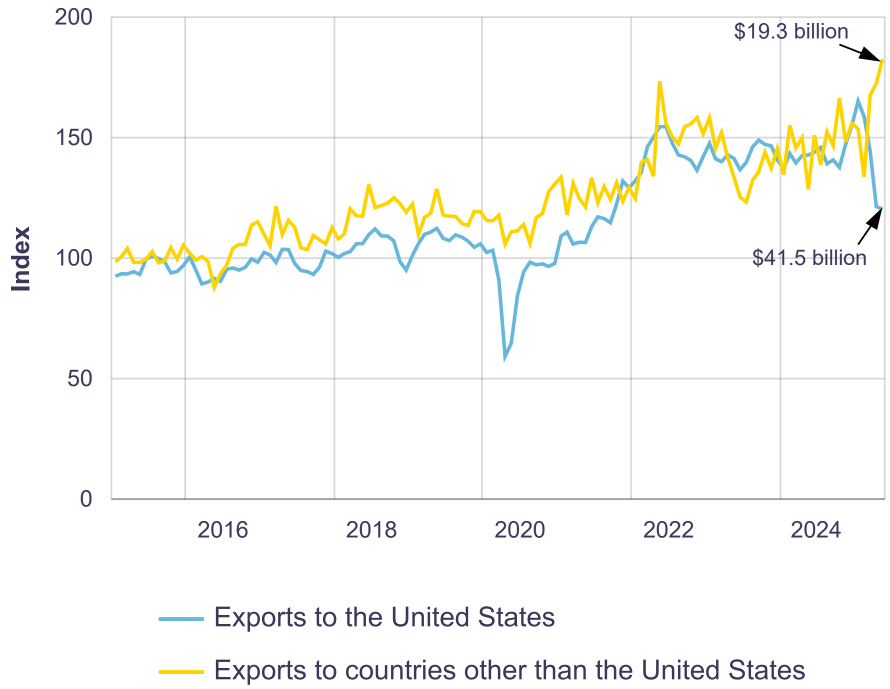
Exports look to have fallen by around 25% in the second quarter. This decline is due to a sharp fall in exports to the United States (**Chart 2**), reflecting a number of factors:

- a broad-based reversal of the pull-forward of trade activity in the two previous quarters
- the imposition of tariffs
- temporary disruptions to oil shipments
- fewer visitors to Canada

These factors were partially offset by resilient foreign demand and increased trade with countries other than the United States.

Chart 2: Exports to the United States have fallen sharply after the pull-forward of trade activity

Nominal exports, index: June 2015 = 100, seasonally adjusted, monthly data



Sources: Statistics Canada and Bank of Canada calculations
Last observation: May 2025

Imports are estimated to have fallen by about 10% in the second quarter. The decline in goods imports reflects both a broad reversal from the first quarter and the impact of Canadian countermeasures to US tariffs. A drop in the number of Canadians travelling to the United States also weighed on services imports.

Inventories are estimated to have expanded further, adding to GDP growth.

Growth in final domestic demand is muted

Final domestic demand was flat in the first quarter of 2025. Consumer spending and business investment continued to grow but at a slower pace than in the fourth quarter of 2024. This modest growth was offset by an 11% fall in residential investment and a decline in government expenditures.

In the second quarter of 2025, growth in final domestic demand is estimated to be just above 1%, supported by resilience in growth in consumption, along with increased government spending. Declines in business and residential investment partially offset this increase.

Consumption growth is estimated to be about 1%, reflecting a soft labour market and slowing population growth. While results from the Canadian Survey of Consumer Expectations (CSCE) for the second quarter of 2025 suggest consumer sentiment declined, some other surveys indicate an improvement more recently.

Government spending is estimated to have picked up by about 3.5% after the temporary decline in the first quarter.

Residential investment is estimated to have contracted again in the second quarter—albeit at a slower pace—falling about 2% amid elevated uncertainty.

- Resale activity continued to decline on average in the second quarter. The level of resale activity remains weak in Ontario and British Columbia but is more robust across the rest of the country.
- Growth in new construction moderated after strong increases over the past year.
- Renovation activity fell due to rising costs and declining housing prices.

However, resale activity and housing starts in May and June point to a pick-up in the near term.

Business investment is estimated to have fallen by 1%, reflecting subdued sentiment and continued trade uncertainty.

Capacity pressures

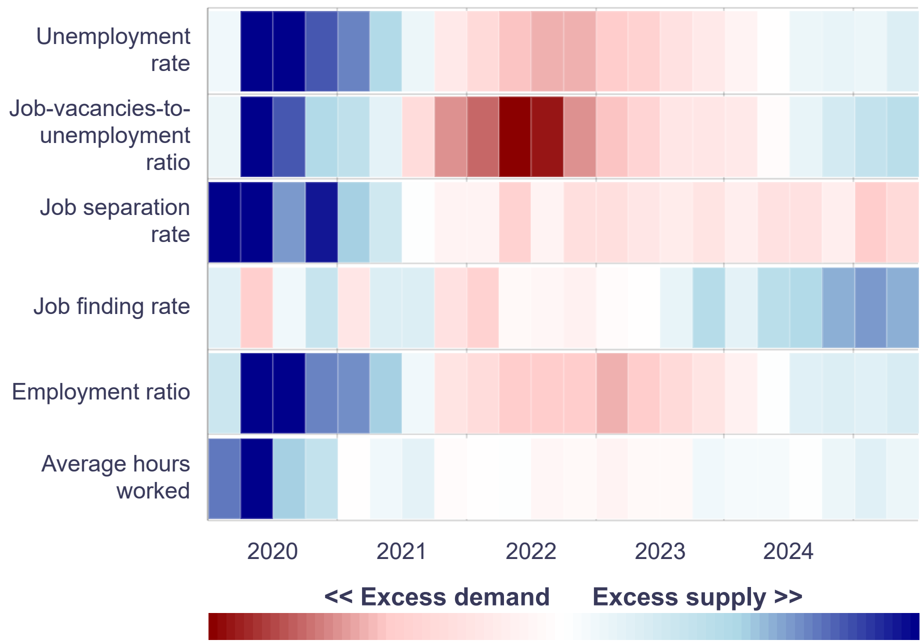
Trade tensions have weakened economic activity and have led to excess supply in the economy. Many businesses expect demand to soften and have paused their hiring and investment plans.[2] Job growth bounced back in June after four months of little gain. Nevertheless, the unemployment rate remains elevated. Overall, the labour market continues to be in excess supply.

With GDP likely to have contracted in the second quarter of 2025, the output gap is estimated to have widened to between -1.5% and -0.5% from between -1.0% and 0% in the first quarter.

The labour market is soft

Although job growth picked up in June, the labour market remains soft (**Chart 3**). The unemployment rate rose from 6.6% at the beginning of the year to 6.9% in June. Weakness in industries that are sensitive to trade is the main reason for the softening in the labour market (**Chart 4**). Employment continued to grow in industries that are less sensitive to trade.

Chart 3: Most indicators point to an excess supply of labour

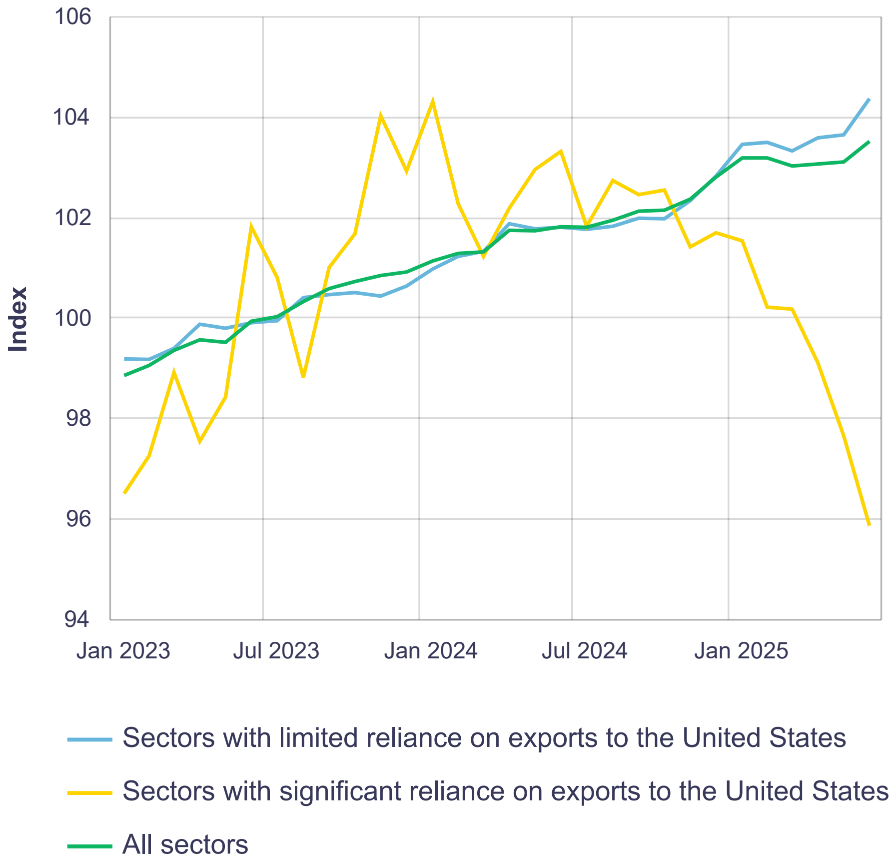


Note: The heatmap shows the distance of each labour market indicator from the midpoint of its benchmark range. The colour is white when the indicator is close to the midpoint of its benchmark range, a varying shade of red when the labour market is in excess demand and a varying shade of blue when the labour market is in excess supply. To make the indicators more comparable, each indicator is divided by its standard deviation. The standard deviation is calculated using data from April 2015 to 2019 for the *Job-vacancies-to-unemployment ratio* and 2003 to 2019 for all other indicators. The benchmark ranges are established using the methodology outlined in E. Ens, K. See and C. Luu, "Benchmarks for assessing labour market health: 2023 update," Bank of Canada Staff Analytical Note No. 2023-07 (May 2023).

Sources: Statistics Canada, Bank of Canada and Bank of Canada calculations
Last observation: 2025Q2

Chart 4: Employment has declined in sectors that rely on exports to the United States

Employment, index: 2023 = 100, seasonally adjusted, monthly data



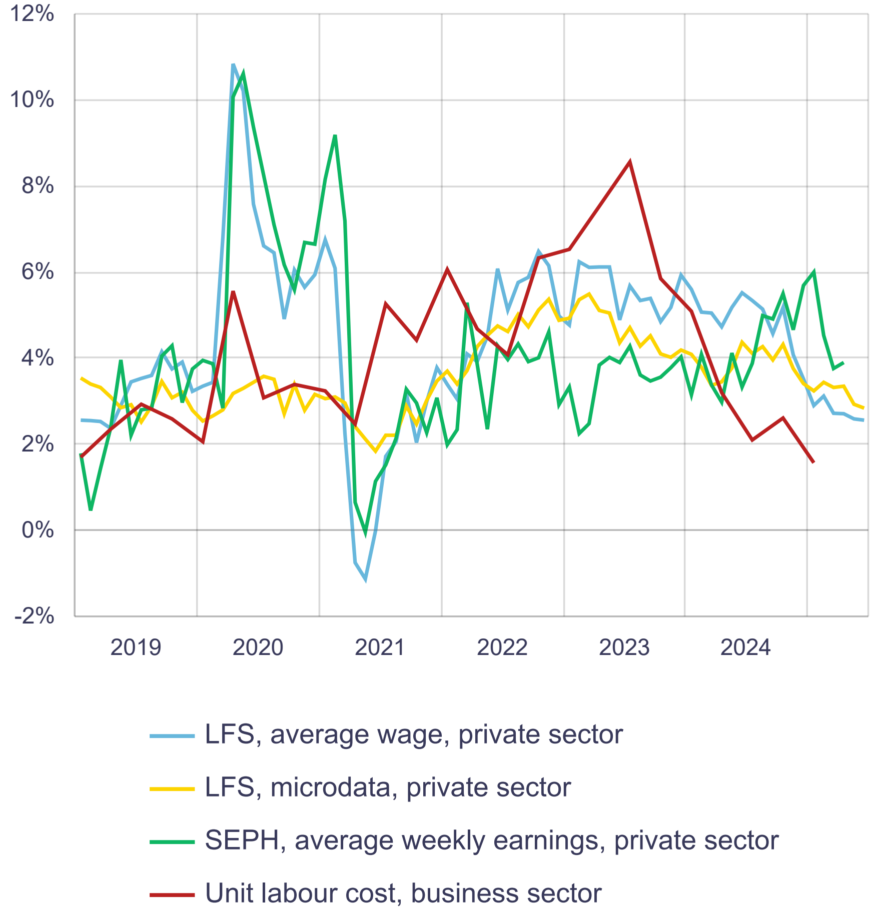
Note: A sector is considered to have significant reliance on exports to the United States if at least 35% of the sector's jobs depend on US demand. These include several manufacturing and transportation subsectors as well as commodities sectors, including energy and forestry. Together, these subsectors make up about 10% of employment.
Sources: Statistics Canada and Bank of Canada calculations
Last observation: June 2025

Job vacancies continued to decline, and the Bank's business surveys indicate that hiring intentions remain subdued.

Most indicators of labour costs—including measures of wage growth and unit labour cost growth in the business sector—continued to ease (**Chart 5**).

Chart 5: Wage growth continued to ease

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, private sector* measures wage growth using microdata from the LFS 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 care and social assistance.

Sources: Statistics Canada and Bank of Canada calculations

Last observations: LFS, June 2025; SEPH, April 2025; Unit labour cost, 2025Q1

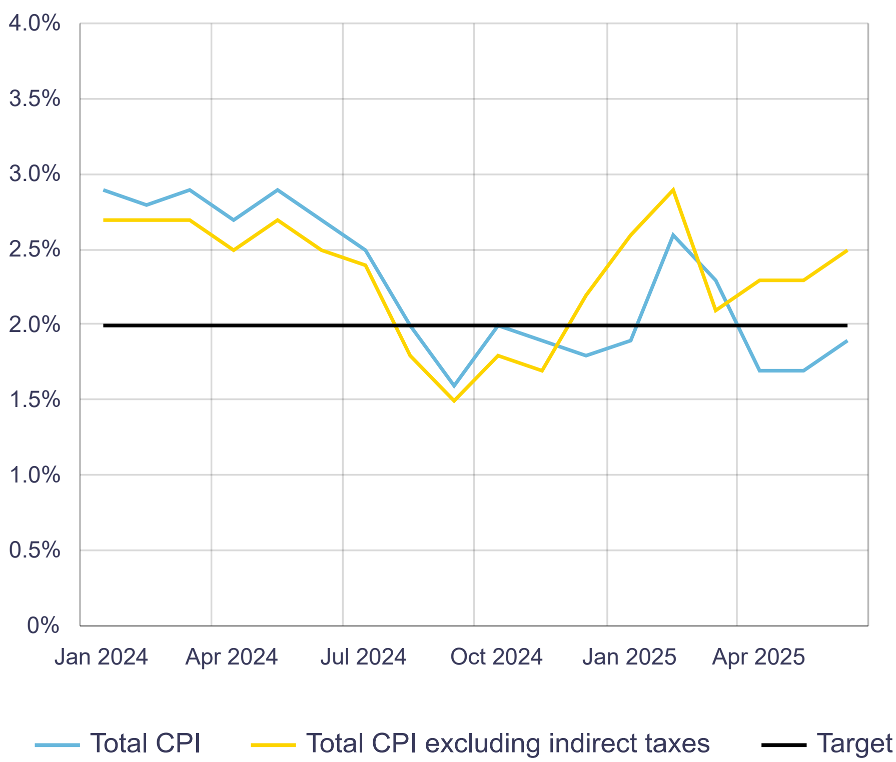
Inflation

CPI inflation was 1.9% in June, pulled down by the impact of the removal of the consumer carbon tax. CPI inflation excluding indirect taxes was 2.5% in June, up from around 2.0% in the second half of 2024 (**Chart 6**).

