BANK OF CANADA
BANQUE DU CANADA

Monetary Policy Framework Renewal: Background Information

November 2026

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Chapter 1: Introduction

The objective of Canada's monetary policy framework is to promote the economic and financial welfare of Canadians by keeping inflation low, stable and predictable. This gives households and businesses confidence to plan for the future. It also supports longer-term investment and fosters sustained job creation and productivity growth—contributing, ultimately, to improving living standards in Canada.

The framework is anchored on a target of 2% inflation, within a 1% to 3% inflation-control range. Inflation is measured by the 12-month rate of change in the total consumer price index (CPI). The framework gives the Bank flexibility over the pace for returning inflation to target, allowing it to respond to economic shocks and uncertainty.

The Bank of Canada and the Government of Canada renew the monetary policy framework agreement every five years to ensure the framework remains effective and relevant. This report summarizes the work done to review the monetary policy framework before its renewal in 2026. The report incorporates the results of research, consultations with Canadians and lessons learned from recent economic challenges, such as the COVID-19 pandemic, the surge in inflation that followed and disruptions to global trade. It also assesses whether the monetary policy framework remains fit to respond to future shocks and challenges.

Backdrop and research questions

In the decades before the pandemic, advanced economies benefited from well-anchored inflation expectations among businesses and households and from globalization—particularly the expansion of global trade, supply chains and competition—which helped dampen price pressures. These economies' monetary policy frameworks were tested mainly by demand shocks, including the negative aggregate demand shock during the 2008–09 global financial crisis. Supply shocks in that period, such as the disruptions to supply after the 2011 Tōhoku earthquake, tended to have short-lived or relatively modest impacts on inflation.

The pandemic triggered one of the worst economic contractions in modern history, leading to unprecedented fiscal and monetary support. As economies around the world reopened in 2020–21, pent-up demand was released far faster than supply could respond. Strong global demand for goods, combined with strained global supply chains, sharply drove up prices for goods in Canada and abroad. In Canada, a combination of low interest rates, pandemic-related income supports, changing housing preferences and surging immigration led to large increases in house prices and shelter costs. As Canada's economy reopened, price pressures broadened from goods to the rest of the economy. Services prices increased, reflecting strong demand and rising wages. Russia's unprovoked invasion of Ukraine in February 2022 further intensified inflationary pressures in energy, food and commodity markets. Canadian inflation peaked at 8.1% in June 2022, the highest level in four decades.

Even as inflation surged, long-term inflation expectations in Canada remained anchored because businesses and households believed inflationary forces would eventually dissipate. The Bank's strong record of keeping inflation close to the 2% target supported this belief. The Bank reinforced the anchoring of expectations by committing to restore

price stability and then undertaking a forceful tightening cycle. The Bank also increased the frequency of its communications to enhance transparency and answer questions Canadians had, thereby fostering public trust. Canadians were told inflation would come down, and they saw it happen. This strengthened the credibility of the Bank and the framework.

Since the pandemic, the economy has been dealing with profound structural changes. The US shift toward protectionism, the reconfiguration of global trade, the rise of artificial intelligence (AI) and other digital technologies, more frequent extreme weather events and heightened geopolitical tensions have all increased uncertainty and macroeconomic volatility (Macklem 2026). Overall, the experience over 2021–26 points to a new reality where both upside and downside inflation risks are heightened. With more frequent and larger supply shocks, greater geopolitical uncertainty and ongoing structural shifts, central banks should be prepared for an economic environment that may no longer be dominated by demand-driven inflation.

The 2026 framework renewal provided the Bank an opportunity to evaluate how well the inflation-targeting framework performed during the past five years of economic turbulence. The renewal helps ensure the framework remains appropriate and robust for a future likely to be characterized by larger and more persistent supply shocks.

If shocks originate more often on the supply side, the result could be upward pressure on prices while economic activity is depressed. This means that monetary policy may increasingly face situations where stabilizing inflation is at odds with stabilizing economic activity. This poses a challenge for policy-makers around how best to use the framework's flexibility to bring inflation back to the target while limiting the impact on output and employment.

Economic developments over the past five years exposed two additional challenges that have implications for how the framework is implemented.

First, amid heightened supply-side volatility, signals from measures of core inflation more frequently diverged from each other and from other indicators of inflationary pressures. This complicated the Bank's work to assess and communicate about overall inflationary pressures during a period of elevated economic uncertainty. This review was an opportunity to re-examine the Bank's measures of core inflation.

Second, persistent mismatches between housing demand and a slowly adjusting supply have intensified since the previous framework renewal in 2021 and are a key concern for Canadians. Furthermore, the measurement of shelter inflation came into focus during the interest rate tightening cycle when increases in mortgage interest costs pushed CPI inflation higher. In this context, the review examines how monetary policy affects housing imbalances and how shelter inflation is measured.

To address these challenges, the review has focused on three groups of questions:

- In a world with more adverse supply shocks affecting inflation dynamics and economic activity, how should monetary policy respond?
- In a world more prone to volatility, how should the Bank assess and communicate about inflation? What measures of core inflation are most robust to structural changes in the economy?

- How does monetary policy affect housing demand and supply, and how is shelter inflation measured and interpreted for policy purposes?

Listening to Canadians

The Bank's decisions and the monetary policy framework that guides those decisions have real impacts on Canadians.

The Bank engaged with a range of stakeholders between 2024 and 2026 to better understand how inflation and monetary policy affect Canadians.[1] These interactions also provided the Bank an opportunity to learn how its framework and communications are perceived and understood. These engagements included:

- consultations with Canadians in 11 cities across all regions of the country, giving the Bank insights into their diverse experiences with inflation and interest rates
- initial consultations with experts to help establish the research agenda
- meetings with experts and other stakeholders across sectors
- a workshop for Bank researchers to receive feedback from external academic economists on the renewal research before it was complete

Overall, the feedback from these engagements underscored that Canadians broadly support inflation targeting and have confidence in the Bank's ability to keep inflation low and stable. However, Canadians are facing cost-of-living pressures and are skeptical of information that does not reflect their lived reality. Participants in community conversations questioned official inflation data and found references to core inflation measures confusing. Many stakeholders suggested the Bank focus more on total CPI inflation in public communications to reinforce trust in and the credibility of the 2% inflation target. Experts indicated they would welcome a dashboard of simple and easily replicable measures of core inflation.

During community conversations, participants were asked to consider the trade-offs for monetary policy in an economy faced with more supply shocks. Canadians did not want prices to rise further, but they viewed higher interest rates as adding to their cost-of-living challenges. When faced with the trade off between bringing down inflation with higher interest rates and supporting the economy with lower interest rates, participants indicated they would be willing to tolerate inflation slightly above 2% if it meant businesses kept running and people stayed employed. More than anything, Canadians are looking for stability and predictability in their financial lives.

Participants in consultations stressed the need for better explanations of the role of monetary policy in housing markets and how housing markets are influenced by various drivers of supply and demand. They also called on the Bank to focus more on the rental market in both its research and its communications.

Key takeaways

The framework allows the Bank to look through transitory inflation and respond when pressures are expected to persist. Research suggests that although the framework is

1 For more details, see Bank of Canada (2026b).

broadly appropriate, its implementation may need to evolve as economic conditions change.

Research indicates that while looking through temporary supply shocks is appropriate in most circumstances, policy action is more likely to be necessary following large or prolonged shocks, when household demand is strong or when impacts spread quickly through production networks. The academic literature also points to the importance of monitoring for second-round effects—such as drifting inflation expectations or a broad pass-through of costs to consumer prices—which may warrant a quicker and more forceful policy response than in the past.

For the framework to work effectively, it must be trusted, and the rationale for decisions must be clearly understood. Feedback from consultations suggests that past efforts to explain the role of core measures of inflation in assessing inflationary pressures may have contributed to some confusion. This suggests that clarifying the role of core inflation measures in setting monetary policy and increasing the focus on total CPI inflation in public communications would help build understanding and enhance the credibility of the framework. Using a range of indicators, including core inflation measures, can help filter out short-term volatility and assess where total CPI inflation is heading over the medium term.

Finally, the Bank's analysis underscores the importance of monitoring developments in housing markets. Monetary policy is only one of many factors shaping housing demand and supply and is not well suited to address any structural supply constraints. Clear communication about both the objectives and the limitations of monetary policy, as well as its focus on the overall rate of inflation, is therefore essential.

Roadmap for the Report

Chapter 2 summarizes Canada's experience with flexible inflation targeting, with a focus on the five years since the previous renewal. **Chapter 3** discusses evidence of structural forces that make the economy more prone to supply shocks, assesses the associated challenges for monetary policy and outlines the Bank's view on the suitability of the inflation-targeting framework for addressing these challenges. **Chapter 4** provides a discussion on assessing and communicating inflation. **Chapter 5** explains the influence of monetary policy on imbalances in housing markets.

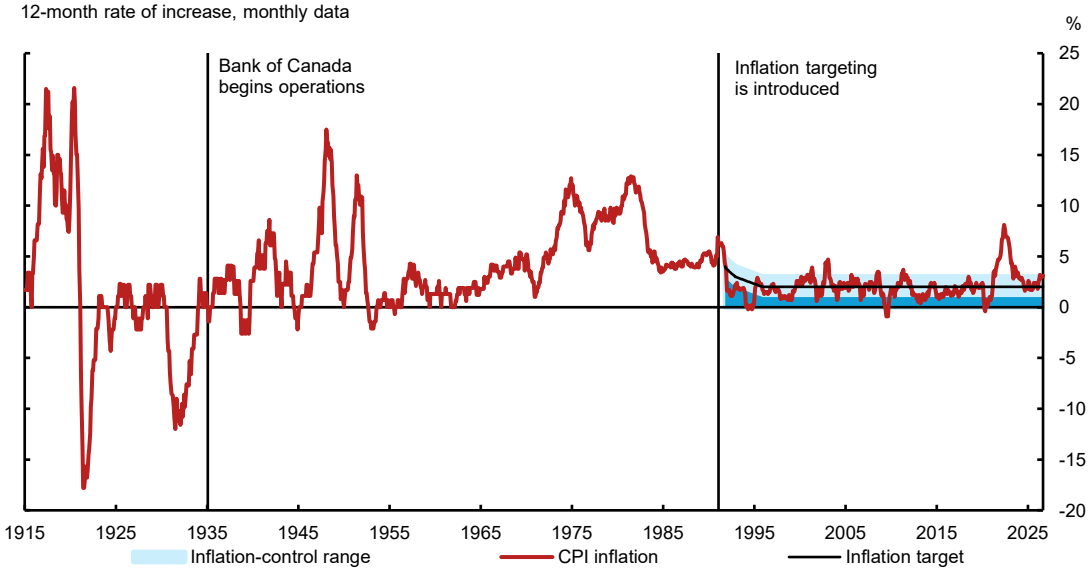
Chapter 2: Canada's experience with inflation targeting

Over the past century, Canada has used several monetary frameworks. These have included the gold standard, the Bretton Woods system of pegged exchange rates, monetary targets and, since the early 1990s, inflation targeting.[2]

Canada first announced an inflation target in February 1991. The initial objective was to bring inflation, as measured by the CPI, down from around 4%–5% to 2% by the end of 1995. The focus then shifted toward maintaining a low, stable and predictable 2% rate of inflation. From the late 1990s to the onset of the COVID-19 pandemic, inflation averaged close to 2% and was substantially less volatile than it had been before the introduction of inflation targeting (**Chart 1**).

Chart 1: The introduction of an inflation target brought inflation down

12-month rate of increase, monthly data



Sources: Statistics Canada and Bank of Canada calculations

Last observation: September 2026

This track record increased the credibility of the inflation-targeting regime. Inflation expectations converged to the 2% target, helping to lower and stabilize interest rates and creating conditions for sustainable economic expansion. This led to more favourable economic outcomes, including lower unemployment and stronger and more stable real economic growth (**Table 1**).

The inflation-targeting framework was an important contributor to this strong overall economic performance. It helped Canadian businesses and households be more confident about the path of inflation, plan more effectively and allocate resources more efficiently. Other factors also played a role. These include the entrenchment of sound fiscal policy, rigorous prudential regulation and supervision, and structural reforms.

2 See Schembri (2008) for an overview of Canada's historical exchange rate and monetary policy regimes.

Canada's flexible exchange rate also helped the economy adjust to shifts in the global economy, allowing the Bank to focus monetary policy on achieving the 2% target.

Table 1: Canada's economic performance before and after inflation targeting

	Average (%)			Standard deviation		
	Jan 1975 to Jan 1991	Feb 1991 to Feb 2020	Mar 2020 to Sep 2026	Jan 1975 to Jan 1991	Feb 1991 to Feb 2020	Mar 2020 to Sep 2026
CPI: 12-month increase	7.1	1.9	3.2	2.9	1.1	2.0
Real GDP growth*	2.7	2.2	2.1	3.8	2.6	12.3
Unemployment rate†	8.9	7.8	6.8	1.7	1.6	1.8
3-month interest rate‡	10.6	3.0	2.4	2.9	2.2	1.8
10-year interest rate§	10.7	4.5	2.6	2.0	2.3	1.1
Share of months with inflation in the 1%–3% inflation-control range	0.0	79.1	46.3			

* This is the annualized quarterly change in the natural logarithm of real GDP for quarters within the period. The table incorporates GDP data through the second quarter of 2026.

† Unemployment data start in January 1976 with the introduction of a new Labour Force Survey.

‡ The *3-month interest rate* is the 3-month treasury bill rate.

§ Due to data availability before June 1982, the *10-year interest rate* is the yield of government bonds with maturations longer than 10 years. Beginning in June 1982, it is the 10-year government bond yield from Statistics Canada.

Sources: Statistics Canada, Canadian Investment Regulatory Organization and Bank of Canada calculations

The post-pandemic surge in inflation tested the framework like never before

The COVID-19 pandemic caused the sharpest economic downturn in a century, followed by a rapid recovery. As the economy rebounded, Canadian inflation rose sharply, eventually hitting a four-decade high.

