ECONOMIC VIEWPOINT

North American Trade Conflict

A First Assessment of the Economic and Financial Consequences

The implementation of broad-based tariffs by the Trump administration is a significant escalation in trade tensions and economic consequences will likely unfold rapidly. Indeed, the swift application of tariffs implies that businesses have much less time to adjust than previously assumed. This means that supply chains disruptions will be felt rapidly, with knock-on effects on price pressures and economic growth. This is on top of the direct and indirect impact of the tariffs themselves on consumer prices, and therefore their purchasing power.

For Canada, while the specific sectoral and provincial impacts differ from our December scenario analysis, the overall magnitude of these measures—assuming they are maintained over a lengthy period—points towards recessionary conditions. The distribution of these effects will be notably uneven across regions and industries, with some sectors such as auto manufacturing, steel and aluminum and the aerospace sector likely facing the most acute challenges, while some others may prove more resilient.

Looking ahead, several developments will warrant close monitoring. The US administration has signaled potential tariff actions against European trading partners, who have already indicated swift retaliation. Representing 65% of US exports, the combined responses from Canada, Mexico, China and the EU should apply significant economic and political pressure in the US, although much will depend on their sequence and coordination.

It is difficult to predict the end of this protectionist escalation. If, as President Trump's executive order dictates, the issue is about Fentanyl, demonstrated improvement could allow Donald Trump, on the advice of the Secretary of Homeland Security, to reverse tariff hikes. Congress can also end the national emergency declaration via a joint resolution of Representatives and Senators. However, President Trump's grievances likely go beyond this. The wish for a sustained protectionist trade policy, or the desire to increase government revenues could keep the tariffs in place, although it would likely turn into a major issue in next year's midterm elections.

Domestically in Canada, the forthcoming announcements of government support packages—where provinces are likely to take the lead in the near term—will also be an important determinant of sector outcomes. Regardless, the Bank of Canada is expected to answer with deeper rate cuts as the shock requires not a merely neutral monetary policy but an accommodative one.

Our team is working to incorporate the fine details of these new developments—as well as potentially forthcoming ones—into comprehensive forecast revisions, which we will publish next week. We encourage our members and clients to maintain close contact with their Desjardins representative as this situation develops.

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As feared since his comments on the very night of his swearing-in, Donald Trump has indeed gone ahead with the imposition of new tariffs on goods imported from Canada, Mexico and China. To do this, the president uses the powers conferred by the International Emergency Economic Powers Act (IEEPA). In an executive order signed on Saturday, February 1, he declared that the threat posed by illegal aliens and drugs, including fentanyl, constitutes a national emergency. The IIEPA allows the president to use economic levers, including tariffs, to alleviate this emergency.

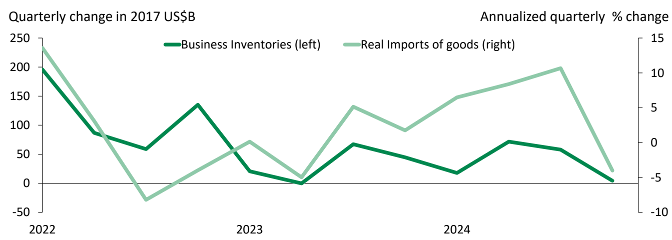
- Thus, tariffs of 25% are added on all imports of goods from Canada, excluding energy, where tariffs of 10% apply. Energy is defined as crude oil, natural gas, lease condensates, natural gas liquids, refined petroleum products, uranium, coal, biofuels, geothermal heat, the kinetic movement of flowing water, and critical minerals.
- Tariffs of 25% are added on all imports of goods from Mexico.
- Tariffs of 10% are added on all imports of goods from China. It should be noted that American tariffs already existed for products from China.
- All such additional rates will apply as of 00:01 (Eastern Standard Time) on Tuesday, February 4, 2025.
- The minimum tariff and tax exemptions (de minimis exemption) that were in effect (up to $800) are no longer applicable.

Implications for the US Economy

This new US trade policy, although under the guise of a public health and immigration issue, is consistent with what transpires from the *"America First Trade Policy"* declared in a memorandum from the president on January 20. However, rather than waiting for the reports requested in this memo to investigated unfair trade practices, that were due by April 1, Donald Trump is moving forward in a much more expeditious way. Moreover, we cannot completely rule out that this is only the first salvo in a trade war that could escalate. The president has already indicated that further measures affecting other countries (but perhaps also those that are already affected) could occur during the month of February.

The actions taken by the new administration will obviously have consequences for the American economy. The economic situation is expected to differ negatively from our previous baseline scenario, which assumed universal tariffs of 10% with exemptions, and applicable only in the fall. The president's eagerness and protectionist desire meant that American importers did not really have time to adjust. It is also noticeable that US business inventories did not increase at the end of 2024 (graph 1), and if there was a rebound at the very beginning of 2025, it was short-lived. As a result, the outlook for the US economy is likely to be more similar to what we estimated according to the "pessimistic" assumptions of our alternative scenarios presented in December, which were based on tariffs of 25% for imports from Canada and Mexico and a 10% increase for those from China. The negative effects on growth, but upward effects on inflation could, however, be felt two months earlier than the assumption used at the time. However, they could be moderately lower considering the 10% rate applied to Canadian energy. If Donald Trump goes ahead with other tariffs, including against other trading partners, or if there is an escalation in retaliation, the situation could be further complicated.