CPI inflation excluding indirect taxes is being held up primarily by high inflation in prices for shelter services. But the rise in inflation excluding indirect taxes since late 2024 is mainly due to a pick-up in prices for non-energy goods (**Chart 7**), which has more than offset the continued easing of inflation in shelter services. Prices for non-energy goods are being pushed up partly by some temporary factors, such as the past depreciation of the Canadian dollar.

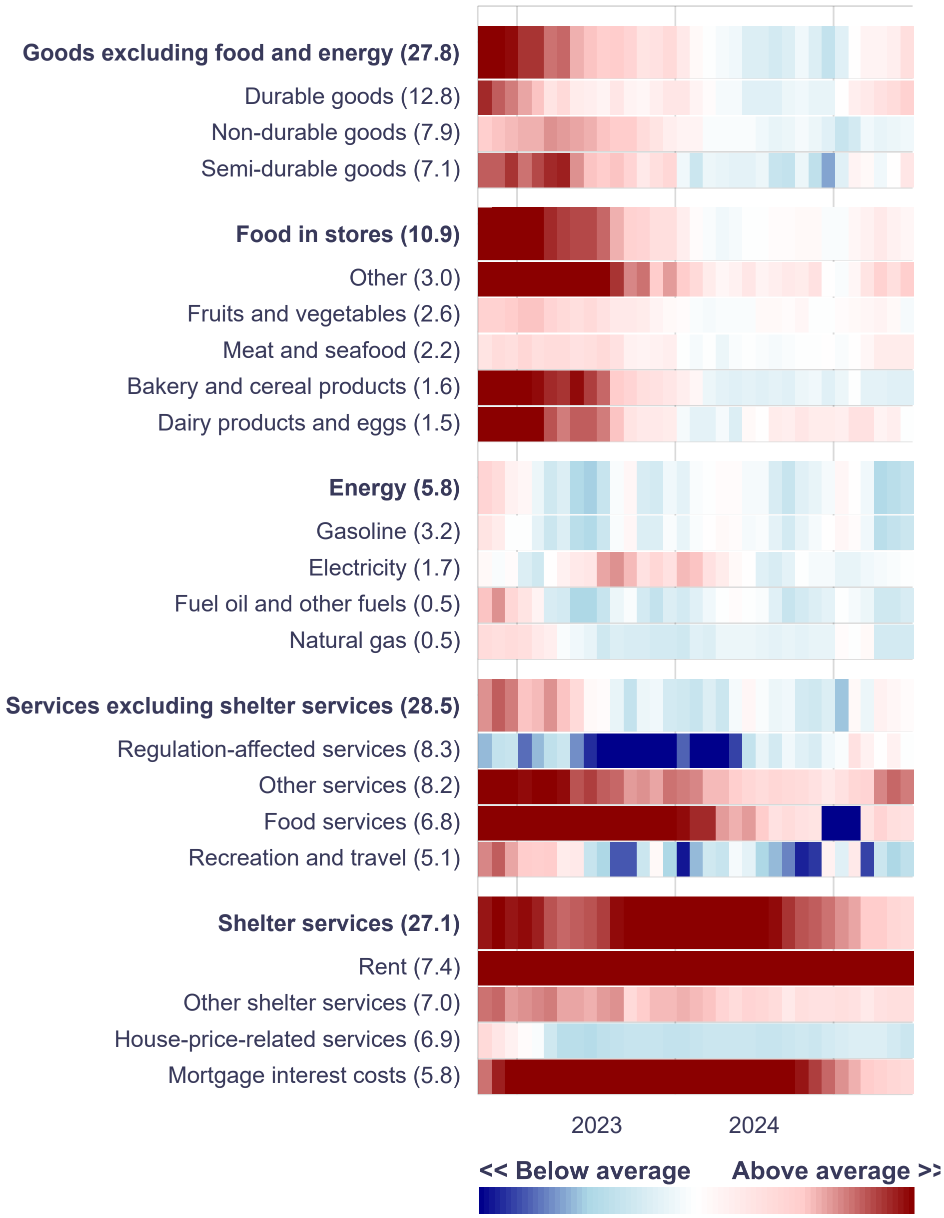
Chart 6: CPI inflation excluding indirect taxes has picked up since the fourth quarter of 2024

Year-over-year percentage change, monthly data



Sources: Statistics Canada and Bank of Canada calculations
Last observation: June 2025

Chart 7: The composition of CPI inflation is shifting



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 blue (red) when the rate is below (above) 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 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. The components also include the removal of the consumer carbon tax (April 1, 2025).
Sources: Statistics Canada and Bank of Canada calculations
Last observation: June 2025

While tariffs and counter-tariffs have had only a limited direct effect on inflation to date, Canadian businesses indicate that adapting to the changing global trade environment is adding to their costs.

Measures of core inflation have risen from 2024 and range between 2.5% and 3.0%. The distribution of inflation rates across CPI components has shifted somewhat higher, with more rising above 3% and fewer below 1%. Overall, underlying inflation is estimated to be about 2½%.

Non-energy goods inflation has continued to rise

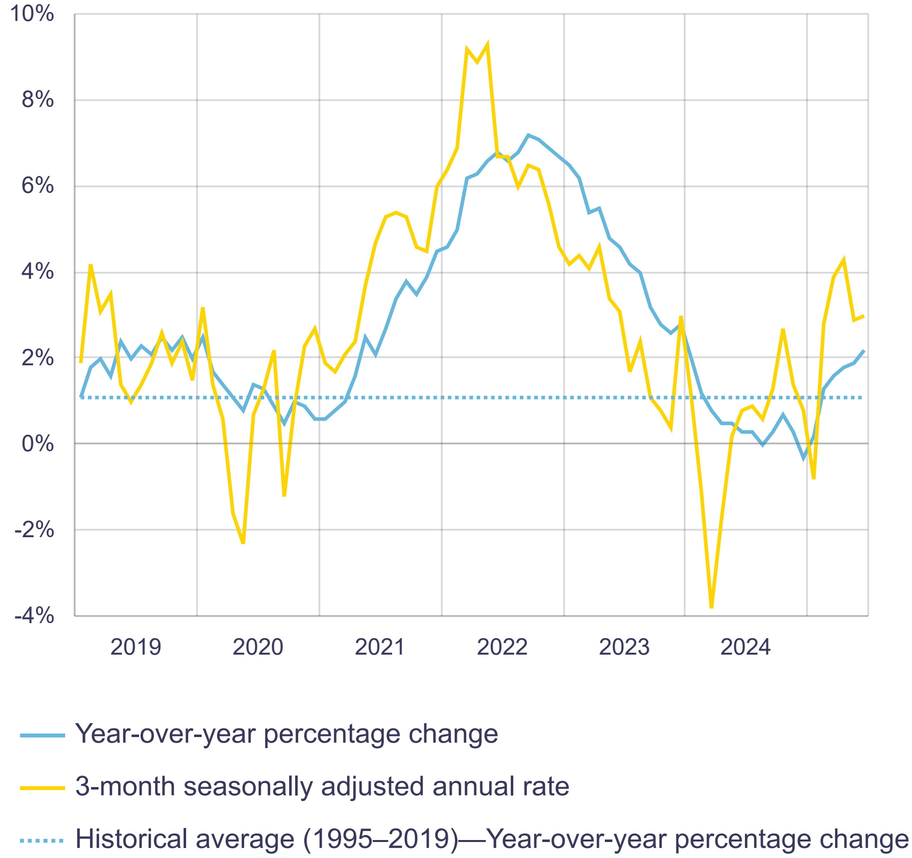
Energy prices declined considerably when the consumer carbon tax was removed (see **In focus: How removing the consumer carbon tax affects inflation** in the April Report). Inflation in energy prices fell to -9.5% in June.

Inflation in prices for goods excluding energy has increased to 2.2% from about zero in the second half of 2024, above its historical average (**Chart 8**). This rise is primarily attributed to the pass-through of past increases in import costs across a broad range of products, from motor vehicles and furniture to clothing and coffee. These increases in import costs reflect:

- the depreciation of the Canadian dollar against the US dollar in late 2024, which made imports more expensive
- past elevated growth in container shipping costs
- past increases in agricultural prices

Chart 8: Inflation in prices of goods excluding energy has picked up

Monthly data



Sources: Statistics Canada and Bank of Canada calculations
Last observation: June 2025

However, with the recent appreciation of the Canadian dollar and slower growth in shipping costs, the impacts of the cost pressures not related to tariffs are expected to ease in the coming months. In contrast, Canadian businesses have indicated that adapting to the evolving global trade environment is already adding to their costs. These cost pressures may persist.

Services price inflation has eased modestly

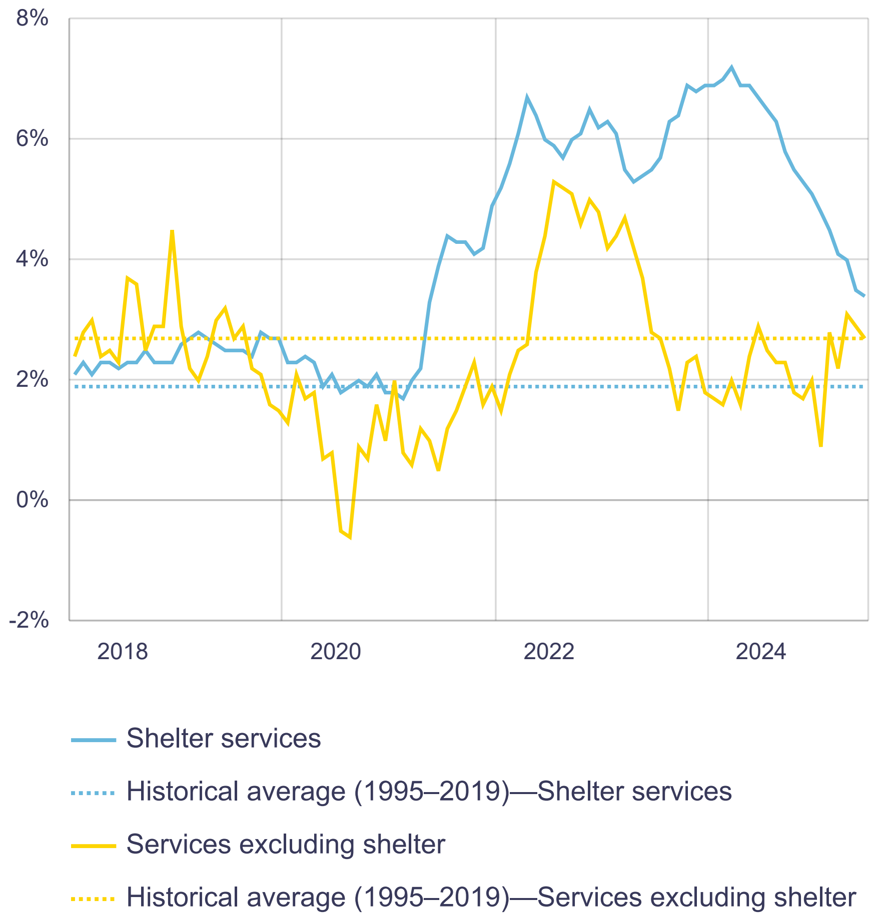
Inflation in services prices was 3% in June, 0.5 percentage points lower than in the second half of 2024.

While shelter price inflation remains above its historical average (**Chart 9**), it has continued to gradually decline:

- Rent inflation has eased since the start of 2025 and was 4.7% in June, likely reflecting increasing rental supply and slowing population growth.
- Growth in mortgage interest cost slowed to 5.6%.

Chart 9: Inflation in shelter services prices is slowing

Year-over-year percentage change, monthly data



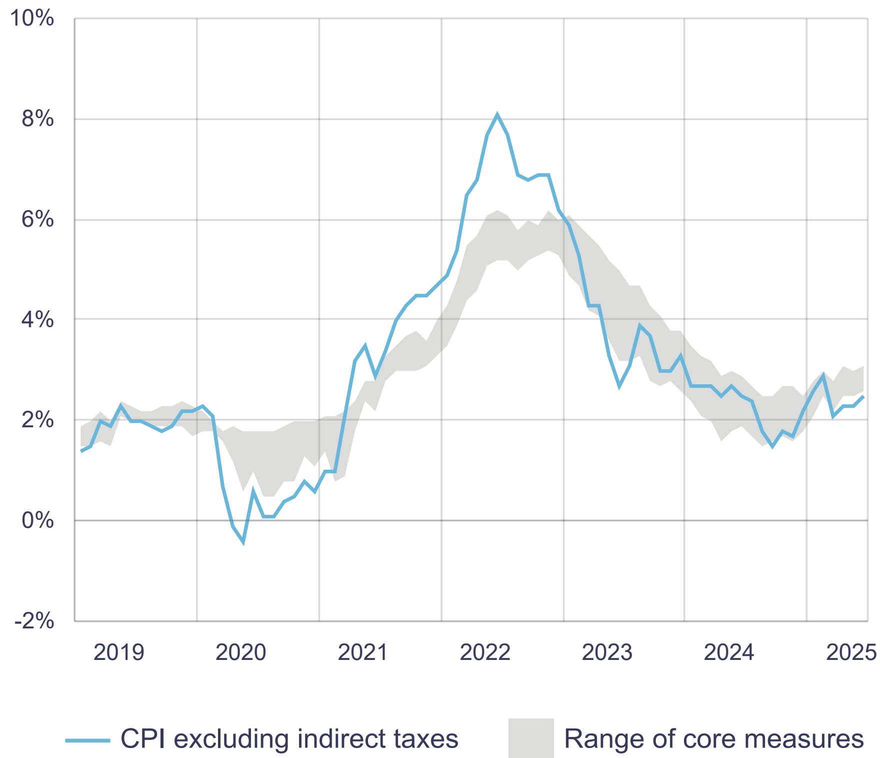
Sources: Statistics Canada and Bank of Canada calculations
Last observation: June 2025

Inflation in services prices excluding shelter picked up from about 2% in the second half of 2024 to 2.7% in June, close to its historical average. The increase since late last year is primarily due to less deflation in some prices, such as for communications and travel tours. Services associated with travel-related spending in Canada, such as hotels and rental cars, also faced some upward price pressures. At the same time, the growth of wages, a key cost for services, eased.

Measures of core inflation have risen since late last year and currently range from about 2.5% to 3% (**Chart 10**). CPI-median and CPI-trim are at the high end of that range. Other measures of underlying inflation have also risen, although they are slightly lower. For instance, CPIX and CPIXFET have been around 2.5% in recent months. All these measures are still somewhat affected by persistently high shelter price inflation.

Chart 10: Core inflation has risen since late 2024

Year-over-year percentage change, monthly data



Note: Core measures included are CPI-trim, CPI-median, CPIX and CPIXFET. CPI-trim excludes CPI components whose rates of change in a given month are located in the tails of the distribution of price changes. CPI-median is a measure of core inflation corresponding to the price change located at the 50th percentile. CPIX excludes eight of the most volatile components of inflation. CPIXFET excludes food and energy inflation. All measures exclude the effect of indirect taxes.