Inflation initially picked up because of a sharp shift away from high-contact services toward goods and housing as people sought more space to live and work. Global goods consumption was boosted by stimulative fiscal and monetary policies in Canada and other major economies. The strong global demand for goods—combined with pandemic- and weather-related disruptions—strained supply chains and pushed inflation in goods prices sharply higher, both globally and in Canada. Rising global demand and activity also lifted commodity prices, especially oil. Meanwhile, policy stimulus in Canada alongside shifting preferences contributed to a boom in the domestic housing market and rapid increases in house prices.

By early 2022, the Canadian economy had largely recovered. Cost pressures, however, were not proving as transitory as expected. Supply problems—both global and domestic—were more widespread and persistent than anticipated. Russia's unprovoked invasion of Ukraine in February 2022 further intensified inflationary pressures, particularly through energy, food and commodity markets.

At the same time, domestic sources of inflation were also becoming more important. When the Canadian economy fully reopened in early 2022, demand for workers surged much faster than supply. Acute labour shortages contributed to growing wage pressures and pushed up services prices. Unable to keep up with demand for goods and services, businesses started to adjust prices more quickly, passing on higher labour, energy and other input costs to consumers. Moreover, a surge in immigration added to shelter inflation pressures, particularly in rental markets.

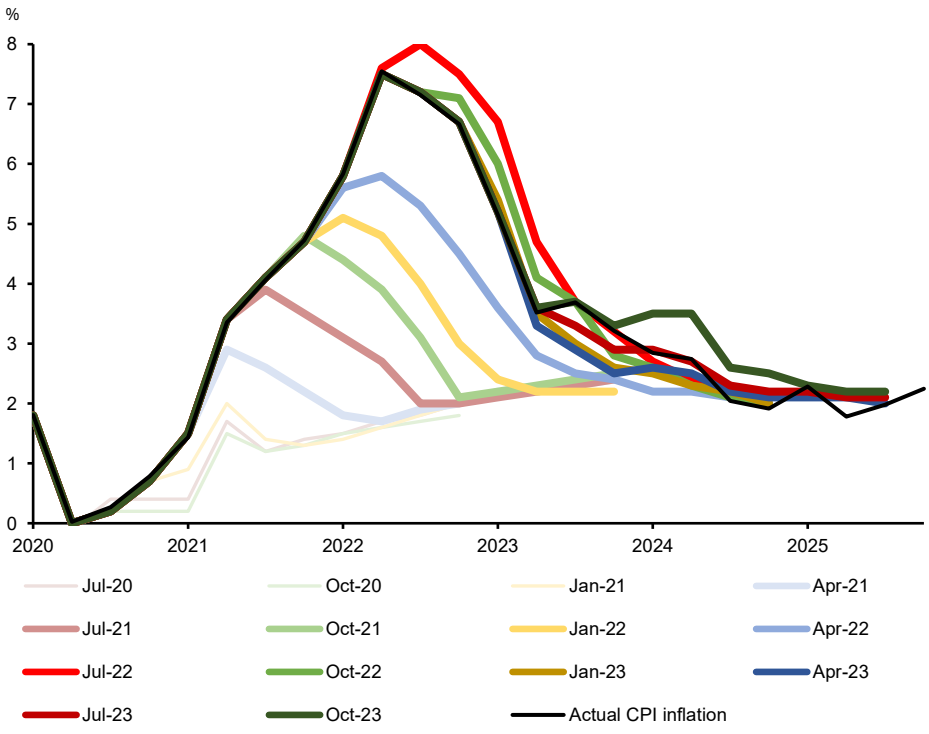
All of this put significant, broad pressure on prices. In June 2022, inflation peaked at 8.1% in Canada.

Despite these challenges, the inflation-targeting framework proved robust

In retrospect, the Bank of Canada, like other central banks, initially underestimated the severity and persistence of the post-pandemic shocks. In 2021, the Bank assessed that the cost pressures from supply bottlenecks would not persist. It also misjudged the speed at which slack was being absorbed in the economy. Unforeseeable events such as the war in Ukraine fuelled inflation further. As a result, the Bank repeatedly revised up its inflation forecasts (**Chart 2**).[3]

Chart 2: The Bank of Canada's forecasts for inflation were revised up continually between January 2021 and July 2022

Year-over-year percentage change, quarterly data



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

Last observation: 2025Q4

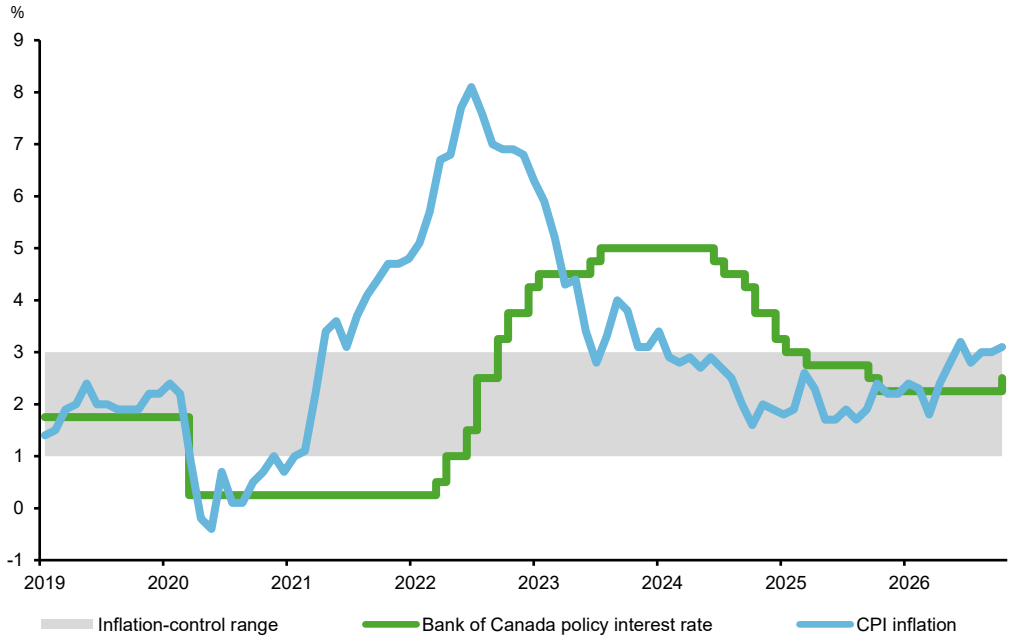
Once it became clear that high inflation was not temporary, the Bank, guided by the framework, responded to bring inflation back down. The Bank ended its extraordinary

3 For more details on the post-pandemic surge in inflation and the Bank's response, see Macklem (2024).

forward guidance about keeping the policy rate at the effective lower bound.[4] It raised the policy interest rate forcefully—425 basis points in less than a year—to cool inflation and keep long-term expectations anchored on the 2% target (**Chart 3**). The adjustment was painful for many Canadians, especially those with a variable-rate mortgage who saw their financing costs increase sharply. But in early 2024, inflation returned to the 1%–3% inflation-control range. Aided in part by strong population gains, which supported growth of gross domestic product (GDP), the Bank's actions helped lower inflation without a recession or major job losses.

Chart 3: The Bank of Canada raised the policy interest rate forcefully in response to persistently high inflation

Monthly and daily data



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

Last observations: policy interrest rate, October 30, 2026; CPI inflation, September 2026

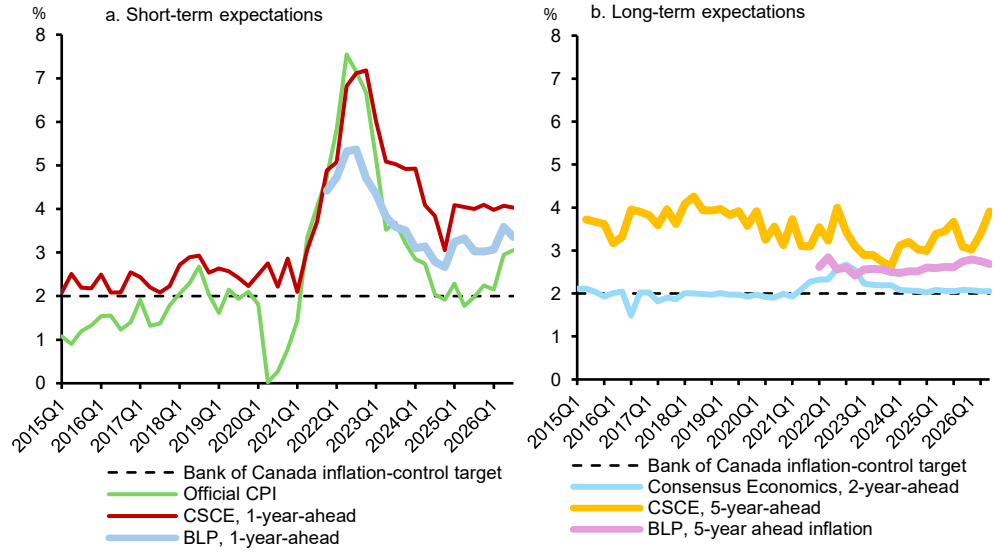
The credibility of the 2% target was the foundation for this success (**Box 1**). Because the Bank had a 30-year track record of keeping inflation close to target, Canadians continued to believe inflation would eventually come down. Even as short-run inflation expectations moved upward with the surge in inflation, long-term inflation expectations remained anchored (**Chart 4**). In its communications, the Bank reaffirmed its commitment to achieve the target, and it raised the policy interest rate forcefully to get inflation back to 2%. This kept long-term inflation expectations anchored and helped lower short-term expectations.

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4 The Bank announced in July 2020 that the policy rate would stay at 0.25% "until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved" (Bank of Canada 2020). It also provided an estimate of the expected timeline, adjusting it as forecasts changed. The Bank officially ended its extraordinary forward guidance in January 2022. For more on the Bank's exceptional policy actions during the pandemic, see Bank of Canada (2025).

Chart 4: Expectations for long-term inflation remained stable even as inflation rose

Year-over-year percentage change, quarterly data



Note: CSCE is the Canadian Survey of Consumer Expectations; BLP is the Business Leaders' Pulse.

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

Last observation: 2026Q3

Box 1

Why the Bank of Canada is not revisiting the 2% inflation target in this review

Every renewal cycle involves conducting research on a range of issues—with new analysis building on past and ongoing research—to determine whether the current monetary policy framework remains the best contribution the Bank of Canada can make to Canada's economic and financial welfare.

Since 1995, the Bank has repeatedly investigated whether 2% is the right inflation target or whether the target should be lower or higher. Each review has concluded that targeting 2% inflation is appropriate. In particular, the potential gains from changing the target level were assessed to be uncertain. On the one hand, setting a higher target level would create more room above the effective lower bound, but any gains would be outweighed by the costly distortions it would cause. Notably, the burden of higher inflation would be borne mostly by households that are generally less able to hedge against inflation risk, such as seniors and low-income households (Bank of Canada 2016; Cao et al. 2021). It could also cause changes in wage- and price-setting behaviour, leading to more persistent inflation. On the other hand, lowering the target would increase the risk that nominal interest rates would reach the effective lower bound more often and remain there longer.

Experience since the previous renewal in 2021 has reinforced these conclusions. The spike in inflation in 2022 highlighted for Canadians how painful high inflation can be. At the same time, Canadians generally understand and support the 2% target, and this familiarity has helped anchor inflation expectations through difficult times.

Moreover, for the previous renewal, Bank staff used model simulations and lab experiments to assess inflation targeting against alternative frameworks, including:[5]

- price-level targeting
- nominal gross domestic product (NGDP)–level targeting
- NGDP-growth targeting
- average inflation targeting
- an employment-inflation dual mandate

Findings from this work show that history-dependent regimes such as price-level targeting or targeting a level of nominal GDP sometimes perform better in theory. But to be effective, they require strong assumptions about how expectations are formed. Further, while some findings suggest that elements of average inflation targeting and a dual mandate have value, neither framework was judged to be better overall than the current approach. Extensive consultations with the public and stakeholders led to a similar finding—most participants favoured flexible inflation targeting over the alternatives. The Bank's research concluded that the current inflation-targeting framework is flexible enough to capture the key benefits of these alternative frameworks without their associated drawbacks.

Overall, the results reinforce that the 2% inflation target is the most robust and reliable anchor for Canada's monetary policy framework.

During the surge in inflation, the Bank increased the frequency of its communications to remain transparent and sustain public trust. Members of Governing Council spoke more often with journalists, and the Bank published more content on its website and social media channels to explain its actions. To better understand how businesses and households were coping, the Bank increased its outreach across Canada and enhanced its surveys, including introducing the Business Leaders' Pulse. These efforts helped reinforce the credibility of the 2% target and made it easier to get inflation under control (**Box 2**).

Box 2

The evolution of monetary policy communications

Since the 2021 renewal of the monetary policy framework, the Bank of Canada has refined how it communicates about monetary policy. In a period marked by high inflation and heightened global uncertainty, the Bank expanded its efforts to communicate clearly and transparently to build public understanding and foster trust.

During the COVID-19 pandemic and the subsequent surge in inflation, the Bank strengthened its focus on explaining the reasons behind its monetary policy decisions. As it introduced and later unwound its pandemic-era extraordinary asset purchase programs and raised the policy interest rate to bring down inflation, it emphasized what it was doing, why and under what conditions policy would change.

As part of its review of exceptional policy actions taken during the pandemic, the Bank drew important lessons about its communications. First, it could have more clearly explained the

5 For more, see Bank of Canada (2021).

purpose of its asset purchase programs and the conditions for ending them to avoid confusion between efforts to stabilize markets and those to provide monetary policy support to the recovery. Second, forward guidance can be misinterpreted if it is communicated without enough detail, leading markets or the public to view it as a stronger commitment than intended.[6]

Over the past five years, the Bank expanded its outreach through new platforms and more frequent engagement. Members of Governing Council visited more communities than in the past and heard from a greater number and broader range of stakeholders, including community groups, labour and Indigenous leaders, and large and small businesses. This widened the range of perspectives and insights informing policy deliberations. At the same time, the Bank expanded its use of digital and social media and emphasized plain-language explanations of its decisions and key economic concepts.

