CIBC

CIBC CAPITAL MARKETS

Economics

ECONOMIC FLASH!

economics.cibccm.com

March 5, 2025

Trade War: It's On! Again

by **Avery Shenfeld** (avery.shenfeld@cibc.com), **Andrew Grantham** (andrew.grantham@cibc.com), **Ali Jaffery** (ali.jaffery@cibc.com)

Table 1: Canadian forecast assuming tariffs dropped by summer 2025

	24Q4A	25Q1F	25Q2F	25Q3F	25Q4F	2024A	2025F	2026F
Real GDP growth (q/q% annualized)	2.6	1.3	-2.4	0.9	1.3	1.5	1.0	2.0
Prior forecast		*1.3*	*1.2*	*1.6*	*2.4*		*1.8*	*2.3*
All items CPI (y/y% change)	1.9	2.0	2.5	2.9	2.7	2.4	2.5	1.5
Prior forecast		*2.0*	*1.7*	*1.7*	*2.0*		*1.8*	*2.0*
Unemployment rate (%)	6.7	6.8	7.1	7.0	6.7	6.4	6.9	6.2
Prior forecast		*6.7*	*6.9*	*6.6*	*6.3*		*6.7*	*6.0*

The 30-day cease fire has run its course, and the North American trade war is back on. The 25% tariff on all Canadian exports (10% on energy products), in addition to tariffs already in place for steel and aluminum, will have a significant impact on exports and business investment and if permanent would drive the Canadian economy into recession.

However, we'll go back to the script we put out a month ago when, for a single day, tariffs were supposedly coming, in which we argued that the combination of negative impacts in the US economy, a thumbs down vote by financial markets, retaliatory measures from Canada, Mexico and China, would bring the US back to the negotiating table by this summer. Indeed, late yesterday, the US Commerce Department Secretary signaled some room to lower these tariff rates, but the President appears to be playing the central role in such decisions. We don't at this point have any signal from President Trump that such a deal is imminent, although we've learned to expect the unexpected from the White House in recent weeks, and we might again have to adjust our forecasts for any changes ahead. Given what we've seen from this President on other files, the countries now under the tariff hammer may have to come with some peace offerings that give the Trump administration a win or two on other matters to achieve a new truce, although even then, we'll still be operating under a cloud until an extension of the USMCA deal is in place.

The war is on, but for how long?

In earlier research (See Canada's tariff troubles: Recession trumps inflation as the worry), CIBC economics estimated that a permanent imposition of a 25% tariff on non-energy goods, and a 10% tariff on energy, would leave the level of real GDP roughly 5% lower than in our prior forecast by the end of 2026 (without accounting for the policy response). If anything, should all of the trade measures announced today remain in place, coupled with some of the negatives from retaliatory measures on Canadian purchasing power, the hit would be somewhat larger, because the tariff on steel and aluminum would be 50%, and additional tariffs coming on lumber might also be stacked onto this one. We would put high odds on a Canadian recession in the first year of a trade war shock. The impacts will fall disproportionately on central Canada, and be greatest in those elements of the manufacturing sector where the US makes up a large share of sales (e.g. autos, steel) and where the US has the capacity to erode Canada's market share.

While, with a lag, that shock could be pared back a bit by monetary and fiscal stimulus, and other policies to promote longer term growth through trade diversification, the level of GDP at full employment will be permanently on a weaker path due to the reduction in two-way trade.

But we're seeing just the kind of signposts we were looking for a month ago when we judged that there was still reason to believe that the tariffs would not be permanent. That includes the reaction in financial markets, the pushback we're beginning to hear about from impacted sectors like autos, the prospect of additional carve outs, and of course, the quick imposition of retaliatory tariffs that will dent some US export sectors. The White House will initially argue that short term pain is worth it for a gain down the road, but we expect to see a bit less patience in the business community. Moreover, the negative impacts of tariffs on US inflation look likely to pile up, as Trump today signalled upcoming tariffs on agricultural products (beyond the Canada-Mexico and China tariffs), as part of an early April announcement.

Table 1 shows the revised forecast for Canadian GDP, inflation, and the unemployment rate over the next four quarters, as well as annual projections for 2025 and 2026, under the assumption that the tariffs are substantially eliminated by this summer. Our Q1 call for growth in the 1 1/2% range remains intact, because the downside hit to March activity will have been offset by the better start to the quarter associated with the strong handoff from December and January GDP. But Q2 will likely see a dive in business capital spending due to the degree of uncertainty, pressure on consumers from tariffs on imports from the US, and of course, weakness in export volumes, and only some of that will be reversed in Q3. The subsequent growth pick-up doesn't make up for all the lost ground in the level of real GDP versus where our forecasts stood in late 2024, due to the hit to business capital spending on this side of the border and a bit of permanent substitution away from Canadian imports stateside. Canadian GDP is about 1% lower as compared to our pre-tariff projection by the end of 2026.