Sources: Statistics Canada and Bank of Canada calculations

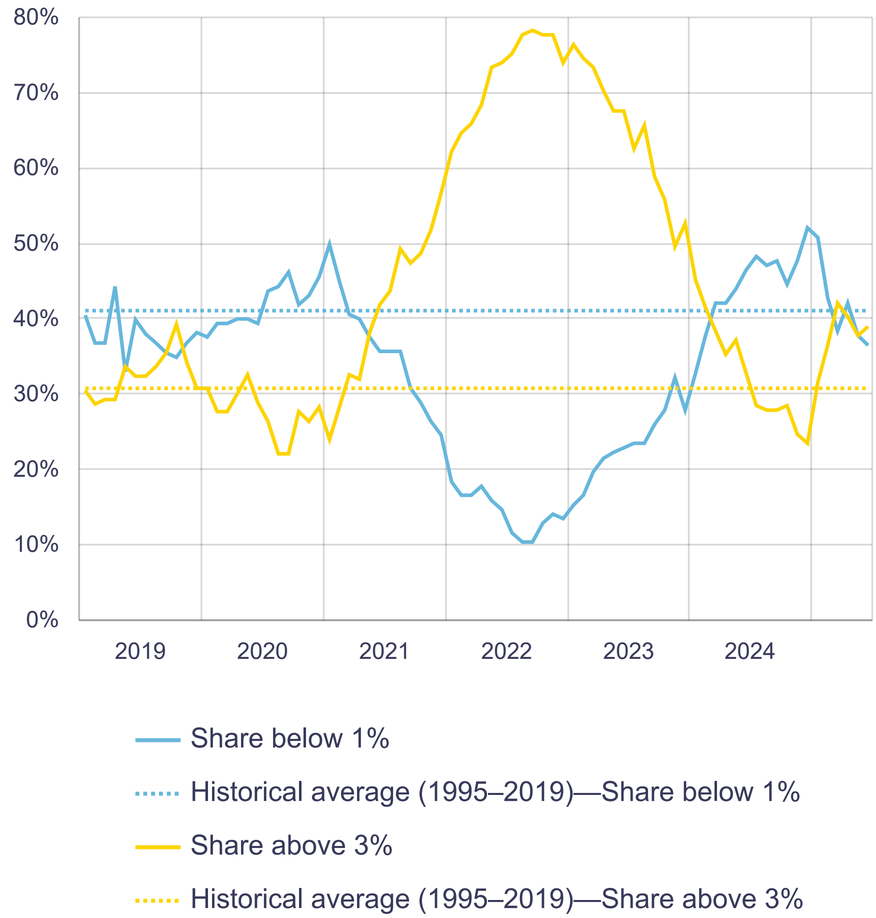
Last observation: June 2025

The share of CPI components rising by more than 3% year-over-year has moved up and is above its historical average (**Chart 11**). The share running below 1% has fallen and is now close to its historical average. This pattern of price growth is typically associated with inflation of around 2½%.

Based on all these measures, the Bank of Canada assesses underlying inflation to be about 2½%.

Chart 11: The share of CPI components growing above 3% has risen

Share of CPI components with price growth above and below the inflation target band, monthly data



Sources: Statistics Canada and Bank of Canada calculations
Last observation: June 2025

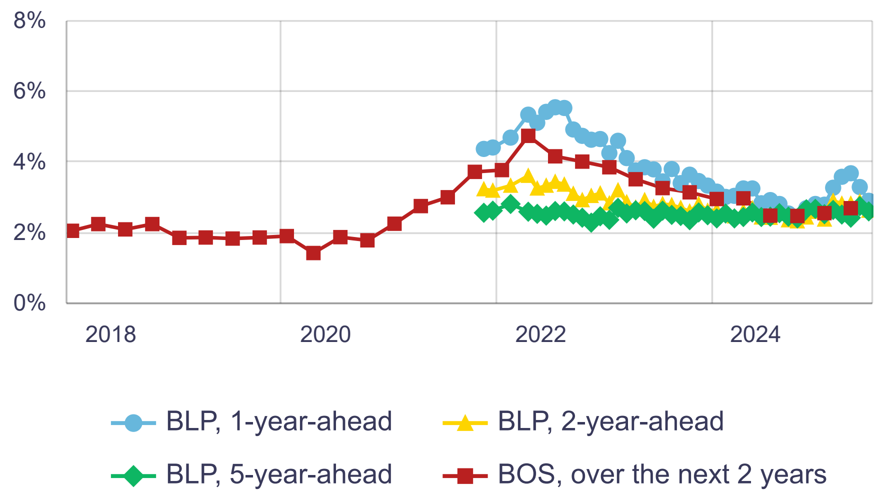
Businesses' short-term inflation expectations have moderated

Businesses' short-term inflation expectations have fallen, returning close to levels last seen at the end of 2024. In contrast, households' short-term inflation expectations have remained unchanged after the increase in the first quarter (**Chart 12**).

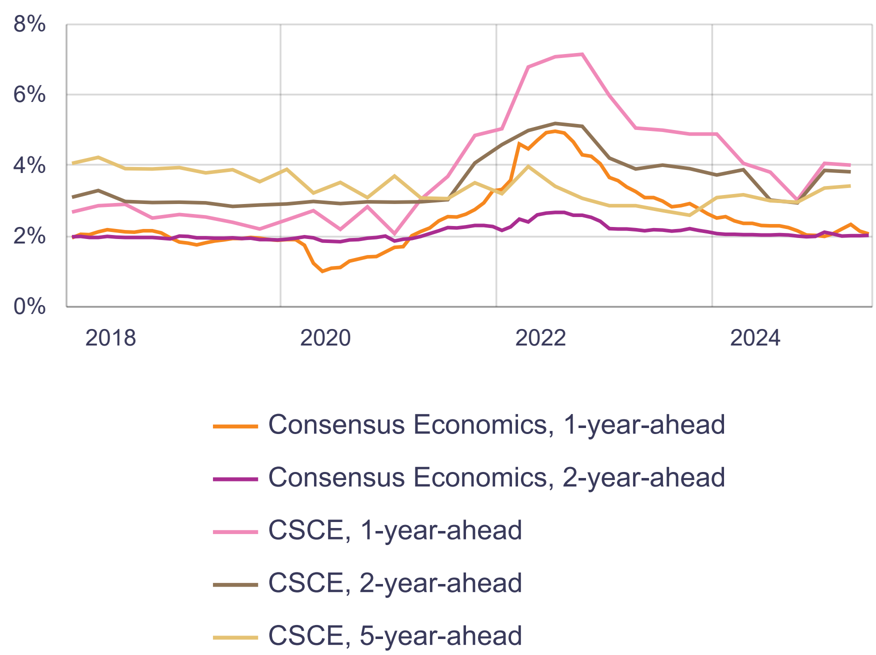
Chart 12: Businesses' inflation expectations have fallen, while consumers' expectations are flat

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 and BLP, June 2025; CSCE and BOS, 2025Q2

Endnotes

1. Statistics Canada treats military aid contributions to Ukraine in the form of weapon system components (i.e., weapon platforms, vehicles and other equipment but excluding ammunition) as disinvestments of assets, thus leading to a reduction in government investment.[←]

2. For more details, see Bank of Canada, ***Business Outlook Survey—Second Quarter of 2025*** (July 2025).[←]

Scenario assumptions

With some new tariff agreements in place, the range of trade policy outcomes has narrowed. Nevertheless, the situation remains fluid and difficult to predict. Canada's economic outlook therefore continues to be highly dependant on assumptions about how US trade policy could unfold.

The risk of a severe trade conflict with very high tariffs has diminished since the April Report. At the same time, tariff agreements reached so far make it clear that the United States is not returning to open trade with no or low tariffs.

This Report presents a scenario conditional on tariffs in place or agreed on as of July 27, 2025—the *current tariff scenario*. However, there continues to be an unusually high degree of uncertainty around future trade policy. Therefore, two alternative scenarios—a *de-escalation scenario* and an *escalation scenario*—are also considered (**Table 1**).

Taken together, the three scenarios illustrate a range of paths for the evolution of the global trade conflict (see the **Outlook** and **Global economy** sections and **In focus: The path of US tariffs remains uncertain**).

Table 1: Key differences in assumptions among the scenarios

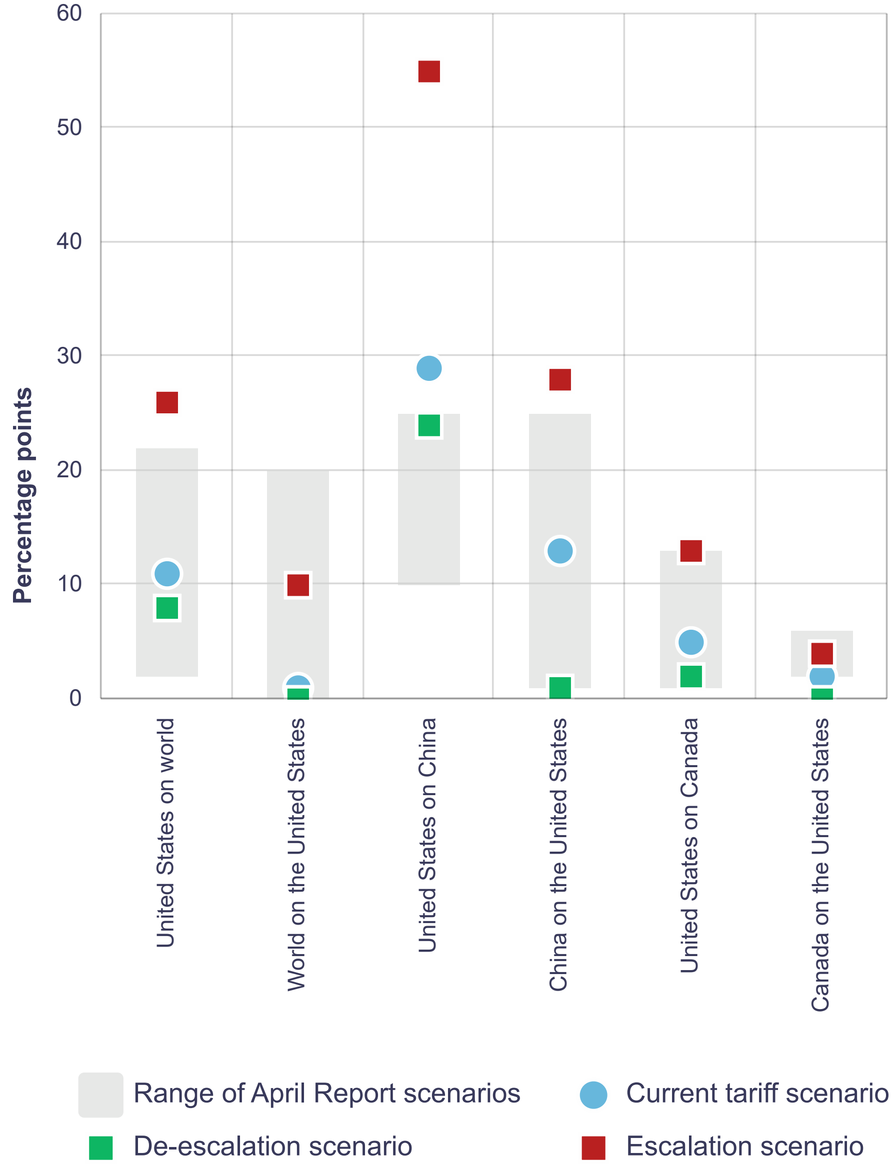
Variation	United States	Canada and other countries
Current tariff scenario	• US tariffs and trade agreements in place or agreed on as of July 27, 2025, are assumed to be permanent • The US weighted average tariff rate on the world is 13% • Uncertainty remains elevated into 2026	• Retaliatory tariffs by Canada and China on the United States in place as of July 27, 2025, are assumed to be permanent • Other countries are assumed to not retaliate • Uncertainty remains elevated into 2026
De-escalation scenario	• The United States lowers its tariffs on most countries • The US weighted average tariff rate on all countries is 10% • US tariffs on Canada are cut in half • Uncertainty is lower than in the *current tariff scenario*	• Canada and most other countries remove their retaliatory tariffs • China keeps a very small amount of retaliation in place • Uncertainty is lower than in the *current tariff scenario*
Escalation scenario	• The United States substantially increases its tariffs on most countries • The US weighted average tariff rate on all countries is 28% • Uncertainty remains the same as in the *current tariff scenario*	• Canada and China roughly double the value of US goods subject to retaliatory tariffs • All other countries substantially increase their tariff rates on the United States • Uncertainty remains the same as in the *current tariff scenario*

The three scenarios show how variations in the rate of tariffs can impact the economic outlook (**Chart 13**). They vary as follows:

- The *current tariff scenario* is based on trade policies in place or agreed on as of July 27, 2025.
- The *de-escalation scenario* illustrates a situation where global trade tensions and tariffs are lower than in the *current tariff scenario*.
- The *escalation scenario* illustrates a situation where negotiations deteriorate, resulting in tariffs that are meaningfully higher than in the *current tariff scenario*.

Chart 13: US tariff policy remains difficult to predict

Estimated increases to weighted average tariff rates since the start of 2025



Source: Bank of Canada calculations

Current tariff scenario

The *current tariff scenario* assumes the following tariffs are in place.

- US tariff measures on Canada:
    - a 50% tariff on imports of steel and aluminum
    - a 25% tariff on the non-US content of imported motor vehicles
    - a 25% tariff on motor vehicle parts that do not comply with the Canada-United States-Mexico Agreement (CUSMA)
    - a 25% tariff on imported goods that do not comply with CUSMA (a 10% tariff on energy or potash products), other than on motor vehicles and parts
        - CUSMA-compliance is assumed to be:
            - 100% for energy exports
            - 95% for all other goods exports[1]
- Canada's retaliatory tariffs on the United States:
    - a 25% tariff on approximately $60 billion of imports of US goods
    - a 25% tariff on the US content of vehicles imported from the United States with exceptions for CUSMA-compliant components made in Canada and Mexico
- United States measures on countries other than Canada:
    - a tariff of at least 50% on imports of steel, aluminum and certain related household appliances
    - a tariff of at least 25% on the non-US content of imported motor vehicles and parts, with lower tariff rates for the European Union, Japan, Mexico and the United Kingdom, as established in their trade agreements
    - an increase in tariffs of 28 percentage points on goods from China compared with the start of 2025, representing both bilateral and sectoral tariffs
    - an increase in tariffs of 9 percentage points on average on countries outside of Canada and China compared with the start of 2025
- China's retaliatory tariffs on the United States:
    - an increase in tariffs on US goods equivalent to 13 percentage points
- China's retaliatory tariffs on Canada:
    - 100% on some agricultural products and 25% on pork and seafood products
- Other countries:
    - no retaliatory tariffs imposed

Other key assumptions include:

- Trade policy uncertainty remains elevated around the world into 2026
- Trade tensions reduce total factor productivity (TFP) and investment, lowering the level of Canadian potential output by 0.5% in 2027
    - Global potential output is lower by 0.1% in 2027
- Over the scenario horizon, the per-barrel prices for oil are assumed to be US$65 for Brent, US$60 for West Texas Intermediate and US$50 for Western Canadian Select
- The Canadian dollar is assumed to average 73 cents US over the scenario

De-escalation scenario

Trade tensions ease. The United States lowers—but does not completely remove—its tariffs on other countries. As a result, Canada and other countries lower their retaliatory tariffs. Uncertainty decreases but does not disappear.

Compared with the *current tariff scenario*, the United States:

- halves the level of sectoral tariffs (steel and aluminum, motor vehicles and parts)
- reduces the tariffs on Canadian goods that do not comply with CUSMA to 10% from 25%
- reduces the increase in tariffs on Chinese goods from 28 percentage points to 24 percentage points
- reduces the weighted average increase in tariffs on other countries from 9 percentage points to 6 percentage points

Canada and other countries react by scaling back countermeasures on the United States:

- Canada removes its counter-tariffs on the United States
- China reduces the incremental tariff increases imposed on the United States from 13 percentage points in the *current tariff scenario* to 1 percentage point
- other countries maintain their policy of not retaliating against the United States

Other key assumptions include:

- Trade policy uncertainty is roughly halved from the level in the *current tariff scenario*.
- Potential output in Canada is 0.2% stronger at the end of 2027 compared with the *current tariff scenario*.
- Over the scenario horizon, the per-barrel prices for oil are assumed to be US$70 for Brent, US$65 for West Texas Intermediate and US$55 for Western Canadian Select.
- The Canadian dollar averages 74 cents US over the scenario.
- Other assumptions remain unchanged.