During this period, the Bank introduced new communications products to enhance transparency. In 2023, it began publishing summaries of policy deliberations, providing additional insight into how Governing Council weighs economic evidence and risks when making interest rate decisions.

In 2024, the Bank began holding press conferences after every policy decision, giving journalists regular opportunities to ask questions and allowing the public to hear directly from the Governor and the Senior Deputy Governor. It also introduced a fully digital *Monetary Policy Report* (MPR), with a more user-friendly design and access to the underlying data.

In 2025, inflation was close to the 2% target and the economy was growing, but Canadians faced a new challenge—the shift toward protectionism in the United States. As it had done in the April 2020 MPR at the onset of the pandemic, the Bank temporarily replaced its base-case projection with scenarios in the April and July 2025 MPRs to reflect extreme uncertainty around US trade policy. The Bank also presented scenarios alongside its base-case projections to better convey the risks and uncertainty surrounding the outlook.[7]

Experience since the previous renewal highlights the importance of clearly explaining policy decisions and being open about what the Bank does and does not know, and what it can and cannot do. Looking ahead, as more frequent supply-driven shocks make monetary policy decisions more complex, it will be important to clearly explain the reasons, trade-offs and uncertainties behind decisions. The combination of recent experience and feedback from Canadians points to a need for the Bank to strengthen its outreach across Canada to bring diverse perspectives into the policy-making process and to continue its efforts to explain its approach, analysis and decisions in accessible ways.

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6 For more on the Bank's review of its exceptional policy actions taken during the pandemic, see Bank of Canada (2025).

7 Examples of MPRs that feature scenarios include those in April 2020, July 2022, April 2025 and April 2026. The scenarios related to the COVID-19 pandemic, a wage-price spiral, a US tariff shock and a persistent oil price shock, respectively.

Although inflation returned near the target in late 2024, prices are much higher than they were before the pandemic. Participants in community conversations cited affordability as a top concern and said they feel CPI statistics do not reflect their shopping experience.

However, the Bank's framework does not allow it to target the price level. Even though the idea of falling prices is appealing after a period of high inflation, the Bank would have needed to keep interest rates very high—or to raise them further—to lower prices to their pre-pandemic levels. This policy tightening would have caused large negative impacts on Canadians and the economy. Among these impacts would have been reduced demand, increased unemployment and additional strain on households and businesses, especially mortgage holders (Mendes 2024).

One way to address the affordability challenges Canadians face is to raise the country's level of productivity (Rogers 2025; Vincent 2025). Canada's productivity performance has lagged that of its G7 peers since the 1980s. Increasing productivity would raise real incomes with little or no inflationary pressure, representing real growth in purchasing power.

Insights from the post-pandemic inflation experience

A review of the Bank's pandemic-era monetary policy actions revealed important reasons why the Bank of Canada and other central banks underestimated both the surge in inflation and the persistence of underlying pressures (Bank of Canada 2025). These insights are already informing policy decisions and shaping ongoing research on the design and implementation of monetary policy frameworks in a more shock-prone environment.

Policies can restore demand more easily than supply

The exceptional monetary and fiscal policies enacted after the start of the pandemic were effective in rapidly restoring demand as economies reopened.[8] In contrast, supply was much slower to recover because of supply-chain disruptions, labour shortages and capacity constraints as firms rebuilt workforces, adapted to remote or hybrid work and managed lockdowns and illness-related absences.

Adverse supply shocks are more inflationary when the economy is in excess demand

Before the pandemic, supply shocks—typically energy-related—tended to have temporary effects on inflation that central banks would look through given the time it takes for changes to the policy rate to affect inflation. After the pandemic, successive inflationary supply shocks coincided with a strong recovery in household demand. Because of strong demand, firms were less worried than usual about losing customers and adjusted their prices more often to pass along the rising costs (Vincent 2023).

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8 In addition to lowering the policy rate, the Bank took several exceptional policy actions to support the Canadian economy and financial system in response to the pandemic. For a review of these actions and an assessment of their effectiveness, see Macklem (2024) and Bank of Canada (2025).

Increases in inflation were faster and more widespread than otherwise would have been the case. This experience suggests that supply shocks are more inflationary and harder to accommodate when the economy is overheated—an important consideration in a future where supply shocks may be larger and last longer than in the past.

Sectoral dynamics matter for inflation

Public health measures during the pandemic restricted the demand for services. Consumers used the money not spent on services to instead buy goods. The inflationary impact of excess demand for goods was larger than the disinflationary forces in close-contact services. The Bank's inflation models had a hard time predicting the rise in inflation because they focused on the overall imbalance between demand and supply in the economy. Deeper sectoral analysis that leverages richer sector-specific data and multi-sector models can help the Bank better understand how imbalances between demand and supply affect inflation when the forces driving each diverge dramatically across sectors.

Unprecedented shocks require considering a broader set of inputs and outcomes

The pandemic highlighted the limitations of models that are calibrated on decades dominated by demand shocks with only infrequent and modest supply shocks. Models that are less tied to recent history are needed. This requires developing a richer set of models that can also be used with different sources of data—for example, disaggregated data that can help track shocks through supply channels in the economy. Getting a more complete picture of what is happening in real time requires leveraging complementary information from surveys, field intelligence and novel sources of data.[9] And using scenarios more flexibly to explore the implications of alternative futures helps with decision-making and transparent communication with various stakeholders.

Public trust is crucial

The extended period of inflation above the 2% target tested Canadians' trust in their central bank. Maintaining confidence requires clearly explaining what decisions were made and why, describing the purpose and limits of monetary policy, and acknowledging and openly explaining forecast errors.[10] The Bank took these steps. It also conducted broad outreach activities with businesses and communities across Canada to better understand local economic dynamics and to get early indicators of economic trends.

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9 For example, the Bank introduced the monthly Business Leaders' Pulse survey in 2021 to provide timely and flexible inputs to its monetary policy decision-making.

10 See Kozicki (2025).

Chapter 3: Trade-offs for monetary policy in a shock-prone world

Recent experience suggests that supply-side disturbances and structural shifts are increasingly important sources of economic uncertainty and volatility and have contributed to periods of elevated inflation. The reconfiguration of global trade, the adoption of AI, the increasing frequency of extreme weather events, population aging and heightened geopolitical tensions primarily affect the supply side of the economy. Unlike demand shocks, which tend to move inflation and output in the same direction, supply shocks can put upward pressure on inflation while weighing on output and employment. In a world with more frequent supply shocks, monetary policy may face more frequent trade-offs between stabilizing inflation around the 2% target and supporting economic activity.

This environment leaves the Bank with several questions:

- How should the Bank judge the source and persistence of inflationary shocks?
- How should the Bank decide when to look through supply shocks and when to respond?
- How should the Bank implement the framework in a world marked by heightened volatility and uncertainty?

What we learned

A more volatile and uncertain economy

The Canadian economy has faced multiple, overlapping supply disturbances over the past five years. These disturbances—caused by the pandemic, geopolitical conflicts and trade uncertainty—have been much larger than those in the past. Using the Bank's Terms-of-Trade Economic Model (ToTEM), Booth et al. (2026) show that the degree of variation in supply shocks between 2020 and 2025 was roughly twice as large as that of similar supply shocks before the pandemic.

While inflation is typically driven by demand shocks, supply-side factors are increasingly contributing to inflation fluctuations. The supply-driven inflation rate in Canada is estimated to have been at least twice as high and more volatile over 2020–25 than it was before the pandemic (Kang et al. 2026). Global shocks—such as those in global markets for goods, services and commodities—can partly explain this change. These shocks have a larger supply-side component than domestic disturbances and have more persistent effects on inflation (Forbes, Ha and Kose 2026). The implication for inflation-targeting central banks in open economies like Canada is that monetary policy cannot stabilize both output and inflation at the same time.

In addition to the cyclical shocks facing the economy, a number of structural forces are emerging that could have important implications for inflation dynamics over the medium term. As Kozicki (2026) emphasizes, these forces include the reconfiguration of global trade, the widespread adoption of AI and other digital technologies, population

aging and more frequent extreme weather events. While structural change typically unfolds gradually, the large and rapid adjustments now underway have important implications for inflation and for the trade-off monetary policy faces between stabilizing inflation and supporting output.

Geopolitical tensions and strategic competition have accelerated the reorganization of global supply chains and disrupted trade networks. Shifting production toward domestic suppliers or a narrower set of trading partners could unwind the efficiency gains from globalization, putting upward pressure on costs and prices while reducing output and investment. This would worsen the trade-off between stabilizing inflation and supporting output (Cacciatore and Gnocchi 2026).

A quantitative assessment shows that larger and more frequent tariff shocks—such as those between Canada and the United States—intensify this trade-off (Cacciatore, Hauser and Imura 2026). Cavallo et al. (2026) find that Canada's 2025 counter-tariffs on US imports raised prices of affected goods by about 6%, roughly one-quarter of the 25% tariff. These effects largely disappeared for goods whose counter-tariffs were removed.

Extreme weather events are another source of supply disturbances that can temporarily raise inflation. These events can reduce the size of harvests, disrupt supply chains, displace labour and affect the insurance costs and precautionary savings of households and businesses (Dahlhaus 2026). They can also destroy physical capital, such as infrastructure and housing. Empirical evidence for Canada shows that inflation may respond differently depending on the type of disaster and the underlying economic conditions (Duprey and Fernandes 2025).

The growing adoption of AI is expected to raise potential output through productivity gains and may exert disinflationary pressures over the medium term. However, it could also disrupt labour markets since around one-third of Canadian workers are in occupations highly exposed to AI-driven automation (Mehdi and Morissette 2024). In the near term, AI is likely to affect labour markets through changes in tasks, workflows and skill demands rather than through broad-based job displacement (Brault, Haghighi and Yang 2026; Alexopoulos 2026). Firm-level evidence from Bank surveys indicates that AI adoption in Canada is still at an early stage, with limited near-term effects on employment. More material impacts are expected to emerge gradually over time (Chawla and Arnburg 2026).

Alongside these ongoing structural changes are economic shocks that have both cyclical and structural components, making them difficult to disentangle in real time and complicating assessments of inflationary pressures (Cateau, Coletti and Portelance 2025; Vincent 2026). Movements that appear cyclical may instead reflect longer-lasting shifts. A recent example is the 2025 tariffs imposed by the United States and Canada’s counter-tariffs, which created an inflationary supply shock that raised costs while weakening economic activity. If prolonged, such shocks can weigh on long-run potential output by discouraging business investment, reducing export competitiveness and disrupting established supply chains and trade relationships.

At the same time, trade conflicts can also resemble negative demand shocks, where heightened trade uncertainty and weaker exports may dampen spending and investment, putting downward pressure on output and inflation. Because these demand- and supply-side effects can occur simultaneously and interact with one

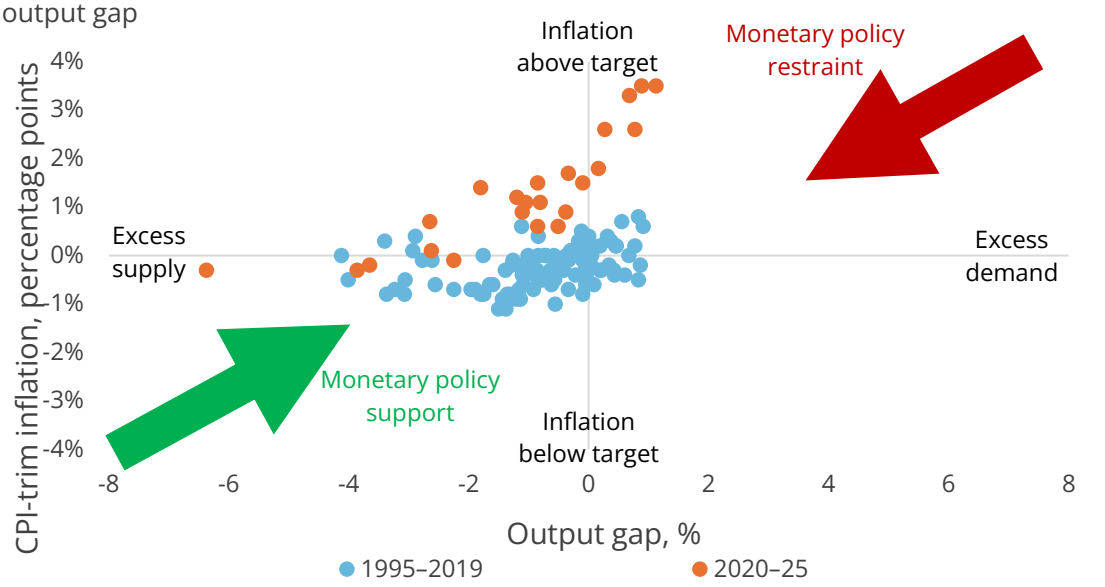
another, it is difficult to identify in real time which forces are dominating. This uncertainty about the drivers of inflation makes economic forecasts less precise and policy trade-offs harder to evaluate.

Monetary policy cannot always stabilize inflation and output at the same time

In the decades before the pandemic, advanced economies benefited from relatively stable supply conditions, anchored inflation expectations and strong globalization forces that helped dampen price pressures. Monetary policy frameworks mostly faced demand fluctuations that did not create a meaningful trade-off between controlling inflation and maintaining economic activity close to the economy's potential. In Canada, when strong demand pushes inflation above the 2% target, raising interest rates cools both an overheated economy and inflation (**Chart 5**, downward arrow). Similarly, when inflation is below target in a weak economy, cutting rates boosts both demand and prices (**Chart 5**, upward arrow).