Initially, inflation will head higher owing to a weaker Canadian dollar, tariffs on imports, and the spillover from the increase in the cost of producing goods in the US (due to their tariffs on inputs). But even if the trade war carries on through 2026, we would see downward pressure on inflation emerge due to the increase in economic slack, and reduced consumer spending power in the wake of material job losses.

We're also revising our near term US outlook, but to a lesser degree (Table 2). GDP Growth in the US will look volatile in the first half of the year as import front-loading and inventory swings impact the headline growth figures, but we expect annual GDP growth to decelerate by a half-percentage point more than our prior forecast in 2025, and the level of GDP to be 0.6% lower by the end of our projection. Domestic demand growth will slow from just over 3% in 2024 to about 2% in 2025 and the jobless rate will rise by almost half percentage point. Prices should meaningfully pick up as businesses pass on the tariffs quickly given the little time they had to prepare and monthly CPI inflation could peak around 3.5% in the middle of 2025 and average 3% annually in 2025 as food and core goods prices rise, even though shelter costs will still come down gradually. Price level effects will start to fade in the second half of the year and inflation will gradually normalize in the 2026.

The picture for the US is better than Canada, but not great by any stretch. The once indefatigable American consumer will look more fatigued, wary and cautious after seeing steep price hikes on imported Mexican fruits and vegetables and Chinese-made consumer durables. The policy uncertainty and supply chain disruptions will grind business investment growth lower. We expect the Fed will be on hold for the first half of the year, trying to balance the challenges of higher inflation and unemployment, aiming to make sure businesses and markets trust the process enough to believe 2% inflation is still believable in the long-term. But if the trade war comes to a close and the labor market shows sustained weakness in the second half of the year, the Fed will have the green light to trim rates late in the year to support growth and the job market, and ultimately, they will live with a bit higher inflation in these circumstances.

Table 2: US forecast assuming tariffs dropped by summer 2025

	24Q4A	25Q1F	25Q2F	25Q3F	25Q4F	2024A	2025F	2026F
Real GDP growth (q/q% annualized)	2.3	0.7	1.4	1.8	1.6	2.8	1.7	2.1
Prior forecast		*2.1*	*2.2*	*1.9*	*1.7*		*2.3*	*2.2*
All items CPI (y/y% change)	2.7	2.7	3.0	3.3	3.2	2.9	3.0	2.6
Prior forecast		*2.5*	*2.2*	*2.5*	*2.7*		*2.5*	*2.5*
Unemployment rate (%)	4.1	4.1	4.3	4.6	4.6	4.0	4.4	4.3
Prior forecast		*4.2*	*4.3*	*4.2*	*4.2*		*4.2*	*4.1*

Where does this leave the Bank of Canada?

Canada's central bank has made it clear that it can't, on its own, protect Canadians from the economic shock of a trade war. Structural damage from what could be a permanent loss of industrial capacity isn't undone by lowering interest rates, and the Bank wants to be careful about its actions as two-way tariffs lift inflation. But Governor Macklem has talked about the BoC acting to help in the adjustment process, and the only tool the central bank has to "help" entails running an easier monetary policy than it would have otherwise.

If Trump had given Canada the all-clear on tariffs this week, stronger second half GDP data, and a couple of better months for job gains, would have given the Bank of Canada leeway to pause on its rate cut path, while it gave time for the economy to show if it needed additional relief. But in recent weeks we kept our call for a March rate cut in place, because we doubted that this week would see anything close to a full reprieve from the tariff cloud. Steel/aluminum tariffs were still coming, as were increases on lumber, and Trump was considering sectoral tariffs on autos even if he judged that Canada and Mexico had sufficiently addressed his concerns over migrants and fentanyl.

Those uncertainties would still have put downward pressure on capital spending in Canada, but this week's news, that the tariff package announced a month ago was now back on, was of course even more of a negative. We still lean towards the Bank delivering a quarter point cut in March as a way to lend a helping hand on the growth side, making the case that the hit to prices will be a one-time bump rather than the start of sustained inflation. We'll sticking with our call for rates to trough at 2.25%, assuming that the tariffs are lifted by the summer and the economy begins to revive. How low rates would go in a more sustained trade war will depend on Canada's fiscal policy response, since the Bank believes that fiscal tools might be better targeted to address the shock.

The Canadian dollar has weakened on days when markets were digesting unfavourable tariff news, but it's been protected by market doubts about whether the trade war will be a lasting reality. The quick reversal by the White House a month ago, only a day after the original tariff announcement, and the Commerce Secretary's recent comments have likely amplified those doubts about the longevity of this re-imposed trade war. But if, as we expect, no immediate ceasefire is forthcoming, we would expect to see some further Canadian dollar depreciation in the weeks ahead. Should the tariffs last beyond a couple of quarters, the dent to Canada's trade flows, and additional Bank of Canada rate cuts, could put further pressure on the Canadian dollar, if markets started to believe that the tariffs were permanent. But in the current environment, we don’t see a jump to the 1.50 range, given that tariff sensitivity has waned due to doubts about their longevity, and increasing concerns about the implications of a trade war for US asset prices and economic growth. In our base case, we would instead anticipate a move back into the low 1.40s if calmer waters are restored.