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Reciprocal tariffs: No news is good news for Canada (sort of)

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No news was good news for Canada, but only relative to what some may have feared. We avoided being listed among countries subjected to new "reciprocal" tariffs announced by President Trump but that still leaves previously announced tariffs on autos, steel, aluminum and lumber, alongside the 25% fentanyl-related tariffs intact for non-USMCA compliant goods. However, if USMCA compliance has improved, meaning exemptions from the latter will have risen, the weighted average tariff paid by Canada could potentially be lower than the 10% baseline reciprocal tariff imposed on other countries today. In a world of full compliance where all US bound exports meet the USMCA criteria, we estimate the weighted average effective tariff could be around 5% or less based on the sectoral-tariffs alone. That's at least a silver lining among the tariff-driven storm clouds that have been forming over the Canadian and global economies this year.

Today's announcement of reciprocal tariffs from President Trump were calculated up from a 10% baseline charge, although for many countries the tariff will be set much higher. These include an announced 20% on imports from the European Union, 24% from Japan and 34% from China. Canada and Mexico will be exempt from reciprocal tariffs as long as the existing fentanyl/immigration driven tariffs on non-USMCA compliant goods remains in place. If these tariffs were to cease, Canada (and Mexico) would be subject to a 12% reciprocal tariff on non-USMCA compliant goods. The US has previously stated that in 2024 38% of Canadian exports were USMCA compliant, although we expect that compliance is ramping up rapidly given that companies now have a big financial incentive to make sure the correct paperwork is in place.

That still leaves Canada subject to higher tariffs on steel, aluminum, autos and lumber. While that might seem like a small list, long-lasting tariffs on those sectors would still leave a sizeable hole in the economy because they are amongst the most vulnerable and dependent on US trade. Using our modelling framework from previous research that accounts for direct and indirect effects, those sector-specific tariffs could leave Canadian GDP 1.5 to 2.0% lower than our pre-tariff baseline and employment lower by 125K. Those numbers don't account government retaliation, which could make them slightly higher, or for how much monetary and fiscal policy try to mitigate some of the hurt. While we averted some of the worst case scenarios today, we could still see a negative quarter in Q2 due to the impact of uncertainty on business investment and a pull-back in exports following the surge seen in Q1 as companies looked to front-run tariffs.

Canada's better fortune comes at the expense of other trading nations however, and could also end up biting us by slowing US and global growth, weighing on demand for Canadian goods even without further tariffs. The effective tariff rate on US imports is now close to 20% based on the selected table the President showed today and the North American exemptions. That is the biggest news of today, and represents an astronomical increase that could reduce GDP over the medium-term by around 1 to 2% through the income channel. Recycled tariff revenue could offset some of that over time, but in the short-run, deteriorating sentiment and uncertainty could amplify the shock as businesses and households hold off on investment and major purchases in the hopes that the administration dials tariffs down. The larger inflationary implications are probably going to sideline the Fed for longer, and so the administration likely won't get rate relief to help smoothen things out until the Fed is confident inflation expectations are anchored, and the risks to the job market spook them more than the inflation risks. The economic pain and the design of the tariffs are reasons to expect that the tariffs announced today will likely be negotiated down. East Asian economies will face a major shock with tariff rates ranging from 25-50%, and the EU is already identifying areas where they are willing to make concessions.

For the Bank of Canada, we lean towards an April pause after today's somewhat better than expected outcome. That doesn't mean the Bank of Canada is necessarily done easing because the tariffs announced today and the uncertainty of renegotiating USMCA with Trump are still going to weigh on the economy and job market. But the Bank of Canada has the luxury of waiting a bit more with an economy that enters this trade war in decent shape and also, to see what the new government in the spring will offer to change the economy's fortunes and how the government approaches the trade war. Ultimately, the real cure will be to get to the negotiating table and dial down the trade war with the US.