Chart 5: The Canadian economy is seeing excess supply with inflation above the 2% target more often than it used to

Deviation of inflation from the 2% target and unrevised, historical estimates of the output gap



Note: This chart is based on Chart 2 in S. Kozicki, "Canada's monetary policy framework in a world of supply-driven trade-offs" (remarks delivered at the Norges Bank Monetary Policy Mandate Conference, Oslo, Norway, March 2, 2026). For each quarter, the value plotted is the estimate of the output gap published when the national accounts data for that quarter first become available. Estimates up to 2011Q2 come from Bank of Canada staff projections, and those after 2011Q3 are from the Bank's quarterly *Monetary Policy Report*. CPI-trim is a measure of core inflation that excludes CPI components whose rates of change in a given month are located in the tails of the distribution of price changes. It also excludes the effect of indirect taxes. The values plotted reflect the data abailable at the time of piblication of the January 2026 report.
Sources: Statistics Canada and Bank of Canada calculations
Last observation: Real-time estimates 1995–2019, 2019Q4; real-time estimates 2020–25, 2025Q3.

However, supply-side disturbances can push prices and output in *opposite* directions, creating a difficult trade-off between returning inflation to target quickly and avoiding excessive volatility in output and employment. Before 2020, high inflation was rarely seen alongside a weak economy. But since the beginning of the pandemic, Canada has more frequently faced inflation above target even when the economy was judged to be in excess supply (**Chart 5**). These cases are associated with adverse supply shocks such as

pandemic-related disruptions to global supply chains and sharp increases in global energy and goods prices. Such shocks drive up inflation as growth falters.

In these situations, the Bank faces an uncomfortable choice. Raising rates puts downward pressure on inflation but weakens the economy further, while lowering rates supports growth but pushes inflation higher. This is the fundamental policy trade-off that inflationary supply shocks create for an inflation-targeting central bank. Canadians the Bank consulted broadly understood this policy trade-off and recognized the limits of monetary policy in the face of structural shifts and supply disruptions.

Typically, central banks do not react to every uptick in inflation caused by supply disruptions. The standard approach is to look through a supply shock when it is expected to have only small or temporary effects on inflation. In practice, this means holding the policy interest rate steady and waiting for the effects of the shock to fade. If a supply-driven price spike is moderate and short-lived—for example, a brief disruption that temporarily restricts oil supply and raises prices—inflation should naturally settle back to target once the supply issue is resolved. In such cases, raising rates would unnecessarily slow the economy while doing little to improve the longer-run inflation outlook. By not reacting to temporary spikes in inflation, monetary policy can avoid introducing unnecessary volatility into interest rates, output and employment growth.

Empirical research, both internal and external to the Bank, indicates that central banks in advanced economies, including Canada, largely followed this approach in the years before the pandemic (Kang et al. 2026). Episodes of supply-driven inflation in this period were generally modest and short-lived, allowing central banks with a high degree of credibility to look through them without jeopardizing well-anchored inflation expectations (Nakamura, Riblier and Steinsson 2025). Analysis suggests that disturbances from deglobalization and extreme weather events are unlikely to push inflation out of the 1%–3% inflation-control range. Therefore, the current inflation-targeting framework provides some scope to look through supply shocks, provided they are not large, persistent or destabilizing to expectations (Cacciatore and Gnocchi 2026).

Consultations with the public highlighted what Canadians value most in practice. Many participants expressed a strong preference for predictability of interest rate changes so that they could better manage their household finances. Stakeholder groups also encouraged the Bank to communicate policy trade-offs, as well as when and why the Bank decides to look through certain shocks. Greater transparency around these decisions would help to maintain trust in the framework.

Policy implications

When shocks are driven by demand, the policy implications remain unchanged: a countercyclical interest rate policy can stabilize both inflation and the output gap. By contrast, policy trade-offs will arise more often in a world with more frequent and persistent supply shocks. Inflation targeting allows the Bank to look through clearly temporary inflationary pressures and to respond, if necessary, when inflation risks become persistent. However, deciding in real time whether to look through or respond is challenging. It is hard to forecast how long a supply shock will last or whether it will be amplified by subsequent disruptions.

Experience over the past five years has taught central bankers worldwide that looking through an inflationary supply shock that is initially thought to be temporary may quickly raise inflationary risks. In some economic conditions, inflation may not reverse in the near term, and, in rare cases, it can surge to high levels. As a result, while the Bank may initially look through supply-driven inflation, policy-makers would need to closely monitor developments through real-time data and consider a wide range of possible inflation scenarios when determining policy. If inflation risks intensify, the Bank may have to respond quickly to bring inflation back to the target. Such an action would reduce the need for further increases in interest rates should the inflation outlook worsen.

When the Bank should not look through supply shocks

There are several circumstances under which tightening monetary policy is a more appropriate response than looking through an adverse supply shock.

- **The supply shock is especially large, and its impacts are potentially both long-lasting and broad-based**: In such cases, ignoring the shock may allow inflation to remain above target over the medium term or beyond, which could undermine confidence in the Bank's ability to return inflation to target.

  Simulations using ToTEM show that increasing the standard deviation of supply shocks from their pre-pandemic to post-pandemic levels increases the likelihood of core inflation being outside the 1%–3% inflation-control range by more than a factor of three. It also raises the risk of a recession (Booth et al. 2026). Bank research using controlled macroeconomic experiments in the laboratory demonstrates that looking through a big, persistent cost-push shock can lead to prolonged inflation, whereas responding with tighter policy and effective communications would curb inflation sooner (Kostyshyna, Petersen and Yang 2026).

  For large shocks whose persistence is uncertain, it may be prudent to respond because the benefits of acting quickly if the shock turns out to be persistent outweigh the costs of having to reverse course (Murchison 2026). The combination of a supply shock's size and persistence helps determine whether monetary tightening is needed. Small one-off shocks could be tolerated, but large or lingering shocks would likely warrant a policy response.

  Some shocks are localized, such as a drought affecting a single crop. But others, such as a sustained disruption in global oil supply, may cascade through production networks, raising costs across multiple sectors. Broad cost pressures mean price increases show up in everything from raw materials to retail goods, making higher inflation pervasive and long-lasting (Ghassibe and Nakov 2025). In these cases, the Bank may need to intervene to prevent a generalized surge in prices.
- **The economy is strong at the time of the shock**: During the post-pandemic recovery, for example, demand outpaced supply. This amplified the inflationary effects of global commodity shocks and contributed to the persistence of inflation (Mendes 2024). When the economy is running hot—such as when household spending is robust and the job market is tight—businesses are more likely to pass on to consumers the cost increases associated with adverse supply shocks (Murchison 2025). Higher pass-through translates into persistently higher inflation, which would require a stronger policy response. For example, during periods of high inflation,

businesses often start raising prices more frequently or passing along cost increases more easily than usual (Vincent 2023; Cavallo and Kryvtsov 2024). Such behaviour can indicate inflation dynamics are speeding up.

- **Inflation expectations start to drift upward**: If households or businesses stop expecting inflation to return to low levels in the medium term, the risk of second-round effects—through higher labour costs or more frequent price adjustments—increases significantly. Even temporary supply shocks can lead to persistent inflation when people expect the future to look like the recent past. In such scenarios, looking through the supply shock could amplify its persistence because higher inflation becomes ingrained in expectations. This underscores the importance of decisively adjusting the policy interest rate to re-anchor expectations (Beaudry, Carter and Lahiri 2023).

Assessing how much policy tightening is needed to return inflation to target without imposing unnecessary costs on the economy can help the Bank determine when to stop looking through a supply shock. The flexibility of the inflation-targeting framework allows the Bank to adjust the pace and path of the policy interest rate depending on the nature of the shock and the balance of risks (Macklem 2025). Bringing inflation back to target after an inflationary supply shock may require choosing a gradual return path that weighs the risk of inflation becoming entrenched against the adverse effects on output and employment. Participants in community conversations held by the Bank expressed a preference for predictability in the path for interest rates.

In other circumstances, the appropriate response may be more forceful, reflecting the state of the economy and the way inflationary pressures are emerging. In operational terms, this means raising the policy interest rate quickly to reach the level needed to bring inflation under control. Such an approach is particularly relevant in an environment of excess demand, when stabilizing inflation often implies a smaller reduction in output than when the economy is weak (Blanco et al. 2024; Karadi et al. 2025). This allows monetary policy to bring inflation down faster and at a lower cost (**Box 3**). Canada's experience over 2021–22 provides a clear example of this type of response. Faced with rapidly rising inflation and strong demand, the Bank raised the policy interest rate in larger steps than usual—including increases of 75 and 100 basis points—to bring inflation down relatively quickly without significantly raising the unemployment rate.

Acting decisively early can reduce the overall cost of an inflationary risk. A timely response lowers the risk that inflation becomes embedded in expectations and wage- and price-setting behaviours, which would otherwise likely require more aggressive tightening later—potentially when inflation is even higher. In this way, a more forceful early response can limit the need for larger subsequent rate hikes and help contain employment losses (Bank for International Settlements 2022).

Determining the appropriate degree of monetary policy restraint remains a delicate balance. Policy-makers must weigh the risks of doing too much against those of doing too little in an environment of incomplete information and heightened uncertainty. Excessive tightening can unnecessarily weaken growth or push inflation below target, while insufficient action risks entrenching elevated inflation. Acting too soon may also impose avoidable costs if the shock proves transitory. These decisions are becoming

more challenging in an environment of more frequent, complex and overlapping shocks. This underscores the need for rich models, a broad range of data and reliable real-time indicators to detect persistent inflationary pressures, as well as the importance of clear communication about the flexibility embedded in the framework.

Box 3

The size of the policy response to a supply shock depends on the state of the economy

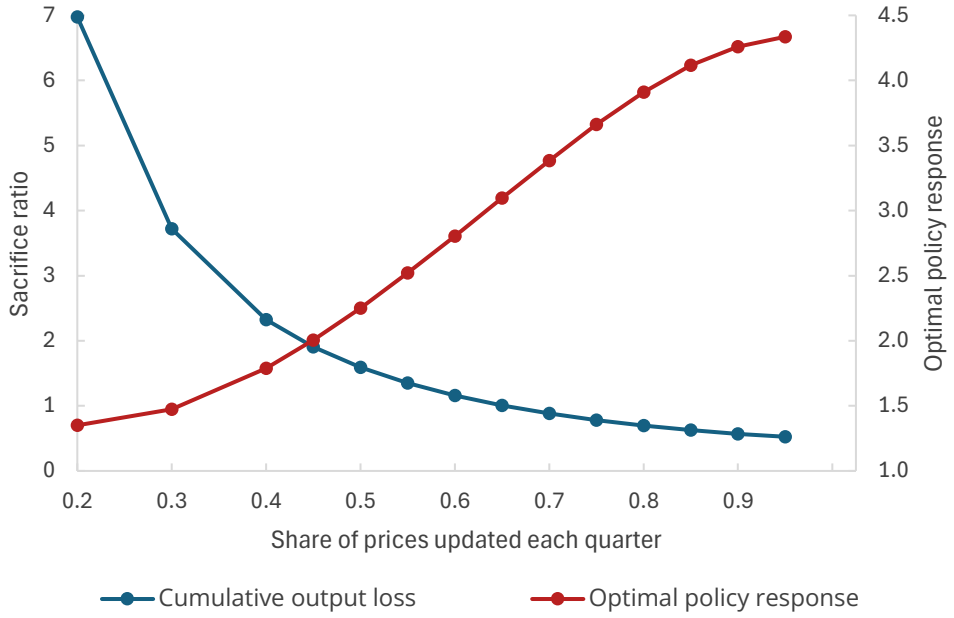
Inflationary supply shocks force central banks to weigh the benefits of reducing inflation against the cost to the real economy of higher interest rates, generally resulting in a less forceful policy response. This cost depends on how sensitive inflation is to economic slack—the imbalance between demand and supply in the economy, often referred to as the slope of the Phillips curve.

When inflation is very responsive to changes in economic slack, central banks can reduce inflation without causing a large decline in output or employment. The degree of responsiveness primarily reflects businesses' pricing behaviour, which varies with the level of inflation and the strength of demand (Blanco et al. 2024; Murchison 2025). In particular, elevated inflation can lead businesses to adjust prices more frequently. In such an environment, the costs to output and employment of reducing inflation are lower (Karadi et al. 2025). This improves the trade-off, allowing monetary policy to respond more aggressively to stabilize inflation.

Murchison (2026) illustrates these insights in a model of the Canadian economy. During periods in which businesses update prices more frequently, inflation becomes more sensitive to changes in costs or demand and therefore more sensitive to monetary policy. This implies that the cost to output required to reduce inflation—also known as the sacrifice ratio—is smaller. **Chart 3-A** illustrates the relationship between the frequency of price changes and the sacrifice ratio. The cumulative output loss required to reduce inflation by 1 percentage point becomes smaller as the share of prices updated each period increases. As a result, the optimal policy response for a flexible inflation-targeting central bank to a negative supply shock is larger relative to the increase in inflation. In terms of a policy rule, this would correspond to a higher weight on deviations of inflation from the target. In the limiting case where the sacrifice ratio is zero, policy could focus exclusively on reducing inflation, since there would be no output cost associated with higher interest rates.

Chart 3-A: Greater price flexibility is associated with a lower cost of bringing down inflation

Output loss and optimal policy vs. price flexibility



Note: This chart is based on Figure 4 from Murchison (2026). *Optimal policy response* is calculated by dividing the average increase in the policy interest rate over two years by the average increase in inflation following a persistent, adverse foreign supply shock.

Improving analyses and broadening data

With supply-side movements likely to increase, closely monitoring indicators of cost pressures is essential. Continued improvements in data monitoring and analytical tools can help identify whether shocks are demand- or supply-driven, persistent or transitory. This would allow the Bank to adjust interest rates at the right time and with the appropriate intensity.

