Market View
Economics and Strategy

NATIONAL BANK OF CANADA
CAPITAL MARKETS

August 24, 2026 – (Vol. X, No. 100)

Tightening trajectory, meet tariffs

By Taylor Schleich & Ethan Currie

As we outlined this morning (**link**), the U.S.'s imposition of 50% tariffs significantly increases Canada's tariff burden, magnifying downside economic risks (particularly in targeted provinces/industries) and providing a wake-up call to officials in Ottawa. But how will recent developments impact the central bank next door? The situation is fluid but this *Market View* lays out the Bank of Canada's likely near-term reaction, which we can assess with some confidence, and the potential medium term policy path, where the range of outcomes is much wider.

The near term: Until now, the Bank has been comfortably sidelined despite headline inflation running near 3%. Well-contained core price pressures and residual economic slack have together afforded policymaker's patience. We already expected the Bank to hold through year-end, but the tariffs make near-term tightening even less likely.

Markets have largely dismissed rate cuts since the Middle East war began, but the Bank has kept this option open. Even as higher oil prices fuelled rate-hike bets, policymakers maintained that new U.S. trade restrictions could require easing. Admittedly, its rate cut scenario was less explicit in July, but two-sided guidance was nonetheless retained: Governing Council is "*prepared to adjust monetary policy as needed*." Given recent developments, the likelihood of rate cuts has clearly grown.

The Bank will also recognize that the trade landscape can change quickly. With 'off-ramps' available (e.g., the 8-Sep implementation date for Canada's retaliatory tariffs) policymakers should refrain from overreacting next week and stress that several policy paths are possible. This was effectively the Bank's strategy during the first wave of trade threats last year. Although the BoC did cut in March 2025, it was already in an established easing cycle with the policy rate at 3%. More instructive to us was its emphasis on data dependence and its own limitations, a message that may be recycled next week:

> *"Monetary policy cannot offset the impacts of a trade war. What it can and must do is ensure that higher prices do not lead to ongoing inflation. GC will be carefully assessing the timing and strength of both the downward pressures on inflation from a weaker economy and the upward pressures on inflation from higher costs. The Council will also be closely monitoring inflation expectations."*

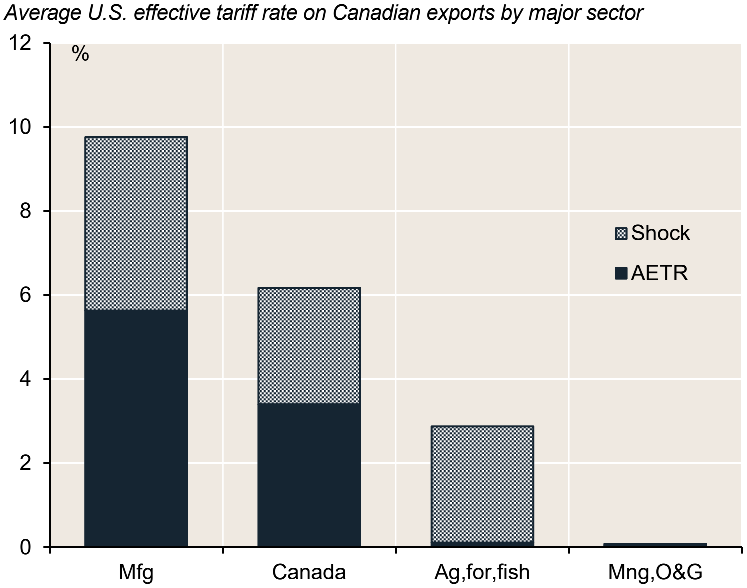
The medium term: If the trade war persists and/or worsens, the Bank's job becomes much harder. These 50% tariffs are relatively narrow, but they could spill over into confidence elsewhere. U.S. retaliation against Canadian countermeasures—as the President threatened today—would broaden the shock. And as our earlier *Special Report* outlined, "pent-up" layoffs could spur 100K+ job cuts. This all clearly argues for easier policy.

At the same time, consumer prices will increase with Canadian counter-tariffs. Alongside elevated energy prices, CPI inflation could move well above the 1-3% control range. The Bank may therefore feel handcuffed even with signs of economic weakness, especially if inflation expectations rise. With fiscal policy stepping in to support affected households and firms, holding steady may be viewed as the best way to balance these opposing forces, at least over the next few meetings.

Bottom Line: In our pre-tariff baseline, we saw the Bank beginning to tighten in Q1:2027. These hikes are now less likely but are not off the table entirely. A swift resolution to this trade conflict may leave the Canadian economy relatively unscathed and keep recent momentum intact. While fragile, this remains our baseline for now, subject to developments over coming weeks. If the trade war persists, however, the Bank of Canada's next move is likely to be a cut with the timing dependent on the evolution of economic and inflation data. The problem is that diagnosing any damage will take time, especially if fiscal policy can temporarily prop up impacted industries. Regardless of direction then, it is difficult to envision the Bank's next move coming before early 2027.

Chart 1: Canada's tariff damage is asymmetric

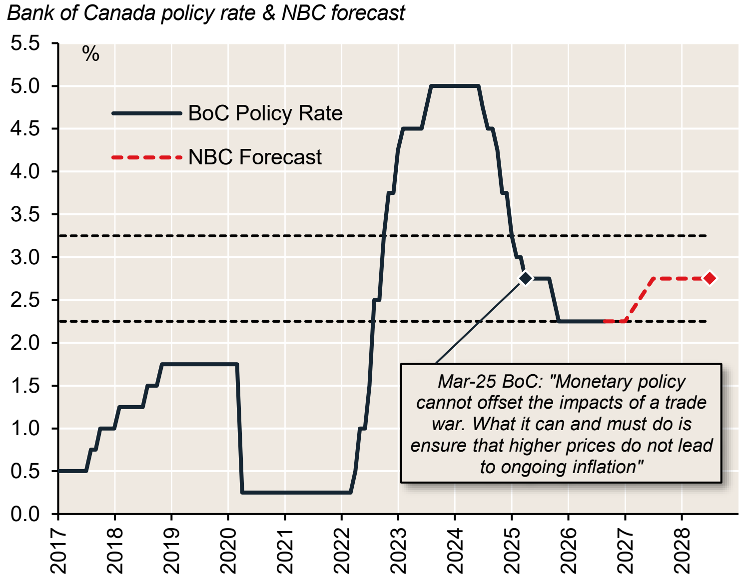
Average U.S. effective tariff rate on Canadian exports by major sector



Source: NBC, U.S. Census, Canadian Trade Date Online | Note: AETR calculated using HS10 & NAICS mapping; latest (Jun-2026) collection rates applied to 2024 trade weights; 'Shock' denotes estimated adjustment to AETR by industry according to new tariff schedule

Chart 2: Before tariffs, BoC was on track for *early* 2027 hikes

Bank of Canada policy rate & NBC forecast



Source: NBC, Bloomberg | Note: Black dotted lines denote BoC estimate of the neutral range (2.25% to 3.25%)

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