Escalation scenario

The United States significantly increases its tariffs on most countries. The increase on Canada and Mexico is less than on other countries over fears of disrupting the integrated nature of North American supply chains. Canada and other countries increase their retaliatory tariffs.

Compared with the *current tariff scenario*, the United States:

- imposes a 50% tariff on all copper imports
- imposes a broad-based 10% tariffs on goods imported from Canada and Mexico—this tariff does not stack on tariffs already applied to steel, aluminum, and motor vehicles and parts
- raises tariffs on goods from China from 28 percentage points to 55 percentage points
- increases the weighted average tariff rate on other countries from 9 percentage points to 23 percentage points

Canada’s retaliatory tariffs on the United States include:

- a 25% tariff on approximately $120 billion of imports of US goods (up from $60 billion in the *current tariff scenario*)

Other economies’ retaliatory tariffs on the United States since the start of 2025 include:

- China: an increase of 28 percentage points in tariffs on US goods (up from an increase of 13 percentage points in the *current tariff scenario*)
- European Union: an increase of 15 percentage points in tariffs on US goods (up from zero in the *current tariff scenario*)
- Mexico: an increase of 5 percentage points in tariffs on US goods (up from zero in the *current tariff scenario*)
- All other countries: an average increase of 9 percentage points in tariffs on US goods (up from zero in the *current tariff scenario*)

Other key assumptions include:

- Canadian potential output is roughly 1% lower at the end of 2027 compared with the *current tariff scenario*.
    - Global potential output is lower by 0.1% in 2027 compared with the *current tariff scenario*.
- The per-barrel prices for oil are assumed to be US$60 for Brent, US$55 for West Texas Intermediate and US$45 for Western Canadian Select.
- Financial conditions are assumed to tighten compared with the *current tariff scenario*, with the risk spreads on global bond yields widening and global equity prices declining.
- The Canadian dollar averages 71 cents US over the scenario.
- Other assumptions remain unchanged.

Assumptions common to all three scenarios

- Tariffs are assumed to be permanent and to reduce TFP and investment.
- In Canada, half of the revenues from tariffs are remitted to businesses affected by tariffs in line with Government of Canada announcements.
    - Remaining tariff revenues are redistributed to households.
- In all other countries, half of the revenues from tariffs are redistributed to households, while the rest is added to general revenues.
- In most countries, three-quarters of the increased costs from tariffs are passed through to consumer prices within six quarters.
    - In the United States, tariffs are assumed to pass through to goods prices in roughly three quarters. The United States is the only country to impose tariffs on all its trading partners, increasing the cost of imports from all countries. Therefore, businesses do not need to worry about cheaper substitutes and can pass on tariff-related cost increases more quickly.
- The scenarios incorporate information from published provincial budgets and recent federal fiscal measures that have been tabled at the time of writing.[2] Major program measures include:
    - the enactment of a federal government tax cut on July 1, 2025
    - increases in federal defence spending announced on June 9, 2025
- The rate of population growth of people aged 15 and over in Canada is assumed to slow from 3.3% in 2024 to 1.3% in 2025 and then to moderate further to 0.5% in 2026. Population growth is assumed to be 0.6% in 2027.
- Because it is still too early to assess, the impact from a reduction in interprovincial trade barriers on potential output has not been included in the scenarios.
- The nominal neutral interest rate in Canada is estimated to be in the range of 2.25% to 3.25%.

Endnotes

1. These assumptions are informed by the latest trade statistics and discussions with Canadian businesses.[←]
2. By convention, fiscal measures and updates are typically incorporated if they have been tabled at the time of writing.[←]

Outlook

Tariffs and trade uncertainty are expected to weigh on Canadian economic activity for some time. Inflation remains close to the 2% target over the scenario horizon.

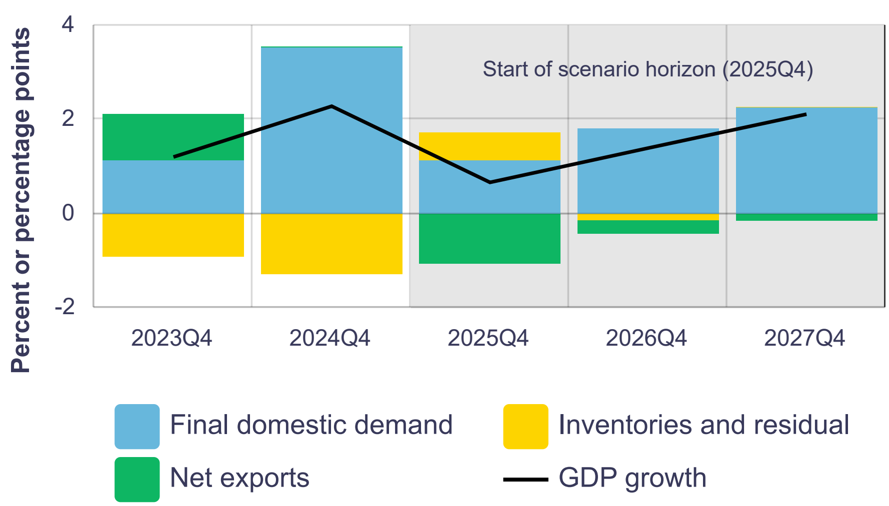
Because the trade environment remains volatile, this section presents a *current tariff scenario* instead of a base-case projection (see the **Scenario assumptions** section). Two alternative scenarios are also presented that, when taken together, encompass a range of potential outcomes (see **In Focus: The path of US tariffs remains uncertain**). Regardless of how US trade policy evolves, risks remain with respect to how businesses, households and governments will react and adapt (see the **Risks** section).

In the *current tariff scenario*, tariffs and trade uncertainty continue to weigh on economic activity. After declining in the second quarter of 2025, gross domestic product (GDP) grows by about 1% in the second half of the year. Exports stabilize—albeit at a lower level of activity—and growth in household spending strengthens.

GDP growth then picks up, reaching 1.8% in 2027, supported by the waning impacts of trade uncertainty and tariffs on export growth (**Chart 14**). Due to the impact of tariffs, the level of activity is on a permanently lower path.

Chart 14: GDP growth slows in 2025 due to the trade conflict but then picks up gradually

Contributions to real GDP growth, fourth-quarter-over-fourth-quarter percentage change, quarterly data



Sources: Statistics Canada and Bank of Canada calculations and estimates
Last data plotted: 2027Q4

Consumer price index (CPI) inflation stays close to the 2% target over the scenario horizon. In 2025 and 2026, this reflects the following offsetting forces:

- upward pressure on inflation from tariffs and the end of the temporary downward impact from the removal of the consumer carbon tax

- downward pressure on inflation from excess supply and a stronger Canadian dollar as well as an easing in shelter price inflation

In 2027, inflation remains close to the 2% target as offsetting pressures from tariffs and excess supply dissipate.

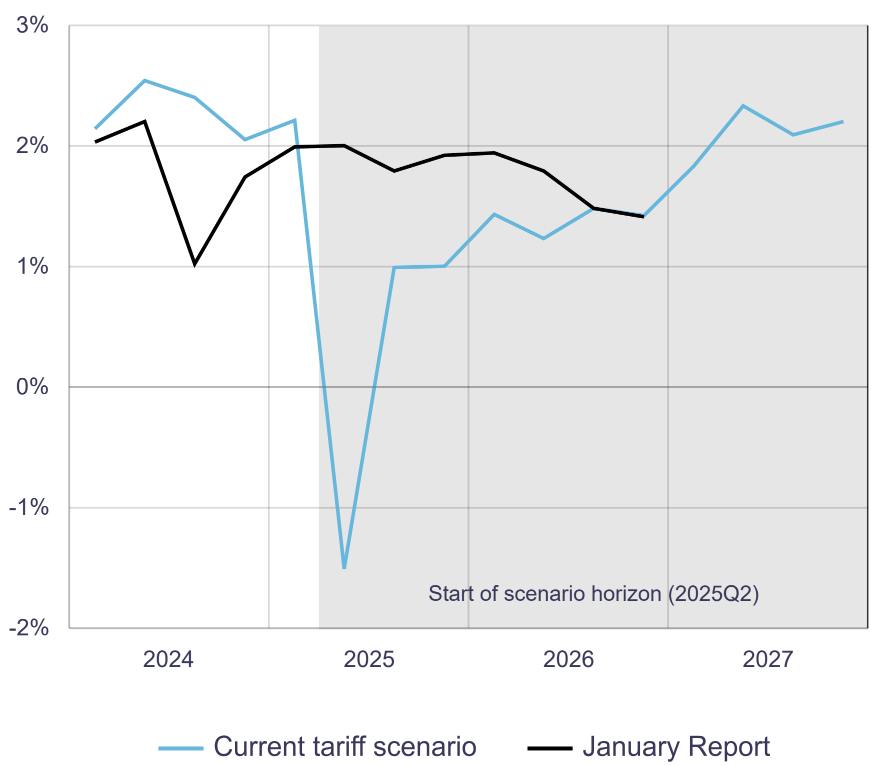
Economic activity

GDP growth picks up in the second half of 2025 as exports stabilize. GDP growth then strengthens to reach 1.8% in 2027 (**Chart 15**), but tariffs permanently lower the path of economic activity.

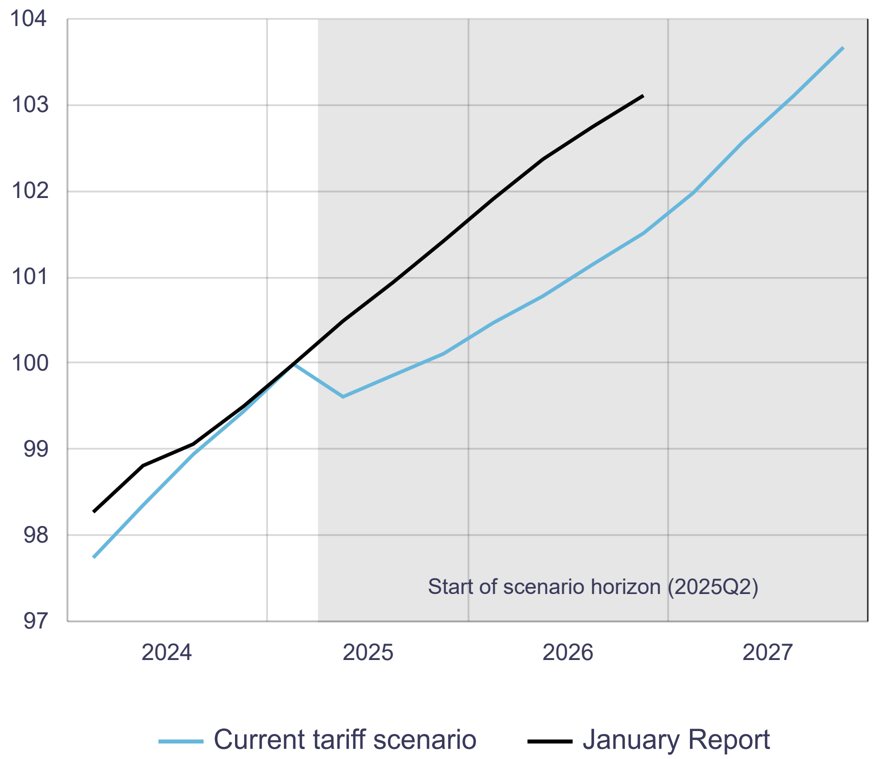
Chart 15: GDP growth strengthens, but the level of activity is permanently lower than projected in the January Report

Quarterly data

a. Quarter-over-quarter percentage change of real GDP at annual rates



b. Level of real GDP, index: 2025Q1 = 100



Sources: Statistics Canada and Bank of Canada calculations and estimates
Last data plotted: 2027Q4

Slow population growth and weak business investment weigh on potential output growth in the second half of 2025. Potential output growth then picks up in 2026 and 2027, mainly due to more robust trend labour productivity growth. Trend labour input growth remains modest.

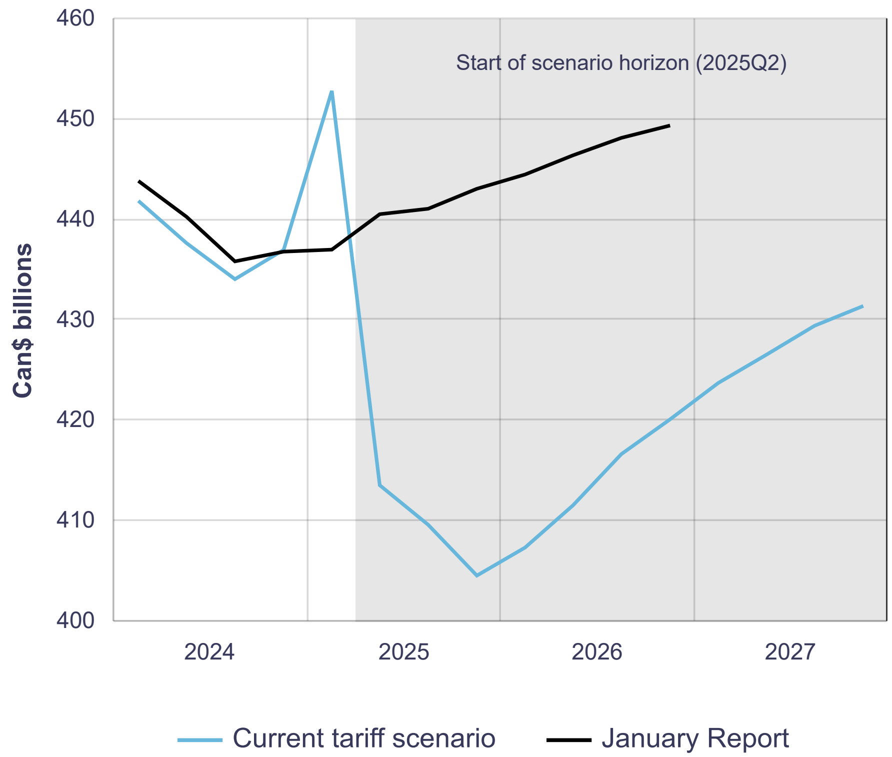
The output gap persists in 2026 and then narrows in 2027 as GDP growth picks up.

Exports rise slowly from current low levels

After falling sharply in the second quarter due to tariffs, exports stabilize in the second half of 2025. They increase modestly over the rest of the scenario horizon as Canadian exporters adjust to the new trade environment. Non-commodity exports remain well below their pre-tariff levels, reflecting the permanent damage done by US tariffs (**Chart 16**).

Chart 16: Non-commodity exports remain below their 2024 levels

Annualized, quarterly data, chained 2017 Canadian dollars



Sources: Statistics Canada and Bank of Canada calculations and estimates
Last data plotted: 2027Q4

Growth of commodity exports is supported by new export capacity for liquefied natural gas and the increased use of the Trans Mountain pipeline.

Imports decline in the second half of 2025 partly because of the impact of Canadian countermeasures. Import growth then picks up in 2026 and 2027 as overall economic activity improves.

Business investment is soft over the near term

Business investment contracts in the second half of 2025, still weighed down by elevated uncertainty.

Growth in business investment picks up in 2026 and 2027. This growth is supported by diminishing uncertainty and a stronger Canadian dollar, which lowers the cost of imported machinery and equipment.

Growth in consumption picks up in 2027

Consumption growth remains modest in the second half of 2025 and in 2026. It is constrained by ongoing trade policy uncertainty, which holds back labour income growth. Higher mortgage payments for some households facing renewals further weigh on consumption. Tax cuts and government transfers provide a partial offset.[1]

Growth in consumption spending picks up in 2027 because of the diminishing impact of trade uncertainty and stronger growth in labour income.

Residential investment rises

Growth in residential investment strengthens in the second half of 2025, partially due to an increase in resale activity after the steep decline in the first half of the year. Growth in residential investment is moderate over 2026 and 2027, supported by dissipating trade uncertainty and rising household incomes.