A top priority for the Bank has been upgrading its core economic models to better capture supply-side dynamics while preserving the models' ability to capture the effects of demand shocks. The Bank is now developing the next-generation projection model, its fourth-generation workhorse model. The model, known as Prima, is designed to provide a richer representation of the supply side and sectoral structure of the Canadian economy, with clearer links to inflation. The aim is to move beyond the limitations of earlier models, which tended to assume fairly stable supply conditions and which could not fully account for the post-pandemic surge in inflation. With Prima, the Bank will be better equipped to diagnose whether inflation is coming from a sector-specific bottleneck, broad input-cost pressures or strengthening demand. It will also be better able to forecast how those factors are likely to evolve (**Box 4**).

Box 4

Prima: A new generation in the Bank of Canada's projection modelling

The Prima projection model is the fourth generation of the Bank of Canada's core projection framework (Coletti et al. 2026). It reflects a deliberate shift toward a richer representation of both the supply side of the economy and inflation dynamics, alongside a more explicit risk management perspective (Coletti 2023).

At its core, Prima links inflation to the outcome of sectoral cost pressures and their transmission through the economy. Rather than relying on a single reduced-form Phillips curve based on an aggregate output gap, the model determines inflation through sector-specific New Keynesian Phillips curves for the main components of the consumer price index: energy, food, goods excluding food and energy, shelter and services excluding shelter. In each sector, inflation depends on sectoral real marginal costs—capturing wages, financing conditions and input costs from other sectors—as well as businesses' ability to pass these costs through to prices under prevailing demand conditions.

A key feature of Prima is its multi-sector production network, which governs how cost shocks propagate. Input–output linkages connect upstream producers to downstream prices, allowing increases in wages, energy or import costs to move gradually through the economy. Data from the Producer Price Index are used to empirically anchor these linkages. This generates a pipeline for inflation in which upstream pressures feed into consumer prices with realistic lags rather than appearing immediately in total inflation. Supported by recent Bank research using granular price data, this pipeline mechanism improves real-time inflation projections and helps identify where inflationary pressures are building and should be monitored most closely.

These structural features give rise to more realistic inflation dynamics. Persistence emerges endogenously from sectoral interactions, production linkages and price rigidities. Businesses adjust their prices gradually, and the extent of cost pass-through varies with economic conditions. When consumption demand is strong, businesses can more easily incorporate cost increases into prices. When demand is weaker, pass-through is more difficult. In the workhorse specification, inflation expectations are model-consistent, while model variants allow for different formation mechanisms for expectations.

In Prima, inflationary pressures do not emerge uniformly across the economy. Because sectors differ in cost structures, exposure to imports and pricing behaviour, using a single aggregate measure of slack can mask important differences. Prima instead measures capacity pressures at the sectoral level, using real marginal costs that capture wages, capital utilization, energy, imports and technology. As a result, it provides a more detailed view of how demand and supply conditions shape inflation across the economy.

These features help address key limitations of earlier projection models—such as the Bank's Large Empirical and Semi-structural model—that became evident during the COVID-19 pandemic (Gosselin and Kozicki 2023). In those modelling frameworks, the combination of weak growth and high inflation was often interpreted as temporary cost-push dynamics, leading to projections of rapid disinflation. In contrast, Prima can generate sustained inflation when elevated costs and capacity constraints persist in specific sectors, even if aggregate output is below trend. It also distinguishes more clearly between shocks of different persistence—

temporary disruptions, persistent increases in marginal costs and permanent changes in productive capacity. This supports a more appropriate policy response.

Finally, Prima embeds uncertainty and risk management directly into the modelling framework. Rather than relying on a single point forecast, it supports a suite-of-models approach in which different specifications are used to explore nonlinearities, the formation of expectations and alternative scenarios. This allows projections to reflect a range of plausible outcomes and aligns the modelling framework more closely with a risk management approach to policy (Cateau, Coletti and Portelance 2025).

The Bank is also casting a wider net for information to understand supply and demand conditions as well as pricing behaviour on the ground. Traditional macroeconomic indicators, such as overall GDP, arrive with a lag, which is problematic when conditions are changing rapidly. To address this, the Bank has been expanding its use of high-frequency, granular data and direct business intelligence. For example, during the pandemic, Bank analysts turned to non-traditional data sources to get timelier information on economic activity. They tracked things such as restaurant reservations, flight bookings, credit card transactions and even online job postings to gauge real-time changes in demand and hiring. Kozicki (2025) notes that these kinds of timely indicators proved "invaluable in times of great economic uncertainty" by revealing shifts that had not yet shown up in official statistics.

The Bank has also ramped up its survey programs and outreach activities to better tap into what businesses and consumers are seeing. Its regular Business Outlook Survey and Canadian Survey of Consumer Expectations have been complemented by new surveys, such as the Business Leaders' Pulse, that provide more timely information. These surveys enable the Bank to better track business activity, prices and consumer sentiment (Bank of Canada 2026a). The surveys also allow the Bank to introduce targeted questions for businesses about supply bottlenecks and the effects of tariffs, and for households about their views on inflation. Hearing directly from households and businesses gives the Bank a more nuanced picture than quantitative data alone.

Because of the high degree of uncertainty in judging the size and persistence of supply shocks, the Bank has taken a risk management approach to monetary policy. In practical terms, this means embedding scenario analysis into the policy process. Rather than relying solely on a single base-case projection, staff regularly develop alternative scenarios to explore how the economy might evolve under different assumptions.

The Bank has already seen the value of this approach in practice. Faced with the extreme uncertainty of the COVID-19 pandemic, for example, the Bank broke new ground by publishing a range of scenario projections instead of a point forecast in the April 2020 *Monetary Policy Report*. And in mid-2022, when inflation was running far above target, Bank staff analyzed a worst-case scenario involving a wage–price spiral—a self-reinforcing inflation dynamic that the baseline model did not predict. This ensured the Bank was prepared to act if signs of such a spiral emerged. More recently, in the April 2026 *Monetary Policy Report*, the Bank examined scenarios with a persistent oil price

shock to assess how different combinations of higher energy prices, supply disruptions and weaker demand could affect inflation and growth.

By comparing such scenarios, policy-makers can identify in advance the conditions under which simply looking through a supply shock is not appropriate and instead a more aggressive policy response is warranted. Scenario-based planning helps avoid both underreacting to risks (by revealing the danger of waiting too long) and overreacting (by clarifying the costs if a shock proves short-lived). It can also support communications by helping the Bank more clearly explain how it weighs the evidence and risks in different situations and why monetary policy responses can vary. Making scenario analysis a more central feature of policy-making and communications can help ensure that policy decisions are well hedged against the many unknowns in a shock-prone world and that the public understands the nuances behind policy decisions.

For a long time, monetary policy mainly had to respond to demand-driven inflation pressures. As a result, many people now think of monetary policy as a simple, mechanical process: when inflation rises, interest rates go up. This rule of thumb has helped Canadians understand the Bank's actions. However, if inflationary supply shocks become more frequent and the Bank looks through these episodes, its decisions may appear to depart from how monetary policy is commonly understood to work. Making fuller use of the framework's built-in flexibility may therefore require the Bank to place greater emphasis on the 1%–3% inflation-control range in its communications while also reaffirming its commitment to the 2% target. This could prove challenging, particularly if inflation is more volatile than in the past and deviations from target skew to the upper end of the inflation-control range.

Improvements to models, data, contingency planning and communications have been part of a concerted effort to upgrade the Bank's monitoring and analysis of supply-side risks. By improving its ability to diagnose shocks in real time and adopting a prudent risk management approach, the Bank can more effectively navigate the trade-offs associated with heightened supply-shock volatility. No one model or dataset will predict the future perfectly. Rather, the aim is to reduce uncertainty for policy-makers, improve the quality of analysis when policy must be set under incomplete information, and clearly explain the risks and trade-offs inherent in this approach. Together, these enhancements will continue to support the monetary policy decision-making process in the face of whatever supply-side surprises may arise in the future.

Chapter 4: Assessing and communicating inflation

Canada's inflation target is defined in terms of total CPI inflation. However, total CPI is often affected by temporary or idiosyncratic factors—such as volatile energy prices—that add noise without providing much information about underlying inflationary pressures. The Bank looks through these short-run movements in the CPI, partly because monetary policy affects inflation with a lag. Measures of core inflation help isolate the more persistent parts of inflation. Over the years, the Bank has used various measures of core inflation alongside other indicators in its broad assessments of inflation dynamics.

As part of the 2026 renewal, the Bank reviewed how core inflation is measured, used to support monetary policy decision-making and communicated. Ensuring these measures remain fit for purpose is particularly important because the economic environment continues to evolve. Compared with previous decades, recent experience has been characterized by a wider and more complex range of disturbances, including disruptions to global supply chains, housing market imbalances, shifts in global trade and geopolitical conflict.

In this environment, the different measures of core inflation have at times sent conflicting signals. As a result, separating signal from noise in inflation data has become more challenging (Mendes 2025). This greater uncertainty requires rethinking how measures of core inflation are used to assess underlying inflation dynamics and inform forecasts for CPI inflation.

A brief history of core inflation at the Bank of Canada

When the Bank adopted inflation targeting in 1991, its measure of core inflation was the CPI excluding food and energy.[11] This choice reflected standard practice at the time and was motivated by the experience of the 1970s, when large and frequent swings in food and energy prices made inflation particularly volatile. Excluding these components was viewed as a practical way to obtain a clearer signal of the underlying inflation trend relevant for policy. The Bank was clear that measures of core inflation could help it look through short-term volatility within a framework in which the objective was defined in terms of total CPI inflation.

As Canada gained experience in a low and stable inflation environment, the Bank refined its measurement of core inflation. In 2001, it introduced CPIX. Rather than excluding the food and energy categories entirely, CPIX removed eight specific CPI components that were identified as being particularly volatile (Macklem 2001).[12] These exclusions were justified on both statistical and conceptual grounds. A prominent example was mortgage interest costs, which move with changes in the Bank's policy interest rate. Including

11 This section draws from Khan (2025).

12 These eight components were found to be in the tails of the inflation distribution more than half the time.

mortgage interest costs would have created a mechanical effect whereby tighter policy raises core inflation.

At the time, the Bank emphasized that exclusion-based measures such as CPIX would need to be reassessed periodically. The statistical properties of CPI components change over time, and what appears appropriate to exclude based on historical data may prove less so when the nature of shocks changes. Over subsequent years, this limitation became increasingly evident. Large temporary shocks often arose in components not excluded from CPIX, causing CPIX inflation to be excessively volatile at times and to diverge from the Bank's broader assessment of underlying inflation. Against this backdrop, and alongside advances in the academic literature, Bank staff explored alternative approaches to measuring core inflation.

Ahead of the 2016 renewal, Bank staff conducted a comprehensive evaluation of core inflation measures (Khan, Morel and Sabourin 2015). That work assessed numerous measures across several criteria, including bias, volatility and persistence, as well as their relationship with macroeconomic drivers, their ability to forecast total inflation and their ease of communication. Although many measures performed similarly across some criteria, three measures stood out as being better at capturing persistent price pressures and correlating with macroeconomic drivers of inflation:

- CPI-trim, which removes the top 20% and the bottom 20% of component-level inflation rates each month
- CPI-median, which lines up all the component-level inflation rates from lowest to highest and picks the one in the middle
- CPI-common, which aims to track inflation that is common across CPI components

Importantly, no single measure was found to be reliable in all circumstances. As a result, the Bank started to emphasize CPI-trim, CPI-median and CPI-common as a set of preferred core measures instead of using one pre-eminent measure as an operational guide. At the same time, it continued to stress that core inflation was only one input into a broader, judgment-based assessment of underlying inflationary pressures, where the policy objective was to keep CPI inflation at 2%.

What we learned

Using a set of core inflation measures has generally helped the Bank avoid risks associated with focusing on a single measure. An updated assessment conducted in 2019 added further empirical support for using the set of three measures (Lao and Steyn 2019).

However, the COVID-19 pandemic and its aftermath presented a challenging test of the Bank's measures while also complicating their evaluation after the fact. Specifically, sharp, temporary changes in the statistical properties of inflation during this period make the empirical criteria used in past evaluations less informative. The Bank has therefore placed greater weight on a more narrative approach based on case studies to assess performance over the pandemic period.

CPI-trim and CPI-median were informative in the run-up to and early stages of the pandemic. They eased as the economy weakened sharply in 2020, without signalling a

broad-based disinflationary shock. They subsequently provided early signals that underlying inflationary pressures were becoming elevated and broad-based (Khan and Sullivan 2022). This period reinforced the value of flexible core inflation measures when confronted with unusual shocks.

However, recent experience also revealed limitations. CPI-trim and CPI-median are based on the premise that extreme price movements are likely to be temporary. This assumption can be challenged, however, when inflation in certain CPI components is both extreme and highly persistent. A prominent example of such circumstances arose during the rapid tightening cycle that began in 2022. As the Bank raised its policy interest rate, inflation in mortgage interest costs increased sharply and remained elevated for about three years. CPI-trim and CPI-median appropriately looked through inflation in mortgage interest costs during this episode. But the persistence of inflation in this component limited their ability to filter out other, more temporary sources of upward pressure on overall inflation. As a result, the measures likely overstated the degree of inflationary pressure in the economy. In this context, CPIX—which by construction excludes mortgage interest costs—provided a useful alternative perspective on inflation developments, even though it was not among the Bank's preferred measures at the time.

Such limitations are inherent in trimmed-mean approaches but are rarely material outside of exceptional circumstances. Analysis by Bank staff finds that the methodologies underlying CPI-trim and CPI-median remain broadly appropriate (Savoie-Chabot and Sullivan, forthcoming).

The pandemic also underscored challenges with measures based on factor models. CPI-common became subject to sizable historical revisions when re-estimated with pandemic-era data. Large and unusual shocks increased co-movement across CPI components and altered estimated model parameters, undermining the reliability of this measure as a real-time indicator (Sullivan 2022). As a result, the Bank stopped using CPI-common as a preferred measure of core inflation in October 2022. Subsequent research by Bank staff shows that more sophisticated factor models—with features such as stochastic volatility and time-varying loadings—can address some of these issues (Uzeda 2025). However, revisions remain an inherent limitation that warrants continued caution in operational use.

