RBC Economics & Thought Leadership

A US-Canada trade shock now in play: first economic takeaways

Canada has been hit with its largest trade shock in nearly 100 years. RBC Economics now finds itself balancing the desire to produce a clear analysis with the recognition that the evolution of trade policies, and policymakers' responses to them, still remains highly uncertain. Still, we now have a growing list of "knowns" compared to a week ago, allowing us to analyze this shock with greater confidence. As the landscape continues to evolve, RBC Economics will provide updates to our outlook, helping to build a deeper understanding of this major economic event. We continue to lean heavily on the RBC Economics Playbook To Measure A Tariff Shock as a model for assessing the outlook amid these uncertainties.

1. This is the most significant trade shock since the Smoot-Hawley tariffs of the 1930s,

which are widely blamed for exacerbating and prolonging the Great Depression. This shock far surpasses the 2018 tariffs in magnitude, diminishing the value of that period as a helpful guide for the economic impact ahead. For context, in 2018, the U.S. average import tariff rose from 1.5% to roughly 3%. Under the new policy, the U.S. average tariff rate rises to nearly 11%, the highest average ratio since the 1940s. More importantly, this policy signifies a fundamental shift in a trade order that has endured for nearly a century, challenging the core economic principle that frictionless trade is a superior model.

2. A persistent tariff of this magnitude is recessionary for Canada.

If sustained, our initial analysis suggests that tariffs of this size (based on many assumptions) could wipe out Canadian growth for up to three years, with the largest impacts in the first and second years. Our estimates align to the Bank of Canada's findings which simulate that a 25% increase in tariffs across the board (U.S. and global) would reduce Canadian GDP ranging from -3.4 to -4.2 percentage points, compared to the baseline forecast. Similarly, an earlier model from the Bank of Canada estimated that GDP could drop by as much as 6 percentage points. By our calculations, such reductions could push Canadian unemployment rates up by between 2 to 3 percentage points. While the precise impact depend on a variety of assumptions - including monetary and fiscal policy responses - this is a significant negative shock to Canadian growth and poses a serious risks of unemployment rate increases.

3. Canadian retaliatory measures (25% on $155bn CAD, phased in) appear designed to asymmetrically challenge the U.S economy more than the Canadian economy.

However, they will still function like tariffs do for any imposing country - by lowering growth and raising inflation on targeted goods. In the days ahead, we will focus on identifying where Canadians are most likely to experience inflationary pressures from these measures.

4. Canada's manufacturing sector is most exposed, but the knock-on effects will also matter in many other indirectly exposed industries.

As we've covered before, Canada's manufacturing sector – which accounts for approximately 9% of Canada's GDP and 70% of total trade with the U.S. – is particularly vulnerable to tariff impacts. Canada's top 15 industries by trade with the United States, most of which are manufacturing based, represent nearly 3.1% of the country's total workforce. A key area of concern is Canada's motor vehicles sector, which is exceptionally integrated with the United States and Mexico. Parts can cross the border multiple times, meaning an end-product like a car may incur several rounds of tariffs.

Notably, Canadian raw commodity exports are less likely to see a drop in U.S. demand as Americans lack substitutes for these goods. This likely encouraged a lower 10% tariff on energy products for Americans, as this particular imported good is one of the most likely to create a larger and more immediate inflationary burden for American producers and consumers.

As outlined in our tariff Playbook, we are mindful that secondary industries in the services sector, for example, are also likely to feel knock-on effects. Consider an auto plant that experiences reduced demand and is forced to lay off workers. These workers, in turn, are less likely to then go to restaurants, movie theatres or engage in other "discretionary" spending. This ripple effect leaves a variety of non-tariffed industries exposed to the broader economic shock, and are also somewhat challenging to model as they can be exacerbated by confidence and sentiment channels.

5. Tariffs are hitting the Canadian economy at a moment during which it is already struggling.

Canada is still recovering from a major interest rate shock, and even as the Bank of Canada has cut interest rates by 200bps, the unemployment rate continues to rise, with the country is still operating with excess supply and below full capacity. GDP per capita has declined for eight of the past nine quarters, and business investment has been stagnant. Both cyclically and structurally, Canada's economy is not well positioned to absorb a shock of this scale.,

6. Tariffs will also be damaging to the U.S. economy.

While the U.S. economy is starting from a relative place of strength (and is far less reliant on trade), it will face a shock large enough to adjust most forecasts downward on growth and upwards on inflation. Additional retaliatory policies from Canada and/or Mexico will likely exacerbate these impacts.

Like in Canada, certain American regions and sectors will be more exposed. The U.S. manufacturing sector, in particular, has already been underperforming. Industrial production is little changed from a year ago and the sector has on aggregate shrunk since 2017. Washington's tariffs are likely to hurt U.S. manufacturing competitiveness further and, worse, as we have argued before will not lead to significant re-shoring of manufacturing capacity.