Government spending supports growth

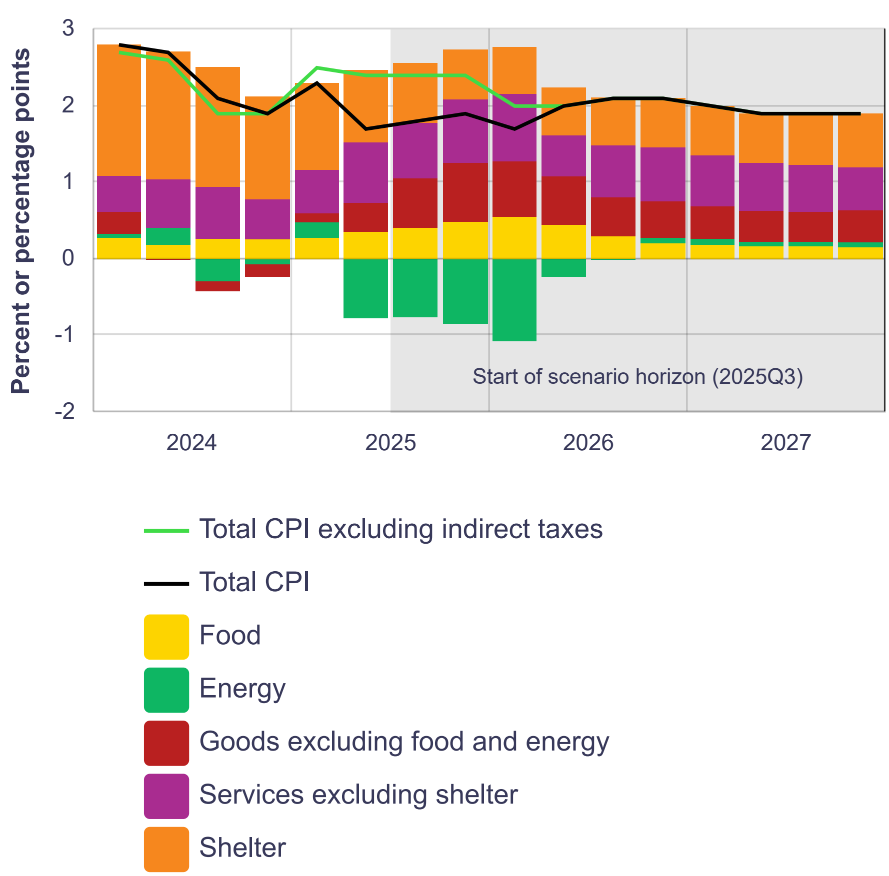
Growth in government spending is assumed to remain above that of potential output over the next year, underpinned by higher defence spending by the federal government and increased investment by provincial governments.

Inflation

Inflation stays close to 2% over the scenario horizon (**Chart 17**). In 2025 and 2026, this reflects a series of offsetting pressures.

Chart 17: CPI inflation averages around 2% over the scenario horizon

Contributions to year-over-year CPI inflation, quarterly data



Note: No changes to indirect tax rates are assumed over the outlook horizon.
Sources: Statistics Canada and Bank of Canada calculations and estimates
Last data plotted: 2027Q4

Factors leading to higher inflation include:

- the end of the downward impact from the elimination of the consumer carbon tax in the second quarter of 2026
- Canada's counter-tariffs, which add up to 0.6 percentage points to inflation, particularly affecting the prices of goods such as food and motor vehicles

In addition, businesses report that they are facing new costs due to the reconfiguration of trade, including the cost of finding new markets and restructuring their supply chains. These cost pressures are particularly difficult to assess, and there is a risk that they will be more significant than anticipated.

Factors leading to lower inflation include:

- excess supply and slower growth in unit labour costs
- easing inflation in shelter prices, reflecting slower growth in rent prices and mortgage interest costs
- the recent appreciation of the Canadian dollar

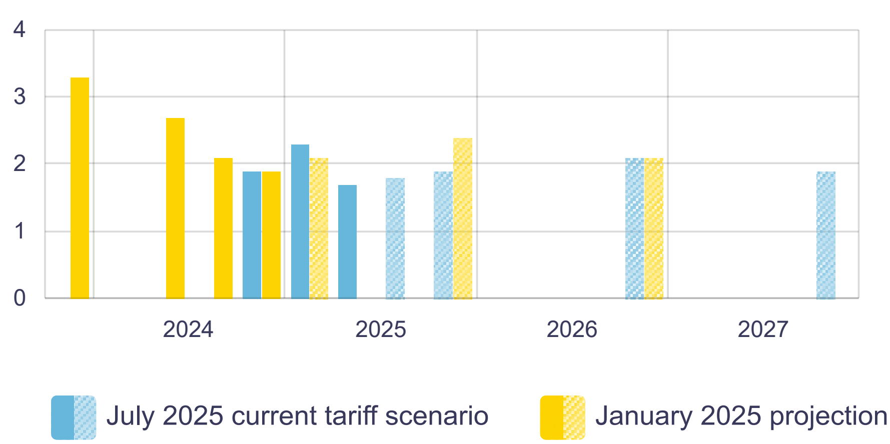
In 2027, inflation remains close to 2% as the effects of tariffs dissipate and excess supply begins to shrink. The composition of inflation shifts, with inflation in goods prices easing and inflation in services prices stabilizing near historical norms.

Comparison of recent Bank outlooks

Chart 18 compares the *current tariff scenario* with the January Report and previous Reports. In January, the near-term outlook for inflation was higher than in the *current tariff scenario* because the consumer carbon tax was still in place. The April Report is excluded because it presented a range of scenarios.

Chart 18: The July 2025 and January 2025 Monetary Policy Report outlooks

CPI inflation (year-over-year percentage change)



The outlook for GDP growth in the *current tariff scenario* is significantly weaker than it was at the time of the January Report, before the trade conflict intensified (**Table 2** and **Table 3**).

- GDP growth is approximately 0.5 percentage points lower in both 2025 and 2026 due to the negative effect of tariffs and associated uncertainty.
- Potential output is weaker by the end of 2026 because tariffs and uncertainty lead to lower trend labour productivity.

The outlook for CPI inflation is around 0.4 percentage points lower in 2025. This is primarily due to lower oil prices and the temporary decline in inflation from removing the consumer carbon tax, which outweigh the one-time price increase from Canada's counter-tariffs.

Table 2: GDP growth and inflation over the current tariff scenario horizon

	2024	2025	2026	2027
GDP (average annual growth)	1.6 (1.3)	1.3 (1.8)	1.1 (1.8)	1.8
Final domestic demand (percentage points)	2.1 (1.6)	2.1 (2.4)	1.8 (1.7)	2.0
Exports (percentage points)	0.2 (0.3)	-1.1 (0.6)	-0.1 (0.8)	0.9
Imports (percentage points)	-0.2 (-0.2)	0.4 (-0.7)	-0.3 (-0.8)	-1.1
CPI inflation (percentage change)	2.4 (2.4)	1.9 (2.3)	2.0 (2.1)	1.9

Note: The assumptions and scenarios were finalized on July 27, 2025. Final domestic demand, exports and imports are calculated as contributions to GDP growth. These components do not add up to total GDP growth because inventories are not included. Numbers in parentheses are projections from the January 2025 Report. In January, the near-term outlook for inflation was higher than in the *current tariff scenario* because the consumer carbon tax was still in place.
Sources: Statistics Canada and Bank of Canada calculations and estimates

Table 3: Summary of GDP growth and inflation for Canada in the current tariff scenario

	2024	2025			2024	2025	2026	2027
	Q4	Q1	Q2	Q3	Q4	Q4	Q4	Q4
CPI inflation (year-over-year percentage change)	1.9 (1.9)	2.3 (2.1)	1.7	1.8	1.9 (1.9)	1.9 (2.4)	2.1 (2.1)	1.9
Core inflation (year-over-year percentage change)*	2.6 (2.6)	2.8 (2.5)	3.1	3.1	2.6 (2.6)	3.1 (2.1)	2.4 (2.1)	2.0
Real GDP (year-over-year percentage change)	2.3 (1.8)	2.3 (1.7)	1.3	0.9	2.3 (1.8)	0.7 (1.9)	1.4 (1.7)	2.1
Real GDP (quarter-over-quarter percentage change at annual rates)†	2.1 (1.8)	2.2 (2.0)	-1.5	1.0				

Note: The assumptions and scenarios were finalized on July 27, 2025. Numbers in parentheses are projections from the January 2025 Report. In January, the near-term outlook for inflation was higher than in the *current tariff scenario* because the consumer carbon tax was still in place.
* Core inflation is the average of CPI-trim and CPI-median.
† Over the scenario horizon, 2025Q2 and 2025Q3 are the only quarters for which some information about real GDP growth was available at the time the scenario was conducted. For longer horizons, fourth-quarter-over-fourth-quarter percentage changes are presented. They show the growth rates of CPI and real GDP within a given year in the Bank's scenario horizon. Therefore, they can differ from the average annual growth rates shown in **Table 2**.
Sources: Statistics Canada and Bank of Canada calculations and estimates

Endnotes

1. Half of the revenues from tariffs are remitted to tariff-affected businesses in line with Government of Canada announcements. The remaining half of tariff revenues are redistributed to households.[←]

Global economy

Global growth has slowed since the start of 2025 amid the ongoing shifts in US trade policy and the resulting uncertainty. Still, the global economy has remained resilient so far, even though US tariffs are at their highest levels in decades.

Since January, the United States has threatened, imposed, paused and reinstated tariffs on many of its trading partners. More recently, it has negotiated agreements on tariffs with some countries, and the trade war with China has moderated. Consequently, financial conditions have recovered in recent months, and confidence has improved from a very low level. Because of this, a rapid slowdown in economic activity has been avoided (**Table 4** and **Chart 19**).

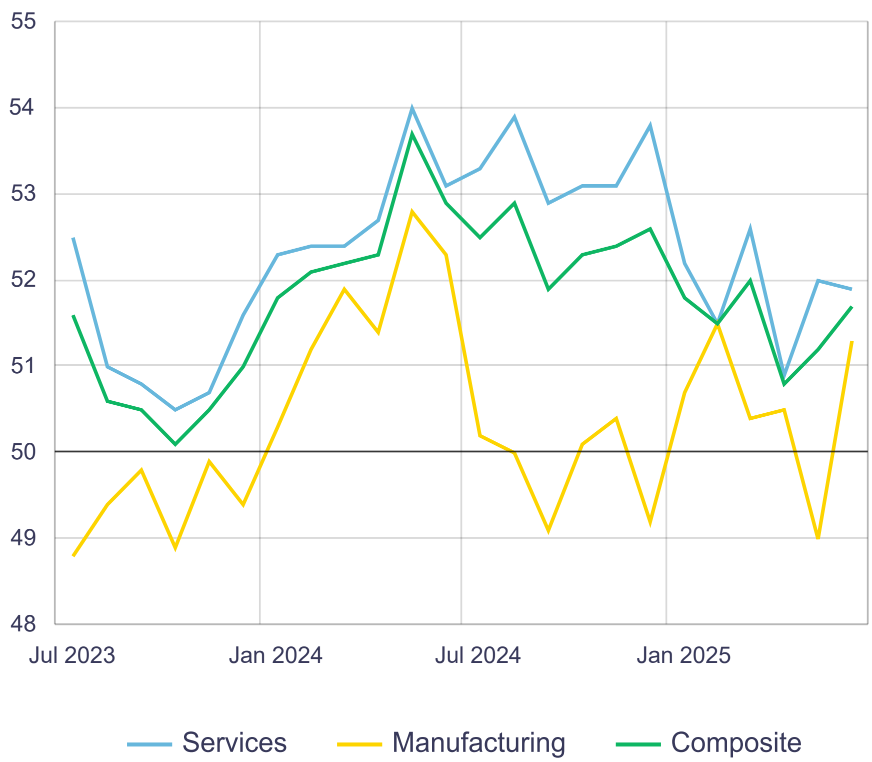
Table 4: Current tariff scenario for global economic growth

	Share of real global GDP* (%)	**Growth† (%)**			
		2024	**2025**	**2026**	**2027**
United States	15	2.8 (2.8)	1.8 (2.6)	2.4 (2.3)	2.1
Euro area	12	0.8 (0.7)	1.1 (0.8)	1.1 (1.3)	1.4
China	19	5.0 (5.0)	4.9 (4.9)	4.5 (4.1)	4.2
World	100	3.2 (3.1)	3.0 (3.1)	2.8 (3.1)	3.1

* 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*.
† Numbers in parentheses are projections from the January Report.
Sources: National sources via Haver Analytics and Bank of Canada calculations

Chart 19: Global economic activity has remained resilient to shifts in US trade policy

Headline purchasing managers' indexes, seasonally adjusted, monthly data



Note: Purchasing managers' indexes greater than 50 indicate growth in the sector.
Source: S&P Global Purchasing Managers' Survey via Haver Analytics
Last observation: June 2025

However, the situation remains fluid, and the level of tariffs is high by historical standards. Given the ongoing uncertainty around US trade policy, the July Report presents a *current tariff scenario* instead of a base-case projection. The *current tariff scenario* is conditional on trade policies in place or agreed on as of July 27, 2025 (see the **Scenario assumptions** section).

In addition, because the outlook is more uncertain than usual, this Report presents two alternative scenarios—a *de-escalation scenario* and an *escalation scenario* (see **In Focus: The path of US tariffs remains uncertain**).

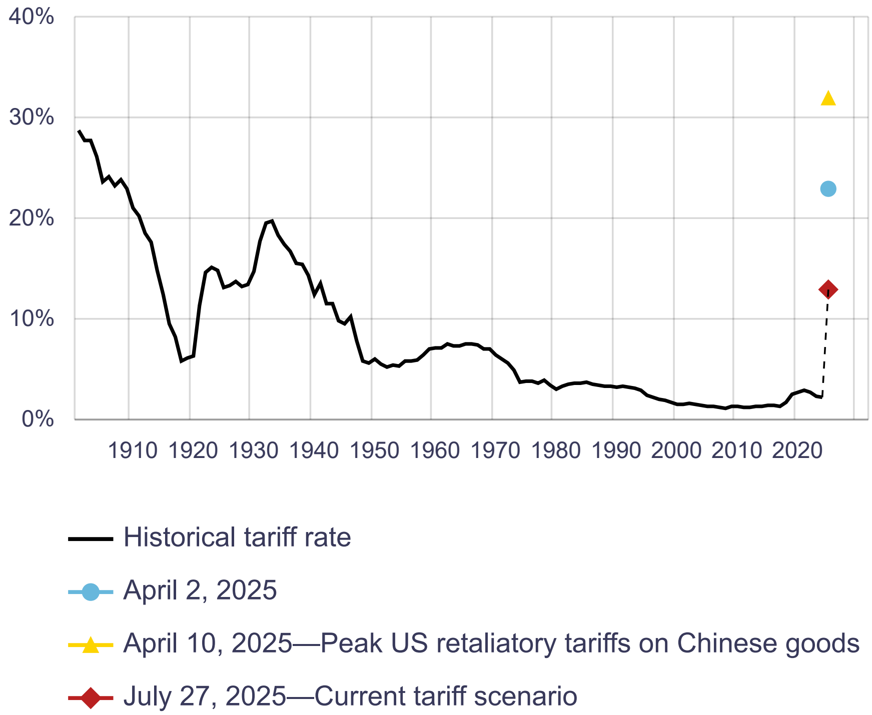
In the *current tariff scenario*, the weighted average US tariff rate stays elevated at 13%—its highest level in decades and more than 10 percentage points above its rate at the start of 2025 (**Chart 20**). Retaliatory actions from other countries are modest, leaving the average tariff on US exports about 1 percentage point higher. Uncertainty related to tariffs is elevated, but its effects dissipate in 2026.

In this scenario:

- Global growth slows to around 2.5% by the end of 2025 before picking up and stabilizing at around 3% over 2026 and 2027.
- Tariffs cause US inflation to rise to about 3% by the end of 2025. It declines thereafter.