More generally, analytical work conducted in support of the framework renewal reinforces that different approaches to measuring core inflation have different trade-offs. Fixed-exclusion measures are transparent and easy to replicate but are ill-suited to environments characterized by atypical shocks. Trimmed-mean measures are effective at filtering out extreme price movements, but they rely on assumptions about the nature of outliers that do not always hold. Their time-varying exclusions can also make it harder to break down inflation movements into different CPI components. Measures based on more advanced econometric techniques, such as CPI-common, are conceptually appealing but are complex and less stable in real time. No approach is clearly superior across all dimensions.

Recent experience has also reinforced the value of examining inflation developments by breaking down CPI into its different categories. During the COVID-19 pandemic and its aftermath, inflationary pressures reflected a range of distinct forces operating across major categories of the CPI. These included:

- increases in goods prices driven by import prices
- elevated shelter price inflation, shaped by large swings in interest rates, population growth and household preferences
- pressures in non-shelter services from domestic demand as the economy reopened in 2022

Breaking inflation into its major categories has therefore been an important complement to summary measures of underlying inflation. It has helped to distinguish between different sources of price pressures and to assess their likely persistence.

Finally, recent experience has sharpened concerns about the Bank's communications around measures of core inflation. Designating certain measures as preferred, featuring core inflation measures prominently in monetary policy communications during and after the pandemic, and referring broadly to core inflation as an operational guide have encouraged an undue focus on a narrow subset of indicators, particularly in financial markets. As a result, the Bank has risked overstating the role of specific core measures in policy decisions at the expense of the broader range of information and judgment that informs monetary policy.

The emphasis placed on core measures in communications has risked creating confusion about the Bank's target variable. Most participants in community conversations found the concept of underlying inflation counterintuitive because it often excludes what participants called "non-negotiable items," such as food and gas. Participants were generally skeptical of measures of core inflation (**Box 5**). Experts the Bank consulted expressed the view that the Bank has referred to too many different measures of core inflation over the past decade, resulting in a lack of clarity. In this context, the Bank's efforts to be transparent about the range of indicators shaping its assessment have, at times, been interpreted as shifts in emphasis or signs of inconsistency, rather than as a reflection of the judgment involved in policy analysis (Rogers 2026).

Box 5

Canadian experiences highlight skepticism about inflation data

During consultations, participants revealed strong and diverse opinions about inflation and affordability. Many expressed skepticism about official inflation data. They questioned how total consumer price index (CPI) inflation is measured because the headline numbers do not seem to reflect their daily reality.[13]

Civil society groups, think tanks and consumer advocates asked the Bank to explore alternative measures of inflation or indexes such as a basic-needs basket, an affordability index or a seniors' price index, to support its understanding of the diversity of experiences. They believe these measures would help provide a more accurate picture of inflation by better tracking real-life experiences. Participants also raised the increasing fragility of the CPI in an era of highly dynamic pricing.

Representatives from these groups called on the Bank to conduct more research on the distributional effects of inflation and monetary policy, noting that impacts differ across income levels, regions, demographics and housing tenure. In their view, this would allow the Bank to speak more credibly to different lived realities and would strengthen confidence in the framework.

The Bank recognizes that Canadians are facing serious cost-of-living challenges and that aggregate data do not always fully capture people's lived experiences. This is why the Bank supplements official data with surveys—such as the Canadian Survey of Consumer Expectations and the Business Outlook Survey—and with outreach across the country to hear directly from businesses and community groups. With only one tool to achieve the inflation target, the Bank cannot target individual prices or one sector of the economy. Nevertheless, it continues to consider the differences among Canadians when setting monetary policy (Kozicki 2022, 2023).

Policy implications

Monetary policy decisions are ultimately guided by the Bank's forecast for total CPI inflation once the effects of temporary factors have passed. Developing this forecast requires judgment about the persistence of price movements. Bank staff draw on a range of CPI-based indicators, including measures of core inflation, the breadth of price changes across the CPI basket, category-level dynamics and evidence from microdata to track changes in price-setting behaviour. They also incorporate information from outside the CPI, including field intelligence, indicators of cost pressures, assessments of economic slack and various measures of inflation expectations.

To help clarify that core inflation is one element within a broader assessment of inflation dynamics, the Bank has developed an online inflation dashboard that brings together

13 Results from the Bank's Canadian Survey of Consumer Expectations show that perceived inflation tends to be higher than actual inflation. This is mainly because perceptions are shaped by the prices of goods that are purchased most often, such as groceries and gasoline (Keshishbanoosy et al. 2022).

core inflation measures and other CPI indicators. By focusing on CPI-based indicators, the dashboard complements other relevant data published on the Bank's website, such as indicators of labour market dynamics and capacity pressures. The dashboard includes clear explanations of what each indicator captures, its strengths and limitations, and the contexts in which it is most informative. Presenting core inflation within this broader approach improves transparency around how the Bank assesses inflation, while reinforcing the central role of the inflation target. In consultations, external experts agreed that a dashboard of inflation measures would be a useful addition to the Bank's communications toolkit if it included a limited set of indicators that are easy to replicate and explain.

These findings imply that the Bank's analysis can draw more heavily on measures of core inflation that are easy to replicate and well understood and that provide complementary signals. In this context, Bank research suggests that CPI-trim and CPIX can serve as the Bank's primary measures of core inflation. Both measures exclude components whose price movements are most likely to obscure underlying inflationary pressures. CPI-trim applies a flexible exclusion rule that removes extreme price movements each month, allowing it to adapt to the nature of shocks as they arise. CPIX, by contrast, excludes a fixed set of components that have historically exhibited particularly volatile price dynamics. Together, these measures provide two transparent and easily interpretable views that can be compared, broken down and reconciled with each other (**Box 6**). External experts also expressed a strong preference for reintroducing a simple fixed-exclusion measure, even though empirical support is less compelling for such measures than for those derived from statistical approaches.

CPI-XFET—which excludes food, energy and the effects of indirect taxes—and CPI-median should be treated as supplementary indicators. CPI-median has statistical properties very similar to those of CPI-trim—the weighted median is, in effect, a special case of the trimmed mean—and therefore adds limited information beyond what CPI-trim already provides.[14] CPI-XFET remains useful for certain purposes, particularly for international comparisons, where excluding food and energy provides a common benchmark across countries, even though it is not a primary measure of underlying inflationary pressures in Canada.

CPI-common has been discontinued because of its limited operational use in recent years.

Discontinuing the practice of designating specific core inflation measures as preferred may be warranted. This practice has had the effect of elevating those measures above other indicators, including headline inflation. Such a change would reduce undue focus on a narrow set of indicators and better reflect the broader, judgment-based approach that underpins the assessment of inflation dynamics.

Overall, the Bank's approach to core inflation continues to evolve in light of new evidence and experience. At the same time, a fundamental principle remains unchanged: no single indicator can capture the full complexity of inflation dynamics. Effective monetary policy depends on synthesizing information from many sources into

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14 The weighted median can be thought of as a 50% trimmed mean, where all but the midpoint of the inflation distribution is trimmed.

a coherent assessment of underlying inflationary pressures and the outlook for total CPI inflation. Thus, placing greater emphasis in communications on total CPI inflation—the target measure of inflation—and continuing to use a broader set of indicators in explaining the Bank's assessment of underlying inflationary pressures would foster greater understanding of how these indicators are used in practice.

Box 6

The complementarity between CPIX and CPI-trim

As part of the 2026 inflation-targeting framework renewal, Bank of Canada staff have undertaken a renewed assessment of CPIX as a fixed-exclusion measure of core inflation. The results of this analysis show that many of the CPI components excluded from CPIX in 2001—such as gasoline, natural gas, fuel oil and intercity transportation—continue to exhibit relatively high volatility when assessed over a much longer and more recent sample. While modestly adjusting the composition of CPIX could be justified based on updated rankings (**Table 6-A**), such changes would have little practical impact on the behaviour of the measure and provide limited rationale for formally revising it. Within the class of fixed-exclusion measures, the components excluded from CPIX therefore remain broadly appropriate.

Table 6-A: Most volatile CPI components

Components excluded from CPIX in black; other components in red

	CPIX, 1986–2001	1995–2019	1995–2025
1	Fuel oil and other fuel	Fuel oil and other fuels	Fuel oil and other fuels
2	Tobacco	Natural gas	Natural gas
3	Natural gas	Gasoline	Gasoline
4	Gasoline	Vegetables and vegetable preparations	Rental of passenger vehicles
5	Vegetables and vegetable preparations	Tobacco products and smokers' supplies	Mortgage interest costs
6	Intercity transportation	Intercity transportation	Intercity transportation
7	Mortgage interest costs	Other passenger vehicle operating expenses	Vegetables and vegetable preparations
8	Fruit, fruit preparations and nuts	Fruit, fruit preparations and nuts	Tobacco products and smokers' supplies

Note: Rankings for the original CPIX sample are from Macklem (2001). Rankings for the 1995–2019 and 1995–2025 sample are based on the standard deviation of tax-adjusted year-over-year growth rates.

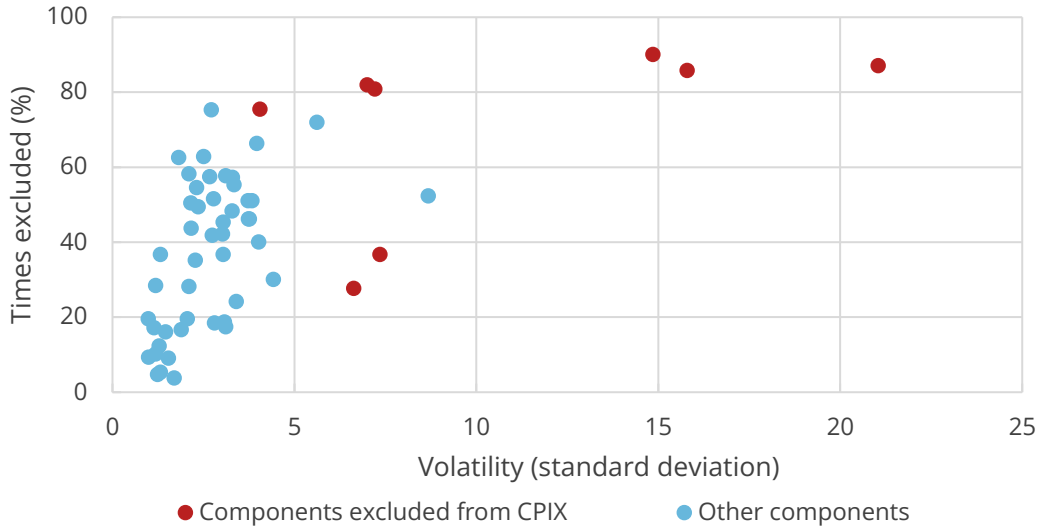
At the same time, the analysis highlights substantial time variation in the statistical properties of individual CPI components. These properties can change for economic, regulatory or methodological reasons, and rankings based on long samples can mask this variation. Prominent examples include prices of travel services and rent, both of which have seen large changes in their volatility rankings following methodological changes by Statistics Canada in recent years. This time variation is not a reason to continually redesign fixed-exclusion measures such as CPIX, but it underscores the value of pairing a fixed-exclusion measure with a more flexible approach.

CPI-trim provides that flexibility. In practice, CPI-trim often excludes many of the same components as CPIX (**Table 6-B**). However, it can also exclude other components when their price movements become extreme, even if those components have not historically been especially volatile (**Chart 6-A**). This makes CPI-trim better able to respond to novel shocks, while CPIX provides a stable and transparent benchmark grounded in historical experience. Using the two measures together therefore provides a complementary perspective on underlying inflation.

Table 6-B: Overlap in exclusions between CPI-trim and CPIX

Components excluded most often from CPI-trim	Excluded from CPIX?
Gasoline	✓
Fuel oil and other fuels	✓
Natural gas	✓
Vegetables and vegetable preparations	✓
Intercity transportation	✓
Fruit, fruit preparations and nuts	✓
Household textiles	×
Travel services	×

Chart 6-A: Volatility and frequency of exclusion from CPI-trim, 1995 to 2025



Note: CPIX is a core measure of inflation that excludes eight of the most volatile components and the effect of indirect taxes.
Sources: Statistics Canada and Bank of Canada calculations
Last observation: December 2025

Chapter 5: Housing

Imbalances in the housing market—persistent mismatches between increasing housing demand and a slowly adjusting supply—are a key concern for Canadians.[15, 16] Against this backdrop, the framework renewal examined:

- how monetary policy interacts with housing supply and demand
- how shelter inflation is measured and interpreted for policy purposes

A key finding for the first issue is that monetary policy—a blunt, economy-wide tool—cannot solve structural supply constraints, though it can temporarily influence housing demand and the imbalances between demand and supply.[17] Shifts in housing fundamentals reflect a wide range of supply- and demand-side forces, including construction costs, population growth and financing.[18] Changes in interest rates are only one factor, and while their impacts on activity are short-lived, they can be important in the near term. Because housing supply adjusts slowly, changes in interest rates tend to affect demand faster and by more than they affect supply, which can temporarily contribute to imbalances.

With respect to the measurement of shelter inflation, Bank research examined how best to capture housing-related price pressures. In Canada, shelter inflation for homeowners is measured with a user-cost framework that reflects the ongoing cost of housing services, including components such as mortgage interest costs, property taxes and maintenance. Other jurisdictions use alternative approaches, including owners' equivalent rent, which imputes the rent homeowners would have to pay for a comparable dwelling, or acquisition-based measures focused on house purchase prices.

The review of these alternatives suggests there is no clearly superior method: each involves trade-offs, and the Canadian approach performs at least as well as others in capturing the cost of housing services; indeed, along some dimensions it performed better. That said, recent experience highlights an important challenge with the mortgage interest cost (MIC) component. When policy rates rise rapidly, MIC inflation can increase quickly and mechanically following rising mortgage rates, even as monetary policy acts to slow demand and bring inflation back to target. The rise associated with the post-pandemic tightening cycle was unusual in that the sharp increase in mortgage

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15 Residential investment—which includes new residential construction, renovations and ownership transfer costs—accounted for about 6% of Canadian real GDP in 2025.