Moreover, comparisons to 2018 tariffs imposed upon China understate the economic impact for Americans. Canada and Mexico account for a combined 29% of U.S. imports as of 2023 (13.6% from Canada, 15.4% from Mexico) – more than twice the share combined compared to China (13.8%). In 2023, Canada was the top import source for 23 U.S. states and second largest for 11. Canada was also the top export destination for 36 states, and the second most important for another 8.

What We Are Watching For Next

The scope of economic impacts for Canada (and the U.S.) remains significant and, even with robust economic models, requires a considerable number of assumptions. As we continue to adjust our outlook based on new developments, **the following elements will be critical variables:**

Items that will worsen the impact

- **Duration of the tariffs:** Tariffs removed within a matter of weeks are likely to create a temporary stall for Canada. However, if they extend over a matter months (e.g. 3-6 months), Canada's recessionary risks increase rapidly. The duration of the tariff isn't just about the immediate shock (or recession) – the longer the tariffs last, the greater the structural damage (i.e. permanent) on the economy. For example, Canada's manufacturing sector (the most trade sensitive) accounts for more than 10% of total Canadian business investment, and almost a quarter of total Canadian machinery and equipment investment. A prolonged slowdown in investment in this sector will further reduce Canadian economic potential in the longer-run and require an even larger long-term adjustment.

- **Evolution of retaliatory measures or escalation of U.S. tariffs.** Canada's retaliatory measures appear aimed at reducing the duration of U.S. tariffs. However, additional adjustments in Canada (and Mexico) could further alter forecasts. Moreover, if the U.S. follows through on its threats to escalate tariffs in response to retaliation, we will need to make further additional adjustments in our analysis.

Items that can soften the impact

- **A weaker Canadian dollar (stronger U.S dollar):** The Canadian dollar has already weakened by 7% in the past 12 months and a further full offset equivalent to the 25% tariff/price increase seems unlikely. That said, any additional weakness in the Canadian dollar will buffer the price shock for Americans and reduce the expected drop in demand for Canadian tariffed goods.

- **An appropriate fiscal policy response:** Beyond the decisions around retaliatory measures, governments will have to make a series of choices and trade-offs around how they support Canadians through a recessionary-type environment, going above and beyond traditional "automatic" stabilizers. A tariff shock differs from a pandemic shock – it represents a structural shift in two countries' most important trading relationship. There is no 'unpause' button on a trade conflict, even after the tariffs are potentially removed, and thus fiscal policy will not simply act as a bridge from one side to another, but also the investment in Canada's next economic chapter. In that context, Canadian governments will now need to navigate:

  - ***The right amount of support.*** Unlike the global pandemic or Great Financial Crisis, Canada is experiencing (along with Mexico) an economic shock that is mostly unique to its economy – it won't be expanding its deficit or debt level along with its global peers and thus benefit from "relative" comparisons by global bond markets. With federal finances already pushing up closely to so-called "fiscal anchors", the rainy day fund isn't as flush as some would have hoped. Meanwhile, excess spending should the length of the trade conflict be (hopefully) short, could exacerbate inflationary pressures that Canada is only now overcoming, complicating the job of the Bank of Canada. Given the length of the conflict is likely more determined in Washington than Ottawa, this represents a particular challenge.

  - ***The right targets for support:*** The tariff shock is, likely to flow through both the goods and services side of the economy, but it will absolutely hit some areas much more than others. Broad-based support, as we saw in the pandemic, is likely to be less effective than appropriately targeted support that stops the bleed from tariffed sectors to non-tariffed sectors. Decoding which sectors need the urgent support will be a critical first step. We will write more on this in the coming weeks.

  - ***The balance of short-term vs. long-term support:*** the longer the tariff shock, the more Canada will have to spend to re-orient its economy towards a shifting trade order. That will have to happen in parallel with near-term support to soften the depths of a possible recession. Unlike the pandemic, we suspect that even a reversal of U.S. tariff policy would not eliminate a growing thirst for Canadian trade diversity and economic independence will grow in the years ahead.

- **A supportive monetary policy response:** Our base case expectation has been that the BoC was already on its way to cutting interest rates to about 2% by year-end 2025 and we suspect a tariff shock that produces a recession (even if it has inflationary elements) would put the BoC on an even more dovish track. All central banks are challenged by tariff shocks because they tend to raise prices but also lower growth. Further, the monetary policy response will need to be calibrated with the fiscal response ahead (more fiscal implies less need for monetary and vice versa). Our expectation is that, based on what we know now, the risks of additional easing over the baseline expectations for 2025 is growing. Regardless, we'll be monitoring for commentary (and/or) action from the BoC that would ameliorate interest rate burdens (and indirectly help support further weakening of the Canadian dollar).