Chart 20: The average US tariff rate is the highest it has been in decades

US weighted average tariff rate, annual data



Sources: US International Trade Commission and Bank of Canada calculations
Last data plotted: July 27, 2025

United States

Tariffs and uncertainty are weighing on growth of gross domestic product (GDP). After initially slowing, economic growth picks up in the second half of 2025. However, the trajectory for the level of GDP is permanently lower.

Tariffs have dampened US growth

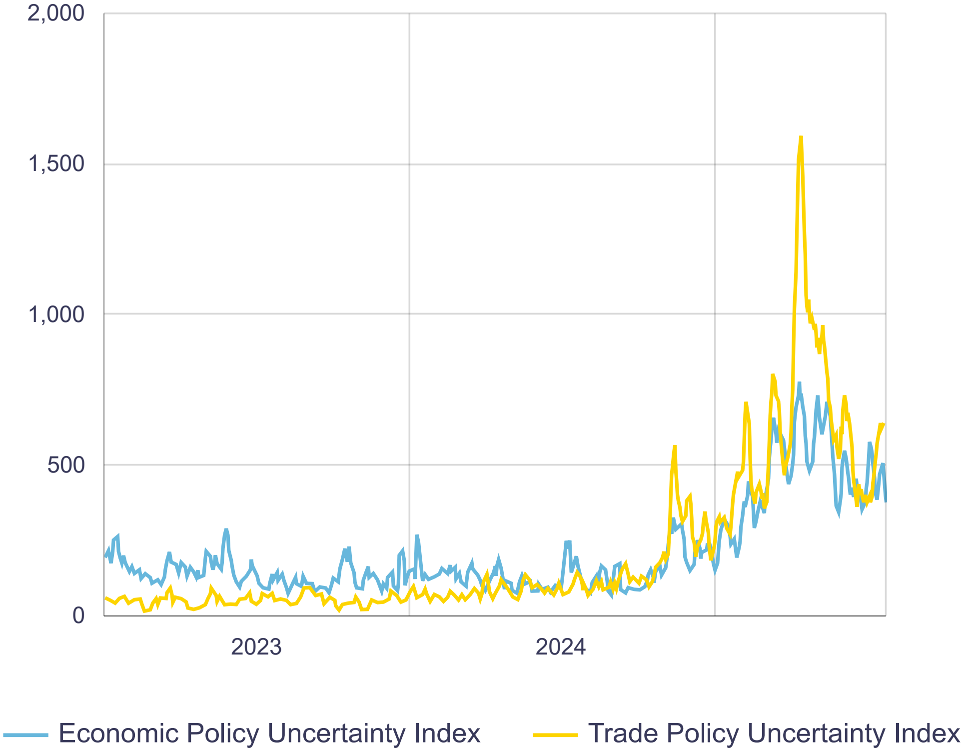
US growth slowed in the first half of 2025 to around 1% on average from around 2¾% in the second half of 2024. Household spending was held back by uncertainty related to trade and other economic policies (**Chart 21**). However, the slowdown was not as severe as it could have been. In particular, domestic demand was relatively resilient, supported by:

- improved business and consumer confidence and a recovery in US equity markets in recent months
- investment related to artificial intelligence (AI)

Other factors that supported GDP growth include robust trend productivity growth and solid job creation. In contrast, changes to immigration policy are weighing on labour supply.

Chart 21: Policy uncertainty remains volatile and above historical levels

US policy uncertainty indexes, index: 2015–19 = 100, 7-day moving average, daily data



Note: The US Trade Policy Uncertainty 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 US Economic Policy Uncertain Index was developed in S. R. Baker, N. Bloom and S. J. Davis, "Measuring Economic Policy Uncertainty," *Quarterly Journal of Economics*, Volume 131, Issue 4 (2016): 1593–1636. Both indexes are available at PolicyUncertainty.com.

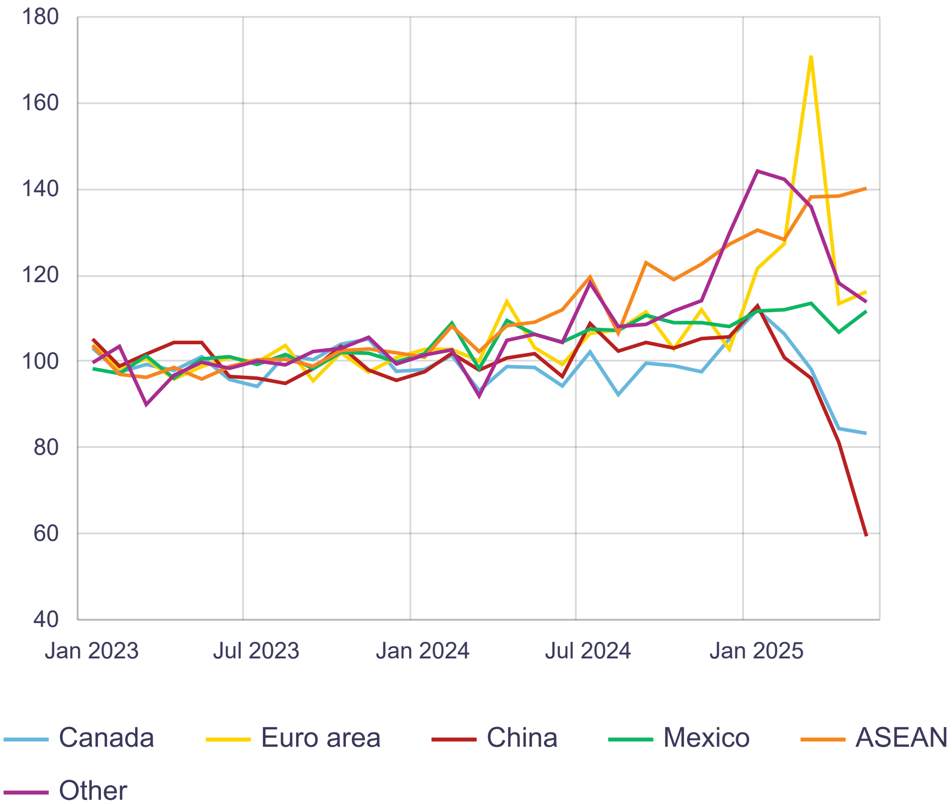
Sources: PolicyUncertainty.com, Caldara et al. and Baker et al. via Haver Analytics and Bank of Canada calculations

Last observations: Economic Policy Uncertainty Index, July 24, 2025; Trade Policy Uncertainty Index, July 21, 2025

Exports and imports were volatile over the first half of 2025 as businesses adjusted the timing of purchases due to tariffs. The United States imported less from China and Canada and more from Europe and countries that are members of the Association of Southeast Asian Nations (ASEAN) (**Chart 22**).

Chart 22: US imports from China and Canada have declined, but imports from other regions have increased

Nominal imports by origin, index: 2023 = 100, seasonally adjusted, monthly data



Note: ASEAN refers to the Association of Southeast Asian Nations.

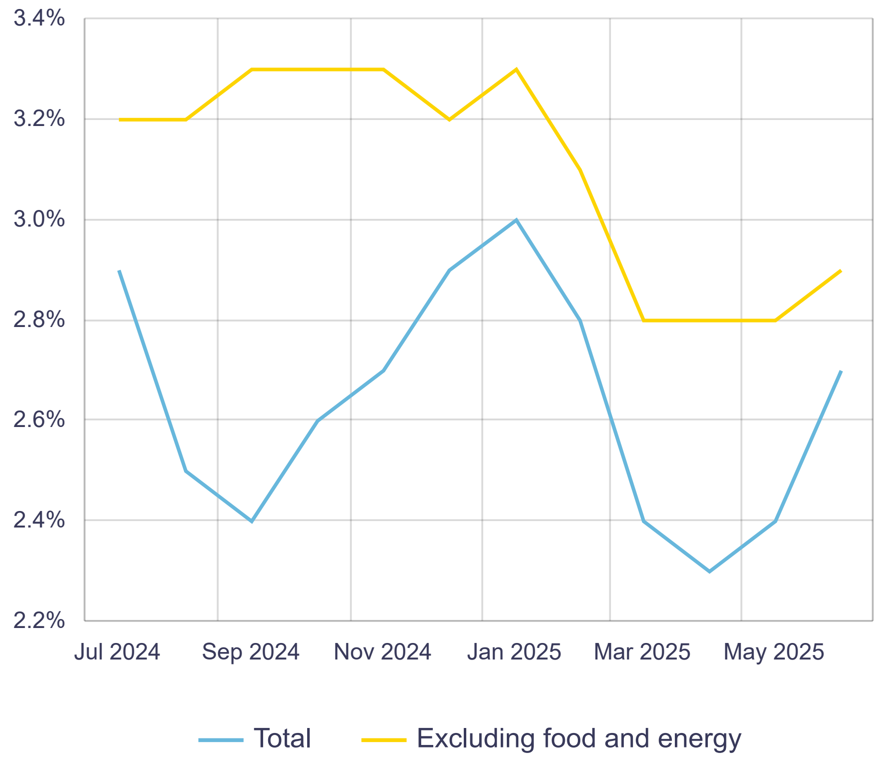
Sources: US Census Bureau via Haver Analytics and Bank of Canada calculations
Last observation: May 2025

Tariffs have started to affect prices

US consumer price index (CPI) inflation remained close to 2.5% in the second quarter of 2025 (**Chart 23**). Inflation in the prices of goods and services excluding food and energy was 2.8%. There is evidence that tariffs are being passed on to consumer prices. For example, data for June showed sizable increases in the prices of tariffed consumer goods, such as household equipment and appliances. In addition, households' and businesses' expectations for inflation continue to be elevated, likely indicating that they anticipate that tariffs will add ongoing upward pressure to prices.

Chart 23: US inflation picked up in June

US consumer price index, year-over-year percentage change, monthly data



Source: US Bureau of Labor Statistics via Haver Analytics
Last observation: June 2025

Wage growth has been solid and, given robust labour productivity growth, remains consistent with the Federal Reserve's 2% inflation target. Interest rates are restraining demand and putting downward pressure on inflation.

Tariffs continue to weigh on US growth

In the scenario, tariffs and uncertainty weigh on US economic activity. The increase in tariffs permanently reduces the path for the level of GDP.

GDP growth picks up modestly to about 2¼% on average in 2026 and 2027.

- Growth in consumption spending slows meaningfully in 2026 because tariff-driven inflation erodes income gains and policy uncertainty weighs on consumer confidence. Expansionary fiscal policy and an easing in monetary policy provide partial offsets. Consumption recovers in 2027, supported by real wage growth and the diminishing effects of uncertainty.
- Business investment growth is restrained by tariffs and ongoing uncertainty. The rollout of AI-related spending provides a boost in the near term.
- Export growth picks up modestly in 2026 and 2027 due to improving global demand and the depreciation of the US dollar. Imports fall sharply in response to tariffs before recovering in 2027.

US inflation picks up and peaks close to 3% at the end of 2025 as the impact of tariffs takes hold and the effect from past declines in the price of oil fades. It then moderates as the impact from tariffs dissipates.

Euro area

Growth in the euro area moderated to near 1% in the first half of 2025 reflecting slower growth in domestic demand, which was partially offset by a strong pull-forward of exports to the United States ahead of tariffs. Despite uncertainty due to US tariffs, demand remained reasonably resilient, aided by past cuts to interest rates.

Inflation in the euro area continued to ease in the first half of 2025. The moderation in inflation reflects:

- falling energy prices
- increasing productivity growth
- slowing wage growth

In the scenario, GDP growth remains weak in the second half of 2025 due to the impacts of US tariffs. Growth picks up in 2026 and 2027 as tariff uncertainty fades and government spending increases, partly due to increased defence spending.

The pick-up in demand brings the euro area economy into balance, and inflation remains close to the European Central Bank’s target of 2%. The trade conflict has only a small effect on inflation in the euro area because it is assumed the region does not impose retaliatory tariffs on the United States.

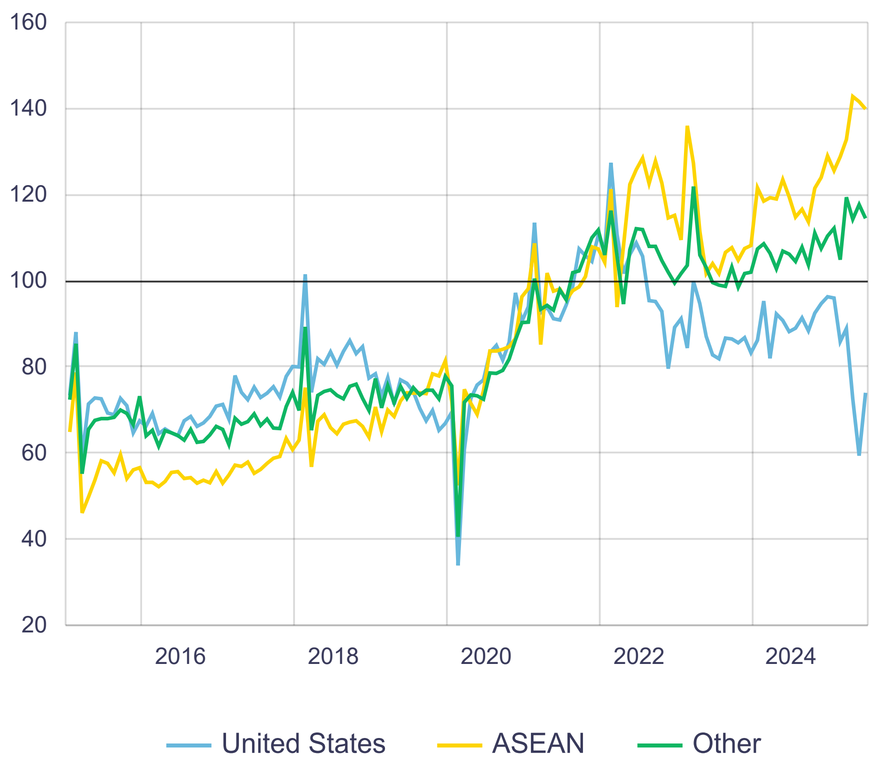
China

Economic growth in China slowed to around 4¾% in the first half of the year. The slowdown was partly due to the trade war between the United States and China, which weighed on investment. Despite the imposition of tariffs, total exports remained broadly unchanged from the elevated levels in 2024.

- Exports to the United States surged at the end of 2024 before falling dramatically in the second quarter of 2025, when the United States temporarily implemented prohibitive tariffs.
- The decrease in exports to the United States was offset by a rise in China's exports to the rest of the world (**Chart 24**), especially to ASEAN member countries. This extends a trend that started after the Regional Comprehensive Economic Partnership came into effect in 2022.[1]

Chart 24: China's exports to the United States and the rest of the world have diverged

Nominal exports by destination in US dollars, index: 2021 = 100, seasonally adjusted, monthly data



Note: ASEAN refers to the Association of Southeast Asian Nations.
Sources: China's General Administration of Customs via Haver Analytics and Bank of Canada calculations
Last observation: June 2025

In the scenario, GDP growth averages just below 4½% in 2026 and 2027. Because of US tariffs, exports contribute less to growth than they have in recent years. Domestic demand strengthens because trade-related uncertainty dissipates, further policy stimulus is provided and stabilization in the property sector leads to a recovery in consumer confidence.

Commodities

Oil prices rose in June to close to US$80 per barrel due to concerns that an escalation of the conflict in the Middle East could disrupt supply. But prices have since dropped back to US$69, slightly above the level at the time of the April Report. The Bank's non-energy commodity price index has been broadly flat because falling prices for industrial metals have been offset by rising gold prices.