16 Housing is broadly defined to include both owned accommodations and rental units. The term "house price" is used for the price of owned accommodations, and "rent" or "rental price" is used for rental units. Both the stock and the flow of housing are important for housing imbalance, and each is discussed in this chapter.

17 For additional background, see Rogers (2026a, 2026b).

18 Mortgage structures shape monetary policy transmission beyond standard interest rate channels. Under adjustable-rate mortgages, policy rate increases pass through quickly, reducing disposable income. In contrast, under fixed-rate mortgages, payments are fixed, so higher inflation reduces real debt burdens. Thus, mortgage structures amplify macroeconomic fluctuations, particularly during housing booms and busts (Garriga, Kydland and Sustek 2017, 2021). Refinancing options in fixed-rate mortgages make transmission state-dependent: rate cuts can amplify stimulus when refinancing is available but are less effective after prolonged periods of low rates (Berger et al. 2021). As a result, mortgage design influences both the speed and the strength of policy transmission. Canada's mortgage system lies in between fixed- and variable-rate systems, allowing relatively quick adjustments alongside some payment stability (Boutros, Clara and Kartashova 2026).

interest costs reflected the scale and speed of policy rate increases. Such dynamics can sometimes create communication challenges for the Bank.

Overall, the housing analysis reinforces the appropriateness of the existing monetary policy framework. The findings reaffirm that the Bank's focus should remain on achieving its overall inflation mandate rather than on targeting specific components such as shelter inflation. Consistent with this approach, the Bank generally looks through mechanically driven MIC-related inflationary pressures. The analysis also underscores the importance of clearly communicating the limits of monetary policy, particularly its inability to address structural housing shortages or sustainably improve housing affordability.

What we learned

Housing imbalances and monetary policy

How monetary policy affects housing demand and supply

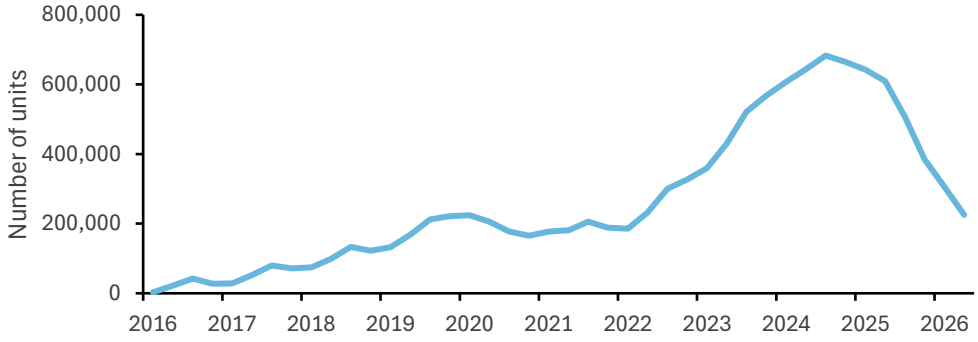
Housing is the component of household demand that is most sensitive to interest rates, which makes it a key channel through which monetary policy affects the economy. As a result, understanding how interest rates interact with housing demand and supply is central to assessing the transmission of monetary policy.

The Canadian housing market experienced a growing structural imbalance between supply and demand in the years following the COVID-19 pandemic (**Chart 6**). The Bank's review finds that this gap was driven by factors other than monetary policy, including construction costs, zoning rules and population growth.

Participants in community conversations said they thought interest rates were the main reason for housing affordability challenges over this period. Explanations subsequently provided to participants regarding how multiple factors affect housing supply and demand helped them better understand the impact of interest rates on house prices and rental costs.

Chart 6: Population growth has outpaced new housing construction over the past decade

Growth in the number of households minus growth in the housing stock since 2015Q4



Note: The number of households is estimated using household formation rates from the 2011 Census of Population. The growth in the housing stock is estimated using net completions of all types of dwelling units.
Sources: Statistics Canada, Canadian Mortgage and Housing Corporation and Bank of Canada calculations

Last observation: 2026Q2

While monetary policy can affect housing imbalances in the owned accommodation market, it is not a key driver, and its strongest effects are short-lived (**Box 7**). Changes in interest rates affect housing markets primarily through their near-term impact on demand, while the supply response is slower and much more muted. When interest rates fall, for example, borrowing capacity increases and housing demand tends to grow quickly, as evidenced by higher mortgage originations and resale activity. Permits and housing starts also pick up, but construction responds with long lags because of the time needed for planning, permitting and building.

This asymmetry means that changes in interest rates tend to have cyclical effects on housing markets—demand adjusts more quickly than supply, contributing to temporary imbalances and price movements over the cycle. The reverse is also true: when interest rates rise, mortgages become more expensive, putting downward pressure on prices. However, house prices do not adjust downward as quickly—they tend to be stickier to the downside.[19] As a result, homebuyers face higher mortgage interest costs and still-elevated house prices.

Box 7

The effects of monetary policy on housing demand and supply in Canada

Monetary policy affects housing demand relatively quickly, while its effects on housing supply are more gradual.[20] Changes in interest rates impact the borrowing capacity of potential homeowners and investors and, in turn, their willingness and ability to purchase a home. Because the supply of housing adjusts slowly, changes in demand can create temporary imbalances that affect house prices and market activity.

Interest rates also have an impact on new construction through builders' financing costs and investment decisions. However, these effects take time to translate into changes in the housing stock because homes must be planned, permitted and constructed.

Housing demand responds quickly to changes in interest rates

When interest rates fall, lower mortgage costs enable households and investors to qualify for larger loans, increasing their willingness and ability to purchase homes. The resulting surge in demand, occurring against inelastic supply, creates a temporary market imbalance that puts upward pressure on prices. Conversely, when interest rates rise, borrowing becomes more expensive, reducing purchasing power and dampening demand. This, in turn, moderates price growth. Because renting and owning are close substitutes, changes in interest rates can also reallocate demand between these markets as relative affordability shifts.

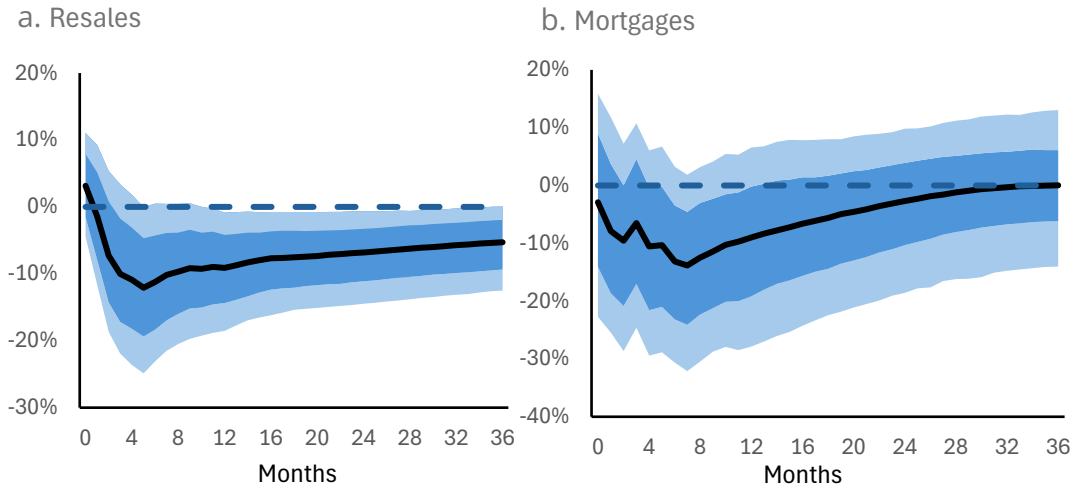
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19 House prices may decline more gradually because homeowners are not forced to sell when prices fall as long as they can continue to meet their mortgage payments. Negative equity and loss aversion reduce sellers' willingness to transact, limiting fire-sale dynamics outside of foreclosure episodes (Genesove and Mayer 1997, 2001; Campbell, Giglio and Pathak 2011).

20 In this context, housing supply refers to the total stock of homes that are potentially available to be occupied, including rented and owner-occupied dwellings as well as those that are currently vacant. Regional estimates of the housing stock evolve over time with the monthly flow of net completions. Within this larger supply, there can also be fluctuations in the number of vacant dwellings that are actively being listed for sale or rent. Changes in the balance of active new buyers and sellers can be important for housing market liquidity and tightness and contribute to short-run fluctuations and volatility in sales and prices (see Anenberg and Ringo 2024).

These effects are quickly reflected in market activity. Empirical evidence shows that following an unexpected 1 percentage point increase in interest rates, home resales and mortgage originations decline by around 10% and 15%, respectively, within the first six months (**Chart 7-A**) (Surprenant 2026).

Chart 7-A: Homebuyer demand typically softens after an interest rate increase



Note: The chart shows the estimated impacts of an unexpected interest rate increase of 1 percentage point on resale activity and mortgage originations over the months following the increase. Shaded areas show 68% and 90% credible intervals; the solid line shows the posterior median.
Source: Bank of Canada calculations

House prices also adjust quickly in response to the resulting imbalance between demand and supply.[21] Bank research shows that an unexpected 1 percentage point increase in mortgage rates would substantially slow house price growth, leaving prices about 5% to 10% lower than they otherwise would have been after one to two years. Other studies find a faster price response. For example, Surprenant (2026) finds that national house prices decline about 5% relative to trend within six months following a rate increase of 1 percentage point.[22] Expectations for future house price growth would also adjust quickly, falling by 10% within the first seven months (Rao and Wang 2026).

Housing supply adjusts slowly and moderately

Changes in interest rates influence housing supply primarily by affecting the incentives for developers and landlords. Although the resulting impacts on the housing stock are delayed and relatively modest in size, they can still influence new construction activity.

Higher rates raise financing costs, while lower rates ease them, shaping decisions about whether and when to build. Developers also respond to the expected impacts of rate changes on future demand and the prices new units can command once they are brought to market. These demand and supply forces interact to determine the equilibrium outcome in the housing market. Research by Bank staff that incorporates this interaction suggests that these expectations play a dominant role. In equilibrium, financing costs account for less than 20% of the interest rate effects on new construction, with most of the impact reflecting anticipated shifts in homebuyer demand (Enkhbold and Kabaca 2026a).

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21 In particular, there is evidence that price responses may be amplified by extrapolative expectations and other behavioural effects. See, for example, Enkhbold and Kabaca 2026a.

22 Results from the Canada Mortgage and Housing Corporation's Integrated Housing Model suggest similar house price effects, with a 1 percentage point increase in interest rates lowering house prices by about 7% over two years.

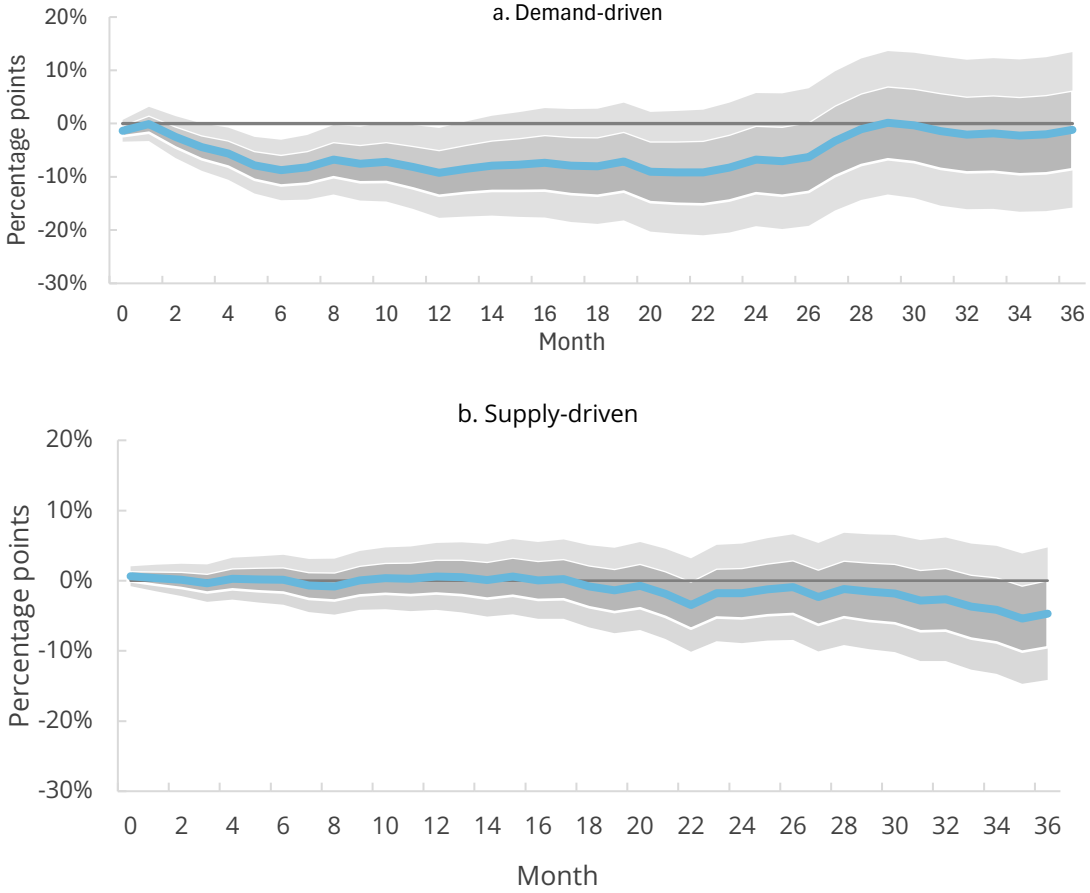
In the short run, adjustments are limited—some housing can shift between rental and ownership markets, and builders may delay or accelerate ongoing projects. However, the overall housing stock evolves slowly because of long construction timelines. In Canada, building a single-detached home can take around 9 months, while apartment projects may take closer to 26 months (Canada Mortgage and Housing Corporation n.d.). Pre-construction phases—including planning, securing financing and obtaining zoning approvals and permits—can add to these timelines, especially for large-scale developments.