Graph 1
US Businesses Didn't Accelerate Their Imports or Stockpile Goods Before The Tariffs Came Into Effect



Bureau of Labor Statistics and Desjardins Economic Studies

The issue of countervailing tariffs could also prove important for the outlook. Saturday's executive order specifically states that the president can increase or extend tariffs already imposed if Canada, Mexico or China retaliate. The governments of these three countries have already indicated their intention to move forward with tariffs on their imports from the United States. Canada presented a list on Sunday covering about $30B worth of US goods. That said, while some of these retaliatory measures may potentially hurt the business of some US producers, or even the economies of some regions, the macroeconomic effect is likely to be rather modest. US GDP is close to US$30T, and in 2024 Americans exported over US$2T worth of goods around the world. Of course, in the case of a more global escalation of the trade war, concerted action by all economies affected by the new US protectionism could cause more damage.

Implications for the Canadian Economy

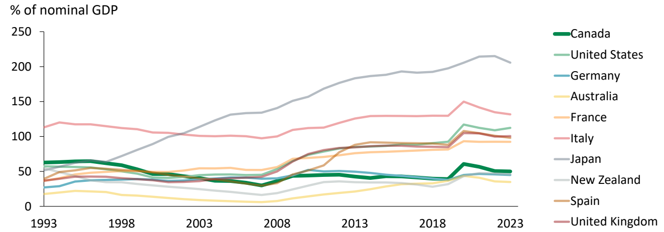
With US tariffs on imports from Canada coming sooner than expected but in line with the 25% assumption in our December 2024 pessimistic scenario (save for the lower 10% tariff on US energy imports), the impact on Canadian economic activity will be swift and substantial. Unless the tariffs are lifted in short order, Canada's economy is very likely to fall into a modest recession starting in Q2 2025 and the unemployment rate could eventually top 8%, up from 6.7% in December. Moreover, the longer the tariffs are in place, the greater the impact on the potential output of the Canadian economy, even if they are eventually reduced. Note our economic impact estimates are in line with those published by the Bank of Canada in its January 2025 Monetary Policy Report.

This economic drag will be exacerbated by the $30B in retaliatory tariffs applied on February 4, rising to $155B on February 25 in an attempt to gradually put pressure on US policymakers. The list of goods impacted by retaliatory tariffs is long but judicious, as it was in 2018, and should limit the impact on the Canadian economy as much as possible. Many goods on the current list are either those that are easily substituted with imports from other countries or those for which Canada runs an existing trade surplus with the US. But regardless, inflation will be higher as a result, rising to around 3%—in the range of 1.0 to 1.5 percentage points higher than otherwise. While crude oil prices are expected to decline due to deregulation in the sector supporting stronger production, the prices of refined products like gasoline are likely to increase on both sides of the border. Canada imports most of its gasoline from the United States, which uses Canadian crude to produce.

While Canadian energy exports have been spared the worst of US import tariffs for now, having been hit with a 10% tariff as opposed to 25%, the remaining US imports from Canada are not so lucky. Our analysis has found that manufacturing will be especially hard hit, particularly the auto sector but also steel, aluminum and aerospace manufacturing. Other sectors that produce intermediate inputs to Canadian manufacturing should also be adversely impacted, such as forestry, agriculture and mining. In Quebec specifically, metals, chemicals, wood and paper products are highly exposed to US import tariffs.

The federal government has committed to rolling out substantial stimulus in support of the Canadian economy. While this might raise concerns given ongoing deficits, Canada remains in one of the strongest fiscal positions among major advanced economies (graph 2). However, it's not clear what and how much the Government of Canada can do while Parliament is prorogued beyond expediting access to existing programs. With a new Prime Minister only taking office in early to mid-March following the conclusion of the Liberal Party of Canada leadership race, it is possible that there could be a federal election before any new stimulus is passed by the House of Commons. While we've estimated that around $100B in one-time stimulus could be passed by the federal government in the 2025–2026 fiscal year without pushing the federal debt-to-GDP ratio beyond the pandemic peak, much of the burden could fall on provincial governments in the near term.

Graph 2
Canada's Federal Government Net Debt is Low Relative to Peer Countries
Central government debt*



* Total stock of debt liabilities issued by the central government and doesn't include the assets or liabilities of public pension plans in Canada.
International Monetary Fund and Desjardins Economic Studies

Provincial Implications

Our research has found that Quebec, Ontario and Manitoba are the provinces most exposed to US import tariffs on non-energy exports. In Quebec, exports that are particularly exposed to US tariffs include metal and mineral products (notably aluminum); aircraft equipment and parts; forestry and paper products; and consumer goods. Overall, we estimate that at least 4% of jobs in Quebec are in highly vulnerable sectors. The actual number is likely higher, as these sectors also have significant downstream effects on their communities (e.g., second-round impacts on consumer demand for services). With motor vehicles and parts comprising about one third of Ontario's non-energy exports, US import tariffs on autos will have an outsized impact on the Ontario economy. But given the lower tariff rate on US energy imports from Canada, we think the impact on the Alberta energy sector and economy will be more modest, with lower prices for Canadian heavy crude and slimmer refiner margins absorbing some of the shock.