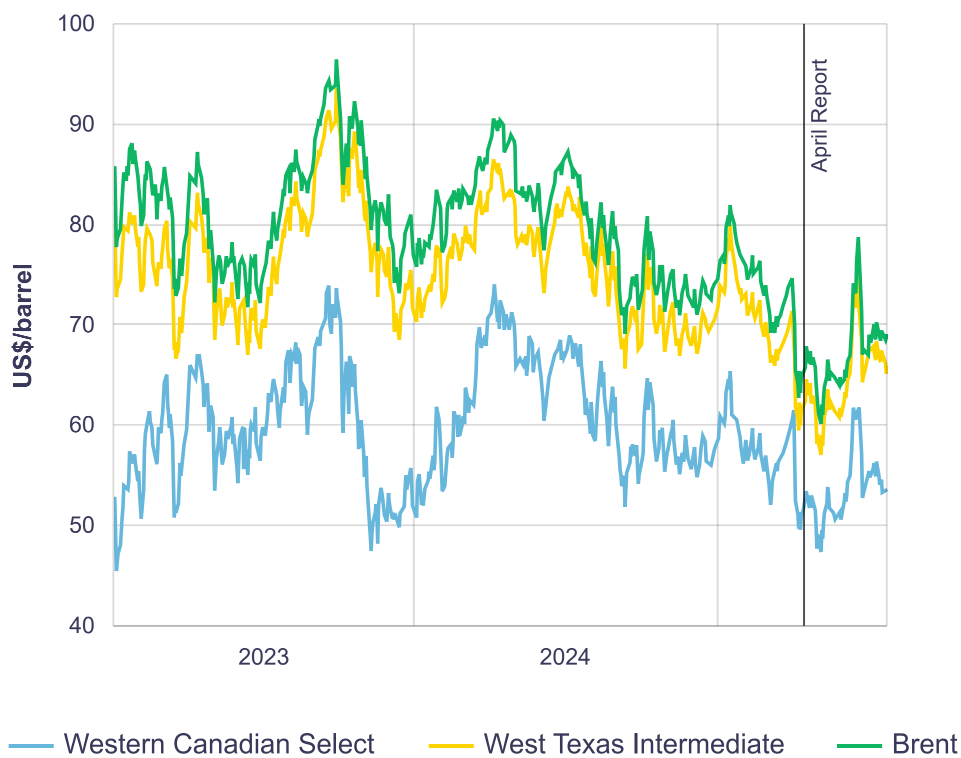
Energy prices have been volatile

Prices for Brent oil have been volatile since the April Report, fluctuating between US$60 and US$80. This is largely the result of the conflict in the Middle East threatening the supply of oil (**Chart 25**). When inflation is accounted for, oil prices are lower than in recent years. This weakness in prices is due to several factors, including:

- strong oil production globally
- concerns that the trade conflict will reduce future demand for oil

Chart 25: Oil prices have been volatile but remain low compared with recent years

Daily data



Sources: NYMEX and Intercontinental Exchange via Haver Analytics and Argus Media
Last observation: July 24, 2025

The spread between West Texas Intermediate and Western Canadian Select has remained steady at around US$10.

Natural gas prices have been supported by strong demand for electricity in the United States. This reflects growing demand because of data processing and extreme weather.

Non-energy commodity prices are flat

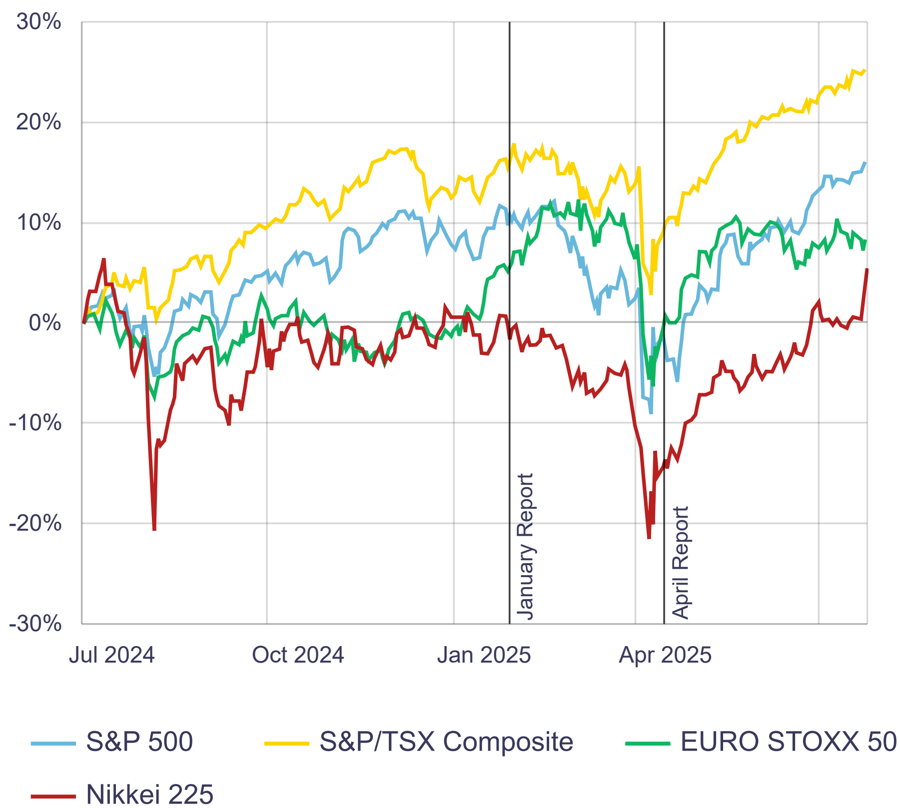
The Bank of Canada's non-energy commodity price index is roughly unchanged since the April Report. US tariffs on steel and aluminum have put downward pressure on international prices for iron, nickel and aluminum. In contrast, gold prices have continued to rise, supported by central bank purchases and by investors seeking a hedge against trade tensions and rising geopolitical uncertainty. After climbing earlier in the year, prices for agricultural products have been broadly stable.

Financial conditions

Since January, financial markets have gone through two distinct phases. Between January and April, the announcement of sweeping new tariffs weakened markets' expectations for growth. Uncertainty and volatility rose, and many asset prices fell. Since April, many asset prices have recovered strongly in response to the markets' assessment that tariffs and their impact will likely be less severe than previously anticipated (**Chart 26**).

Chart 26: Equity markets have recovered and are above their pre-tariff announcement levels

Change in equity indexes since July 1, 2024, daily data



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

From January to April, financial markets were extremely volatile.

- Equity markets fell sharply as risk sentiment deteriorated. The largest declines from peak levels across major markets ranged from 10% to 20%.

- The deterioration in risk sentiment also led to higher credit spreads globally.

During this period, markets also priced in additional monetary policy easing by central banks in response to weaker expectations for growth. This led to a decline in short-term government bond yields, both in Canada and globally.

Since the April Report, these price movements have essentially all reversed.

- In response to signs of economic resilience, global equities have recovered and are now trading at or above their levels at the start of 2025.
- Corporate credit spreads have fully recovered and are in line with their levels at the beginning of 2025. Market volatility is now also more in line with historical averages.

Market assessments of growth outlooks have improved. Therefore, markets have priced in less monetary policy easing and the expected policy interest rate paths have returned closer to the levels they were at in early January. This has led to an increase in short-term government bond yields in Canada and many other countries.

Since early April, long-term government bond yields have also risen in many countries, including Canada. They are now generally higher than observed in January. In part, this reflects higher expected paths for policy rates. As well, some investors have continued to demand a higher term premium for holding long-term government bonds because they are concerned about high public debt and deficits in some countries.

Since the beginning of 2025, the US dollar has depreciated steadily against many other currencies. The Nominal Broad US Dollar Index has declined by about 8% from its peak in early January. The value of the Canadian dollar has strengthened against the US dollar to about 73 cents US but has weakened modestly against a basket of other currencies.

Continuing depreciation of the US dollar appears to be linked to reduced trade-related uncertainty and improved growth outlooks in economies other than the United States. In addition, there is evidence that some investors are hedging their exposures to the US dollar due to concerns about the future direction of US policy and fiscal outlooks.

Endnotes

1. The Regional Comprehensive Economic Partnership is the largest free trade agreement in the world based on the sum of the member countries’ GDPs. Its members include all ASEAN members plus Australia, China, Japan, New Zealand and South Korea.[←]

Risks

Considerable uncertainty surrounds the outlook for inflation. It is extremely difficult to predict how US trade policy will play out and how businesses, households and governments will react to a given level of tariffs. The outlook also faces risks that are not directly related to tariffs.

There are three main types of risks to the outlook for inflation. The first is the level of tariffs. To address this risk, this Report presents a *current tariff scenario* and two alternative scenarios—a *de-escalation scenario* and an *escalation scenario*. When taken together, these scenarios encompass a range of potential outcomes (see the **Outlook** and **Global economy** sections and **In focus: The path of US tariffs remains uncertain**).

The second type is the effect that tariffs will have on the economy. Regardless of how US trade policy evolves, risks remain with respect to how businesses, households and governments will react and adapt. Tariffs, counter-tariffs and the reconfiguration of trade could lead to more persistent cost pressures than captured in the scenarios. This is of particular concern given the recent uptick in underlying inflation.

The third type encompasses risks beyond those related to the trade conflict. This section addresses the second and third types of risks.

Main upside risks to inflation

Trade conflict could put greater upward pressure on inflation

Tariffs could put greater upward pressure on inflation than in the *current tariff scenario*:

- Businesses may pass on a larger share of the cost of tariffs to consumers. This pass-through may also happen at a faster pace.
- Global supply chains could be more severely affected, and the costs of reconfiguring trade could be higher than assessed, raising production costs and import prices.
- Businesses not directly impacted by tariffs may take advantage of the reduced competition and raise their prices.
- Inflation expectations could drift higher, especially given the recent experience of high inflation. Consumers and businesses affected by tariff-related price increases may begin to expect that prices will rise persistently at an elevated pace. This expectation could feed through to wage demands and costs and could influence how businesses set their prices.

These risks would likely be amplified in the *escalation scenario*.

Geopolitical tensions could increase costs

Ongoing geopolitical tensions could lead to unexpected upward pressure on costs. For example, oil prices could rise sharply if tensions in the Middle East increased or Russia's war on Ukraine escalated again. This would drive up fuel prices and cause inflation to rise. If these conflicts were to escalate, global supply chains could also be disrupted.

Main downside risks to inflation

Tariffs could weaken the economy more than expected

The demand for Canadian exports may be weaker than in the *current tariff scenario*. This could arise because:

- global economic activity is weaker
- US tariffs on Canadian goods have a bigger impact than expected

In addition, the weakness in the export sector could spread to the rest of the Canadian economy by more than expected.

With unemployment already at elevated levels and households uncertain about their economic future, spending on housing and other major purchases could be meaningfully softer. This impact could be amplified by the recent weakness in some regional housing markets. Greater excess supply in the Canadian economy would create more downward pressure on inflation.

Global financial conditions could be tighter

Long-term government bond yields could increase in response to the rapid expansion of government debt issuance around the world. This could, in turn, lead to higher borrowing costs for Canadian households and businesses. The result would be weaker domestic demand and greater downward pressure on Canadian inflation because of excess supply.

The path of US tariffs remains uncertain

Because the trade environment remains so uncertain, the path for Canadian growth and inflation is less clear than usual. If the trade conflict were to escalate or de-escalate, those shifts would alter economic outcomes.

Since January, the United States has threatened, imposed, paused and reinstated tariffs on many of its trading partners. It has negotiated agreements with some countries, but many others still face threats of significant new tariffs. These policy shifts have happened quickly and sometimes without warning.

As a result, this Report presents a *current tariff scenario* instead of a base-case projection as well as two alternative scenarios—a *de-escalation scenario* and an *escalation scenario.* When taken together, these scenarios encompass a range of potential outcomes.

The *current tariff scenario* is presented in the **Outlook** and **Global economy** sections. This section presents the *de-escalation* and *escalation* scenarios.

In the *de-escalation scenario*, tariffs are lower than in the *current tariff scenario*, and the degree of trade uncertainty decreases. Compared with the *current tariff scenario*:

- economic growth in Canada rebounds faster once tariffs are reduced and uncertainty eases
- inflation in Canada is lower over most of the scenario horizon, primarily because tariffs are lifted

In the *escalation scenario*, trade negotiations deteriorate, causing tariffs to rise significantly. Compared with the *current tariff scenario*:

- economic growth in Canada slows markedly, with gross domestic product (GDP) about 1.25% lower by the end of the scenario horizon
- inflation rises faster, because of the increase in tariffs, to around 2.5% in 2026, before stabilizing around 2% in 2027

De-escalation scenario

In this scenario, the United States lowers its tariffs against Canada and other countries. In response, China significantly reduces its counter-tariffs, while Canada removes them. Although uncertainty declines somewhat, it persists due to lingering concerns about the stability of US trade policy (see the **Scenario assumptions** section).

Economic growth in Canada rebounds over the second half of 2025. It then eases to a more moderate pace over the rest of the scenario horizon. GDP growth is stronger than in the *current tariff scenario* because the removal of tariffs and reduced uncertainty lead to stronger growth in exports and domestic demand. The level of GDP is roughly 0.5% higher at the end of the scenario horizon.

Consumer price index (CPI) inflation stays below the 2% target until late 2026. It then averages around 2% in 2027. Inflation in 2026 is lower than in the *current tariff scenario* because tariffs are lifted.

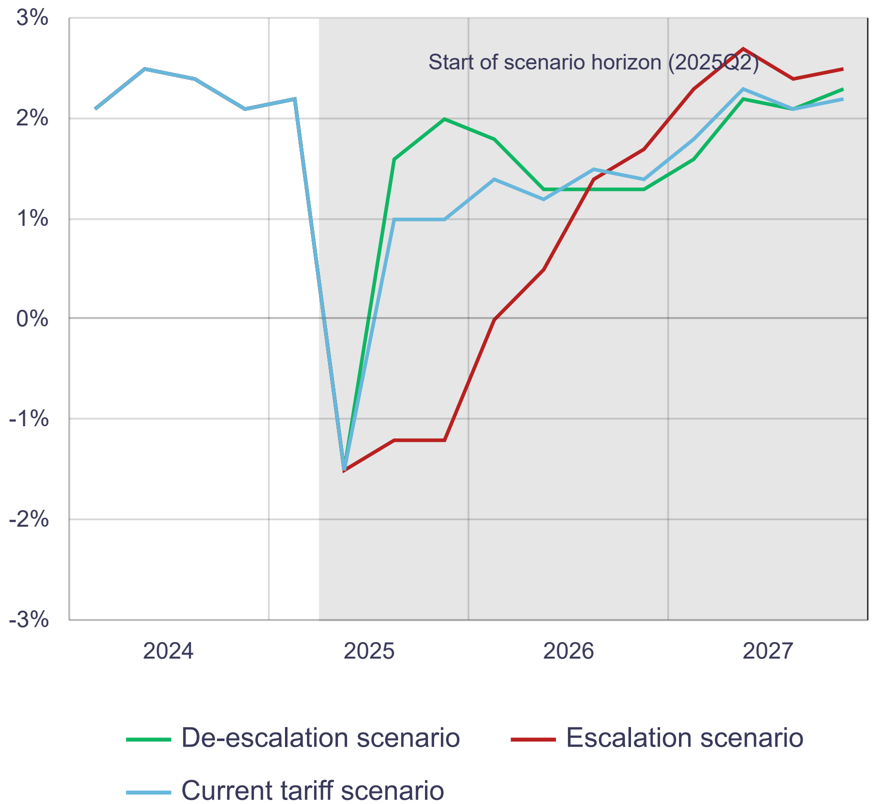
Lower tariffs increase economic activity

GDP in Canada grows around 2% over the second half of 2025 because tariffs are reduced (**Chart 27**). It then averages around 1.7% through the end of 2027.