As a result, the effects of monetary policy on supply unfold gradually. Analysis by Bank staff finds that a 1 percentage point increase in interest rates lowers both permits and housing starts by about 10% in the first six months (Surprenant 2026). However, because of the lags between permits, construction starts and completions, the slowdown in new housing supply can take several years to fully materialize, impacting housing stock growth for up to three years or longer.

Finally, Bank research has also examined the effects of monetary policy on housing resale markets by using an empirical approach to break down house price movements into demand- and supply-driven components (Booth and Terajima, forthcoming). The results suggest that the effects on house prices from unexpected changes in interest rates are largely demand-driven, with supply-driven responses contributing little to the overall price response over the first two years (**Chart 7-B**).

Chart 7-B: Monetary policy affects inflation in house prices mainly through demand

Impulse response function for demand- and supply-driven house price inflation



Note: The chart shows the estimated impacts of an unexpected interest rate increase of 1 percentage point on cumulative house-price inflation over the months following the increase. The decomposition of demand- and supply-driven house-price inflation follows the method developed in A. H. Shapiro, "Decomposing Supply- and Demand-Driven Inflation," *Journal of Money, Credit and Banking 58,* no. 2 (2026): 365–388. Shaded areas show 68% and 95% credible intervals; the solid line displays the point estimates. Although monetary policy tightening significantly decreases demand-driven house-price inflation after a few months, its effects are not significantly different from zero on supply-driven inflation over the three-year period in the analysis.

Source: Bank of Canada calculations

The finding that demand reacts more quickly than supply is consistent with the idea that monetary policy can temporarily amplify or dampen housing imbalances. Bank research finds that these impacts vary by region and by the state of the economy (e.g., labour market conditions, population growth).[23]

These results for the Canadian housing market are consistent with findings in the broader academic literature that monetary policy has strong effects on housing demand

23 Differences in homeownership and rental status also shape how households experience these policy effects (Irwin and Vieyra 2026). Homeowners are more sensitive to interest-rate–induced changes in mortgage interest costs and house prices, leading them to prefer policies that keep rates lower. Renters, by contrast, demand housing only indirectly and are often saving to transition into ownership. Therefore, tighter monetary policy that raises returns on savings and dampens house price growth can improve renters' welfare by lowering the effective cost of future housing demand. These opposing demand responses generate large redistributive effects across renters and owners, even when the overall effects of monetary policy remain small.

over the near term.[24] For example, there is evidence that US listing prices begin to adjust within weeks of a policy shock (Gorea, Kryvtsov and Kudlyak 2024).

How the effects of monetary policy on housing demand and supply feed through into mortgage interest costs, house prices and rents

Understanding how monetary policy affects different shelter components is critical for assessing inflationary pressures and determining the appropriate policy response. Monetary policy influences shelter inflation through distinct channels tied to:

- house prices
- rent prices
- mortgage interest costs

Each responds differently and has distinct implications for inflation dynamics and monetary policy.

House prices respond to monetary policy primarily through demand-driven channels. Understanding how monetary policy affects housing demand is therefore central to assessing whether policy-makers should look through specific price movements. Research by Bank staff finds that an unexpected 100 basis point increase in interest rates would lead to house prices being about 5% lower over a six-month horizon than they otherwise would have been (Surprenant 2026).[25] Certain economic conditions can amplify these house-price responses. The effects of monetary policy easing on house prices are stronger when unemployment is low and weaker when unemployment is high (Straus, Surprenant and Tuzcuoglu 2026). Regional differences in housing supply constraints further shape these responses, with more inelastic markets exhibiting larger price movements (Rao and Wang 2026).[26] The analysis also suggests that if demand-driven pressures are amplified by expectations shaped by recent price movements, they can exacerbate volatility in housing markets and the economy (Enkhbold and Kabaca 2026a).

Rent prices have responses to changes in monetary policy that are generally weaker, more lagged and more context-dependent than those of house prices. While tighter monetary policy tends to lower house prices, its estimated effects on rents are typically flat to positive. These effects can be positive because renting becomes relatively more affordable than buying, increasing household demand for rental units (Rao and Wang 2026). Landlords may also attempt to pass their higher mortgage costs through to rents. As a result, the varying estimates in the literature likely reflect, in part, differences in institutional features such as rent controls and the composition and ownership structure of the rental market. Moreover, because strong demand conditions can make it easier for landlords to pass through their higher mortgage costs, population growth can amplify rent inflation even as policy tightens (Enkhbold and Kabaca 2026b).

Mortgage interest cost (MIC) is mechanically linked to the policy rate. When interest rates are raised to bring down inflation, MIC increases by design. Even though MIC gives a short-term boost to inflation through this channel, the higher policy rate brings down

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24 See, for example, Burgert, Eugster and Otten (2024) and Anenberg and Ringo (2024).

25 These estimates are within the range found in the literature. See Williams (2015) for a summary of the literature with international evidence.

26 Paixão (2021) estimates housing supply elasticity across regions in Canada.

aggregate demand more broadly, leading to less inflation overall. If monetary policy responds to inflation related to MIC, it leads to a circularity where higher rates lead to even higher rates, making monetary policy too tight. Results of macroeconomic modelling show that responding directly to MIC inflation can generate a feedback loop with increased consumption volatility (Irwin and Vieyra 2026). These results support looking through direct movements in MIC.

Measuring shelter inflation

Why measuring shelter inflation matters for monetary policy

Shelter is a large component of the CPI basket and is closely tied to households' experience of inflation. In Canada, shelter services accounts for 26% of the CPI basket, and its underlying components are also among the most sensitive to interest rates. As a result, measuring shelter inflation is particularly important for inflation targeting and for public understanding of monetary policy. At the same time, no international consensus exists on how best to measure the cost of owner-occupied housing, and all approaches involve trade-offs.

The recent episode of high inflation brought these issues into sharp focus. As policy rates rose, MIC increased mechanically, temporarily pushing headline CPI inflation higher. This created challenges for the public's interpretation of inflation and for the Bank's communications, sometimes adding complexity or creating the perception of moving the goalposts (Rogers 2026a).

Canada's measurement approach remains fit for purpose

The Bank's review of shelter measurement confirms that the approach Statistics Canada currently uses remains appropriate for the inflation-targeting framework. Canada's method is closest to a user-cost approach, which captures the flow of housing services consumed by homeowners over time. It includes several observable expenses such as mortgage interest costs, maintenance and repairs, and property taxes and insurance, as well as imputed depreciation, also known as homeowners' replacement cost. In this sense, the method closely captures Canadians' out-of-pocket expenses.

During consultations, most private sector economists and consumer groups agreed that MIC should remain in the CPI inflation that the Bank targets because it is a substantial cost that households must bear. Some stakeholders stressed that current measures understate how the cost of housing is putting younger generations at a disadvantage.

Compared with the approaches in other jurisdictions, Canada's approach performs well when tested against key criteria for an inflation-targeting framework. These criteria include:

- consistency with a cost-of-living index
- availability of data
- usefulness as a monetary policy signal
- ease of communication
- Given Canadian data constraints and policy needs, no alternative approach is clearly better, and the current approach has some distinct advantages. Importantly, the user-cost framework allows shelter inflation to reflect

supply and demand pressures in housing markets through house prices and depreciation costs, which supports its relevance for policy assessment.

Finally, the review reaffirmed the Bank's practice of targeting total CPI inflation, including MIC, noting that alternative target measures do not offer a clearly superior signal for monetary policy once trade-offs are taken into account.

The trade-offs of alternative approaches

The review considered alternative approaches used in other jurisdictions, including rental equivalence and net acquisition (**Table 2**).[27]

Table 2: Assessment of alternative approaches to measuring owned accommodation in shelter inflation

	Method		
Criteria	Statistics Canada (user cost)	Rental equivalence	Net acquisition
Cost-of-living index	✓	✓	✗
Monetary policy signal	✓	✓**	✓
Issues communicating about mortgage interest costs	✓*	✓	✓

* Although policy rate changes mechanically affect mortgage interest costs, this is not a frequent issue.
** Measurement issues can be alleviated with improved data on market rents.

Rental equivalence uses the rent a homeowner would pay for a similar dwelling as a proxy for the cost of owning. Rental equivalence is also a relatively broad and intuitive measure; it may appear attractive for central banks from a communications perspective, though it is less representative of homeowners' out-of-pocket expenses. Moreover, the rental equivalence approach faces significant practical limitations in Canada. Data on rent prices do not accurately reflect the stock of owner-occupied housing (e.g., rental units skewed more toward apartments and urban areas), the coverage is uneven, and long measurement lags mean rent inflation can provide a poor signal of shelter inflation in real time. These practical concerns could be partly alleviated with better data and a higher weighting on new rents.

The **net acquisition** approach measures housing costs based on the price of new dwellings purchased by households. Participants talked about this approach during consultations, noting that it is relatively easy to understand and communicate. However, it is less closely aligned with a cost-of-living concept. It does not capture ongoing out-of-pocket expenses as well as the user-cost approach, and it includes swings in asset values. In particular, this approach would require potentially large imputations to break

27 See Kaur et al. (2026) for a discussion of these alternative approaches to measuring owned accommodation in the Canadian CPI.

down the value of all existing homes into land and structures, which could introduce measurement errors. It would also be more sensitive to swings in house prices that are unrelated to economic fundamentals (e.g., house price bubbles), making it a poor signal for monetary policy.

Given these trade-offs between the current approach and the alternatives, the analysis does not support a major shift in methodology. Instead, the Bank's findings reinforce the need to retain the current approach while improving how shelter inflation is explained and communicated.

Policy implications

Taken together, these findings have three main implications for the conduct of monetary policy:

- Monetary policy can temporarily influence housing demand but cannot address supply constraints.
- Policy deliberations should differentiate between shelter components.
- Communications should be clear about the limits of monetary policy for housing imbalances and affordability.

Monetary policy has varying and offsetting effects on housing affordability. Housing markets are decentralized, supply responds slowly, and the effects of policy vary across regions and households. Higher interest rates can dampen growth in house prices but raise mortgage costs and, in some cases, rents. Lower interest rates reduce financing costs but stimulate housing demand, putting upward pressure on house prices, particularly because housing supply adjusts slowly.

These effects mean that monetary policy cannot directly address housing affordability or target housing imbalances beyond what is required to achieve the inflation mandate. Government policy—including making changes to zoning rules, building codes and tax incentives—is more effective at easing structural supply constraints.

The findings are also consistent with the Bank keeping its focus on its mandate to target an overall rate of CPI inflation and not housing affordability specifically.

Policy deliberations should differentiate between shelter components

The analysis reinforces that not all components of shelter inflation should be treated the same in deliberations about monetary policy. Mortgage interest costs, house prices and rent prices respond to policy changes through different channels and with different lags. Misreading the underlying details of shelter inflation could therefore raise the risk of mechanically responding with an inappropriate policy action. In practice, this implies that:

- Consistent with the broader approach to assessing underlying inflation outlined in **Chapter 4**—where core measures are used to filter out temporary or mechanically driven movements in inflation—looking through movements in CPI inflation driven by MIC is appropriate. Historically, swings in MIC inflation have not typically been large enough to materially affect total inflation over the horizon that matters for monetary policy. As a result, the distinction between

total CPI and CPI excluding MIC has generally not been very relevant. The period beginning in 2022 was an important exception: policy rates rose rapidly during the 2022–23 tightening cycle, generating a large and persistent increase in MIC even after inflation in most other components had eased. Should a similar situation arise again—with MIC inflation driving elevated total inflation—the Bank could use the flexibility in its inflation-targeting framework to allow inflation to return to target over a longer-than-usual horizon. This would be contingent on the Bank being confident that elevated MIC inflation is not spilling over into other prices or inflation expectations, consistent with the broader framework's focus on persistent, underlying inflation pressures rather than temporary or mechanically driven movements.

- Movements in house and rent prices reflect broader demand and supply conditions, financial conditions and expectations. As a result, they can provide information about underlying inflationary pressure, to which monetary policy should respond proportionately, taking into account the lagged effects of rental prices or house price bubbles.

Monitoring housing demand and supply conditions and using scenario analysis can help policy-makers assess how housing markets and shelter inflation might evolve under various conditions and how these dynamics could affect inflation and output. This approach is consistent with the broader risk management perspective discussed in **Chapter 3**. This perspective emphasizes the role of state-contingent analysis, scenario thinking and judgment in an environment characterized by greater uncertainty and more frequent shocks. Applying the same discipline to housing-related risks helps ensure that monetary policy accounts for potential amplification mechanisms in housing markets while remaining focused on the inflation mandate.

Communications should be clear about the limits of monetary policy for housing imbalances and affordability

The analysis underscores the limits of monetary policy to address housing imbalances and affordability. While monetary policy can influence housing demand and prices in the short run, it cannot resolve long-run structural supply constraints or sustainably improve affordability for all households. Input received during consultations reinforced the limits of monetary policy in addressing housing imbalances. Stakeholders encouraged the Bank to clarify what it can and cannot do, explain how many factors influence supply and demand for housing, and highlight where governments or other regulators have responsibilities. They called on the Bank to reinforce the message that keeping the overall level of inflation low and stable, rather than targeting a specific sector such as housing, remains the best contribution it can make to Canadians' economic well-being.

The Bank sets its policy rate with a focus on the economy as a whole, and its primary objective is price stability. When inflation is broad-based and persistent, restoring price stability may require actions that have uneven and sometimes adverse effects across sectors, including housing. While these trade-offs are difficult, maintaining low, stable and predictable inflation is essential for supporting overall affordability over time in the economy. Focusing too narrowly on housing outcomes would risk undermining the credibility and effectiveness of monetary policy in achieving its core mandate.

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