The labour market impacts of US import tariffs are likely to be significant. While the national unemployment rate expected to rise to around 8%, Ontario could see its unemployment rate rise closer to 10% (up from 7.5% in December 2024). That would translate into more than 250,000 jobs lost. Quebec might see its unemployment rate rise to 7.0%, up from 5.6%, which would correspond to just under 100,000 jobs lost. That's broadly in line with the peak unemployment rates posted during the Global Financial Crisis, but well below those seen during the pandemic.

Given the more limited ability of the Government of Canada to respond to the shock of US import tariffs with renewed stimulus in the near term, more of the fiscal burden may fall to the provinces. While Employment Insurance is likely to provide the base of near-term federal support, provinces may choose to augment this with income supports for workers most immediately and severely impacted by layoffs. Support for impacted sectors and businesses will also be called for. But given the potentially structural nature of the shock, particularly if tariffs are kept in place, broad-based and short-term, pandemic-style stimulus should be avoided. Instead, focus should be placed on the structural adjustment of the Canadian economy to this new economic regime.

Interest Rate and Currency Implications

The outlook for the Fed isn't much different than it was before this announcement. Despite the broad-based nature of US tariffs and the knock-on inflationary impacts, the bar for rate hikes is very high. It's likely that the Fed stays on the sidelines until there's more clarity surrounding the economic fallout from this trade war. Still, given that we expect core inflation to reaccelerate at least temporarily because of the tariffs, US monetary policymakers will be less inclined to cut rates as much as previously expected. The Fed is further away from its price stability goal than the full employment part of its mandate. So, while there will be job losses stateside, the easing cycle will need to be shallower than previously assumed to achieve the Fed's inflation goals.

By contrast, given that inflation in Canada is back on target, central bankers will be able to respond to trade war-induced economic damage with a more aggressive rate cutting cycle. If tariffs remain in place, look for the Bank of Canada to cut rates at each of its upcoming announcement dates until the policy rate is at least somewhat stimulative. That said, even if the economy contracts, don't expect officials to do as much easing as their predecessors did in recessions of years past. While the Bank of Canada will assume that the rise in inflation as a result of retaliatory tariffs and currency depreciation is temporary, they won't bet the farm on it. Typically, central bankers have cut interest rates between 400 and 500 basis points in the face of a recession, but this time we expect them to trim rates roughly 150 basis points over the course of this year. On its own that would see the unemployment rate falling more slowly than after similarly sized downturns, potentially placing more pressure on fiscal policymakers to pick up the slack.

As for the currency, our analysis suggests that the Canadian dollar should depreciate 5% vs. USD for every 10% permanent increase in tariffs. We estimate the effective tariff increase to be around 20% (10% for energy, 25% for other sectors). Using 1.40 as a starting point when the market began to price tariffs, the model-implied fair value for USDCAD would be around 1.54, if the tariff hike is permanent.

Our year-end forecast of 1.48 (or ¢0.68 in CADUSD terms), which is among the highest in the street, incorporated a 10% tariff hike in the second half of the year. Given the earlier and larger increase in tariffs, we are putting our FX forecasts under review as we assess the incoming news flow.

Conclusion

The implementation of broad-based tariffs by the Trump administration is a significant escalation in trade tensions and economic consequences will likely unfold rapidly. Indeed, the swift application of tariffs implies that businesses have much less time to adjust than previously assumed. This means that supply chains disruptions will be felt rapidly, with knock-on effects on price pressures and economic growth. This is on top of the direct and indirect impact of the tariffs themselves on consumer prices, and therefore their purchasing power.

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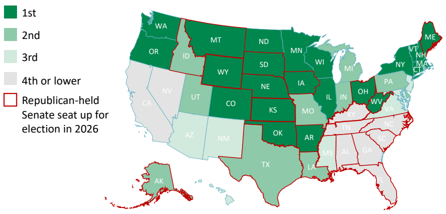
Exhibit 1
Canada Is the #1 Source of Imports for 23 States

Canada's rank as a source of goods imports by US state, 2023



States where Canada ranks 1st	Canada as a % of imports
Montana	92
Maine	69
Vermont	67
North Dakota	64
Wyoming	54
Oklahoma	51
West Virginia	44
South Dakota	41
Minnesota	38
Colorado	31
Iowa	30
Washington	30
Illinois	29
Connecticut	27
Massachusetts	26
Nebraska	25
Ohio	22
Oregon	21
New Hampshire	21
Arkansas	17
Kansas	17
Wisconsin	16
New York	14

* Florida and Ohio: special election.
US Census Bureau, Bing (map) and Desjardins Economic Studies

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