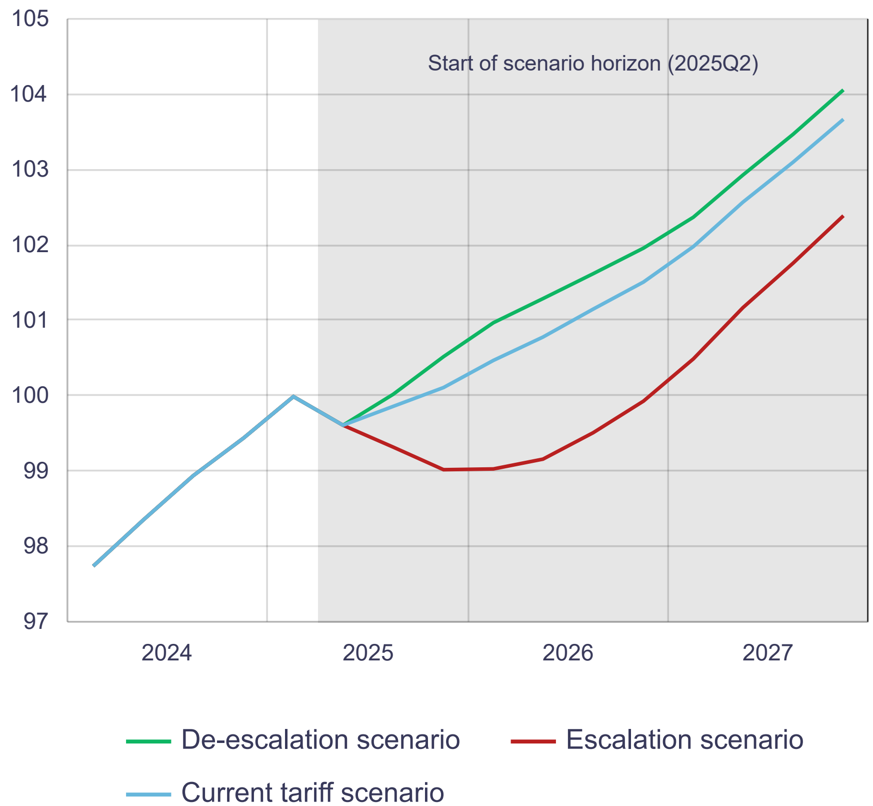
Chart 27: Economic activity picks up in the de-escalation scenario

Quarterly data

a. Quarter-over-quarter percentage change of real GDP at annual rates



b. Level of real GDP, index: 2025Q1 = 100



Sources: Statistics Canada and Bank of Canada calculations and estimates
Last data plotted: 2027Q4

Export growth rebounds as US demand returns

Growth of Canadian exports strengthens significantly into late 2026. This boost can be explained by lower tariffs, which result in increased US demand for Canadian exports. Export growth then moderates as the positive impact from the new trade agreement fades.

Similarly, import growth in Canada rises sharply over roughly the same time frame, fuelled by robust consumer spending and business investment. However, this momentum slows in 2027.

Final domestic demand improves

Growth in final domestic demand rises and remains robust from the second half of 2025 into the first quarter of 2026. Growth in both consumption and residential investment is strong, supported by increases in disposable income. Disposable income rises mostly because of the recovery in export demand, which strengthens labour market conditions. After this initial surge, growth in household spending returns to a more moderate pace.

Businesses become more confident in the strength of demand once tariffs are lifted, leading to a surge in business investment over roughly the next year.

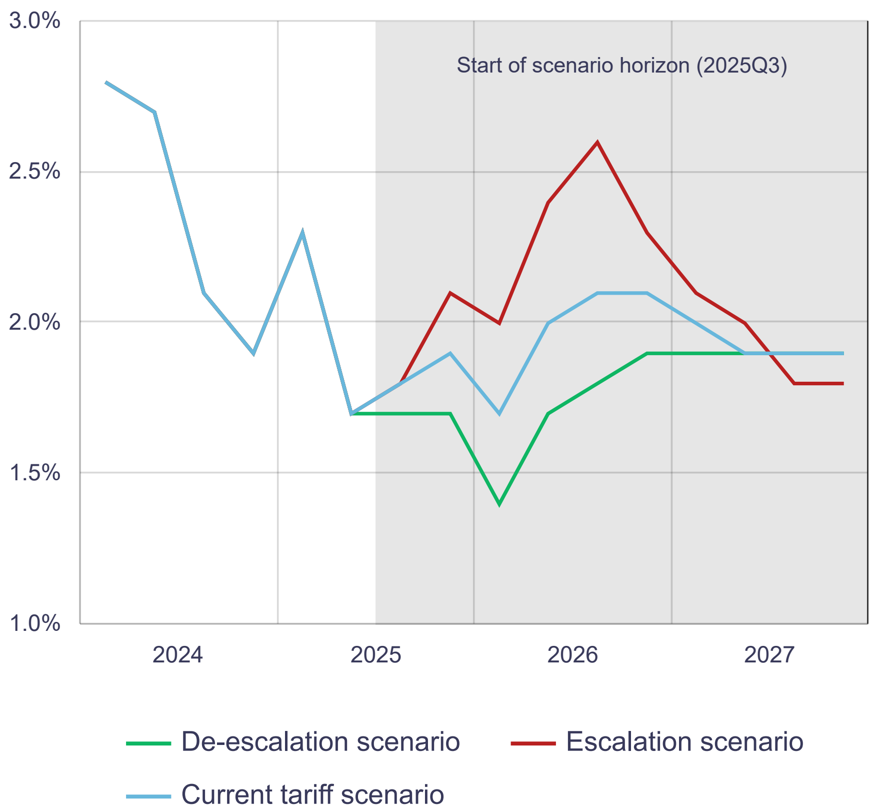
Inflation eases below target

CPI inflation remains below target and declines in the first quarter of 2026 because of the ongoing effect of removing the consumer carbon tax and modest excess supply in the economy. Inflation is lower than in the *current tariff scenario* due to the elimination of tariffs, which more than offsets the impact of stronger growth and higher energy prices.

Inflation starts to rise toward 2% in the middle of 2026 because excess supply is slowly absorbed and the removal of the consumer carbon tax no longer affects inflation (**Chart 28**). In 2027, inflation is close to 2%.

Chart 28: Inflation eases further below target in the de-escalation scenario

Year-over-year percentage change, quarterly data



Sources: Statistics Canada and Bank of Canada calculations and estimates
Last data plotted: 2027Q4

Escalation scenario

In this scenario, the United States implements most of the tariff increases that it has threatened on its global trading partners. However, the increases in tariffs on Canada and Mexico are somewhat less severe than those imposed on other nations. Countries retaliate by further increasing their own tariffs on the United States. Trade uncertainty remains elevated over the scenario horizon (see the **Scenario assumptions** section).

The intensifying trade conflict leads to a recession that lasts for three quarters. Growth begins to recover slowly in 2026 as the economy adjusts to the new global trade regime. The level of GDP is around 1.25% lower than in the *current tariff scenario* at the end of 2027.

CPI inflation peaks at just above 2.5% in the third quarter of 2026 before declining to 2% in 2027. Inflation is higher in 2026 than in the *current tariff scenario* due to increased tariffs, which more than offset slower growth and lower energy prices.

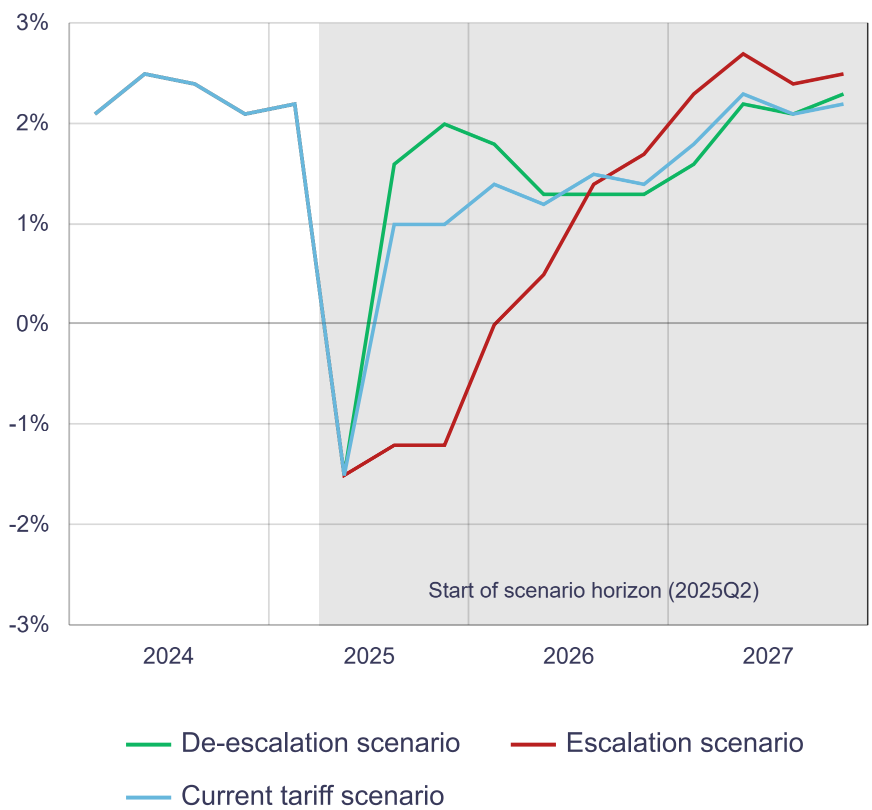
Higher tariffs slow economic activity

GDP contracts over the rest of 2025 as the trade conflict intensifies (**Chart 29**). Growth picks up slowly over the first half of 2026 as the economy adjusts to higher tariffs and then strengthens to an average of around 2%. Because GDP growth is weaker than potential output growth, the output gap widens. Significant excess supply remains at the end of the scenario horizon.

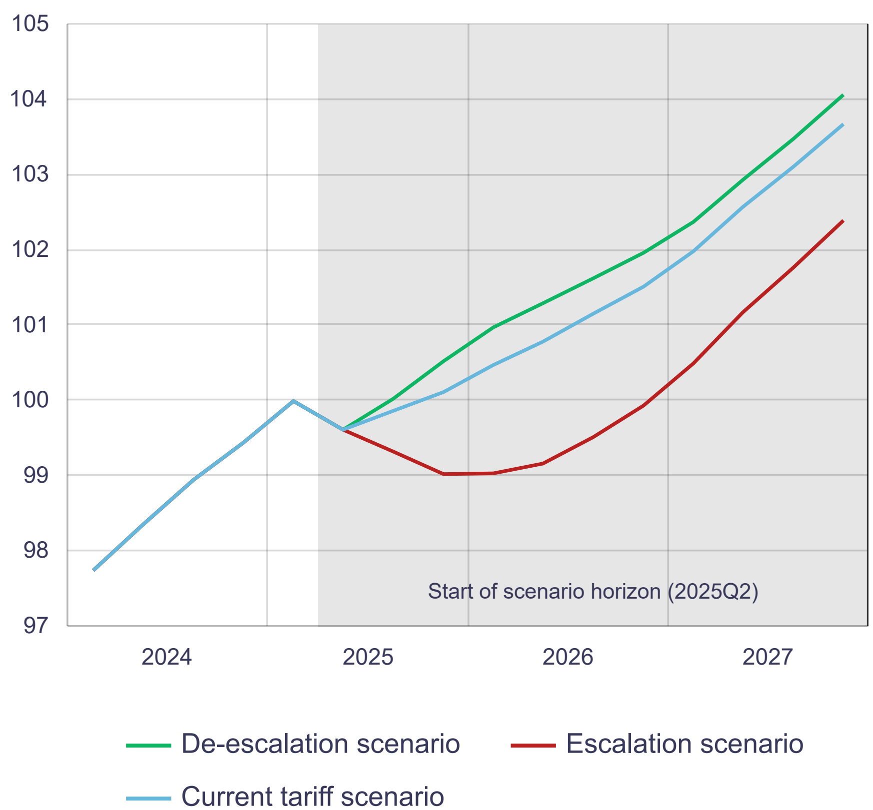
Chart 29: Economic activity is weak in the escalation scenario

Quarterly data

a. Quarter-over-quarter percentage change of real GDP at annual rates



b. Level of real GDP, index: 2025Q1 = 100



Sources: Statistics Canada and Bank of Canada calculations and estimates
Last data plotted: 2027Q4

Tariffs drastically reduce trade

Export growth contracts into the middle of 2026 because of higher US tariffs on Canadian imports and a global economic slowdown. After that, export growth resumes as Canadian exporters adjust to the new trade environment.

Imports decline until the first quarter of 2026 as counter-tariffs and weak business investment reduce demand for inputs from abroad. Import growth then picks up, supported by growth in domestic demand.

Domestic demand moderates due to trade pressures

The intensifying global conflict slows growth in final domestic demand in Canada. Household purchasing power weakens because of deteriorating labour market conditions. Less demand from the United States causes some exporters to reduce hours and lay off workers. Additionally, a decline in Canada’s terms of trade weighs on household incomes, and higher tariffs raise the prices of imports, such as food and consumer goods.

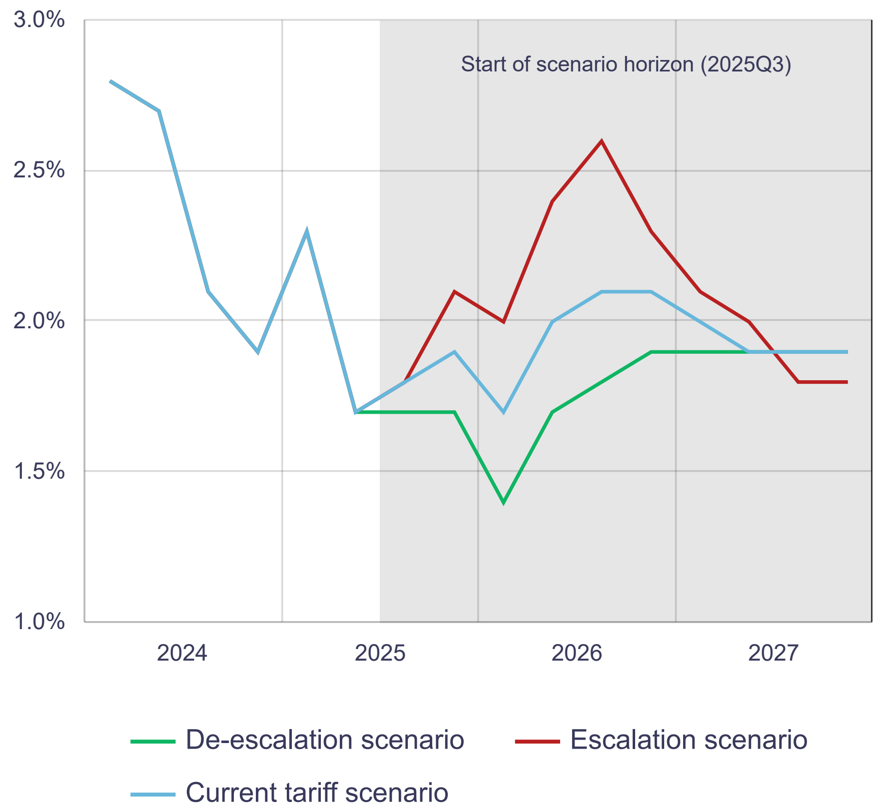
Business investment falls because of higher import costs and reduced demand for capital goods due to lower exports. However, as the trade environment begins to stabilize, investment growth turns positive.

Inflation picks up

Inflation rises to just above 2.5% by the third quarter of 2026 (**Chart 30**). Inflation then falls to around the 2% target in 2027 due to persistent excess supply and the diminishing impact of tariffs on the prices of imported goods. Inflation is higher in 2025 and 2026 than in the *current tariff scenario* because of the effects of higher tariffs, which more than offset the impact of greater excess supply and lower energy prices.

Chart 30: Inflation picks up in the escalation scenario

Year-over-year percentage change, quarterly data



Sources: Statistics Canada and Bank of Canada calculations and estimates
Last data plotted: 2027Q4