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Canada-US Trade: Talks Break Down, Tariffs Headed Up as the Tit-for-Tat Trade War Escalates

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Negotiations to stave off another round of US tariffs on Canadian goods, in this case a 50% tariff on roughly 5% of Canada's exports, broke down on Friday night, as the two sides were unable to find common ground on a deal to forestall those tariffs, and soften some existing levies and trade irritants. The new tariffs were threatened a month ago on claims that Canada was discriminating against American goods relative to the treatment of other imports. But most of these claims related to measures Canada took in retaliation to sectoral tariffs imposed by the US in 2025, as these US tariffs were in violation of the Canada-US-Mexico trade deal.

With talks breaking down, tariffs will go up immediately on those targeted Canadian exports, but also on US exports to Canada, with Prime Minister Carney announcing that he will levy an equivalent tariffs in response. But US Trade Representative Greer had warned that the US would "not tolerate" new Canadian countermeasures, which raises the risk that it will respond with still further tariffs on Canada. The net impacts on our forecast are, at this point, still in flux, as for reasons we outline below, there are important elements of the story that will only emerge in the coming weeks.

Economic Implications: Deep for the affected companies, not yet clear for the economy overall

The new US tariffs will deeply affect Canadian exporters in the targeted sectors, which include electronics, wood products, furniture, plastic products, paper products, machinery and more. A 50% tariff could well represent an insurmountable barrier for their ability to reach the US market. The direct impact hits shipments worth roughly 0.9% of Canadian GDP, but after stripping out their import content, even assuming these shipments drop to zero, that would reduce Canadian GDP by about half a percentage point. Since many of the affected industries are populated by small and medium sized, labour intensive firms, the hit to employment would likely be a bit larger. That, however, isn't the full story here, as there are plusses and minuses to consider.

On the negative side, our existing forecast had assumed that while a return to free trade was never in the cards, the US might offer at least a moderate dose of relief from reductions in tariffs on metals and autos, both of which had already been discussed with the US in an earlier set of talks. Failing to reach such a deal today doesn't preclude it from being part of additional negotiations ahead of CUSMA, but it does signal that the US side isn't as flexible as we hoped. Our expectation for such a deal rested on a judgement that it was in the US interest to pare back these tariffs. Tariffs on Canadian aluminum were increasing costs for US businesses without stimulating much in the way of additional US supplies, steel tariffs were having the same impacts on steel-consuming sectors, and other countries were already facing lower metals tariffs on exports to the US. Canadian tariffs on US vehicles threatened to do damage to US production that would offset benefits to US plants from reducing imports from Canada.

But the other additional negative is that this story is not yet over, in terms of a further escalation of tariffs on Canada. The Trump administration could opt to retaliate to Canada's retaliation to the US tariff that went into effect on midnight Friday, and therefore we could find ourselves looking at a dent to other Canadian exports. More broadly, an escalating trade war will be a negative for business sentiment, and run counter to our assumption that the worst economic hit would be behind us soon. If we wanted to find a silver lining in that scenario, it's that ratcheting up the pressure on exporters in both directions might help push the parties to get back to the negotiating table.

On the side of cushioning these impacts, the Prime Minister has promised financial assistance to companies and workers in these sectors for as long as necessary, even beyond the end of the current US Administration. Canada's retaliatory tariffs will, where applicable, target US products that compete in Canada's home markets, helping the affected companies offset export losses with an increase in domestic market share. In other cases, the capacity freed up by a drop in exports will on its own incentivize Canadian companies to more aggressively seek out customers in Canada and non-US external markets, and the US actions are likely to reinforce a buy-Canada, travel-in-Canada sentiment among households on this side of the border.

Moreover, the drag on growth could see the upcoming fall federal budget, and spring provincial governments, lean towards providing additional fiscal stimulus, as we saw in the prior Federal budget's response to 2025 tariffs. For monetary policy, the impacts are a bit more ambiguous, but on balance are likely lean to a delay in any tightening in policy in 2027, as slower growth would open up additional disinflationary slack.

While Canadian retaliatory tariffs could work in the opposite direction, by boosting inflation, the previous retaliatory tariffs ended up only adding a few decimal places to the CPI at their peak impact, and were only a one-time lift to the price level as opposed to an ongoing source of inflation. We would expect a similarly minimal inflation impact in this case, and therefore, a potential for this trade-war escalation to keep interest rates low for longer if growth is negatively impacted. The Prime Minister has pledged to select items for retaliatory tariffs that have the smallest negative impact on consumers, likely by imposing tariffs on items where there are domestic or non-US-import substitutes, forcing US suppliers to absorb some of the tariff to remain competitive. Note that the 2025 tariff rounds did not see the BoC lift interest rates to address the modest tariff contribution to inflation, and the drag on growth may well have encouraged the Bank of Canada to keep rates down even as energy prices lifted headline inflation.

None of this will have a material impact on our call for Canadian real GDP growth to be a shade under 1% for 2026 as a whole. There's only four months left in the year, and some companies have rushed to ship inventories to US warehouses ahead of these tariffs in a way that will cushion their Q4 sales. Moreover, what we lose in Q4 growth looks to have been roughly offset by an upward surprise in Q2, with results due to be reported this week. But our forecast for 2% real growth in 2027, while resting on some larger capital projects getting underway and a reduced negative from housing, also factored in a modest dialing down of existing tariffs and an assumption of no further tariff increases. We might be more in the 1 1/2% range when we fine tune that call in the coming weeks.

Where to From Here?

It's important to remember that this story is far from over, and could either darken on an escalating trade war, or brighten if the two countries reach a rapprochement. We've already cited the risks of American retaliation to Canada's retaliation. But let's not forget that in February 2025, the White House announced a 25% fentanyl tariff on Canada (10% on energy) . That lasted only one day before it was postponed, and ultimately cancelled for the vast majority of Canadian exports that met the terms of the CUSMA trade agreement. When you tell a car dealer that you're not willing to take his last "best" offer and walk out the door, sometimes he rushes after you with a better offer.

Even if that sort of quick turnaround isn't in the cards in this case, Canada, the U.S. and Mexico have trilateral talks ahead on their existing trade pact. That could create another opportunity to address these new impediments in exchange for dealing with some broader issues that the US side wants action on. But here too there is a risk in the other direction. In his Q&A on Saturday, the Prime Minister seemed concerned about what these recent, failed talks revealed about the US willingness to reach a mutually beneficial CUSMA deal. For now, CUSMA is still important in providing protection against tariffs for most of Canada's US-bound exports. That said, these latest developments have undermined the confidence that Canadians will place in the American side's willingness to adhere to CUSMA provisions, since the new tariffs will hit goods that are in compliance with that treaty.

Canada could also move away from trying to reach a grand bargain covering all of the affected sectors towards talks aimed at reducing some of the tariffs now in place. That might not have been politically acceptable on this side of the border up to this point, but might be an option now that its very clear that a comprehensive deal isn't achievable.

American importers of Canadian goods hit by tariffs could also pursue legal action in the US that would challenge the authority under which the President imposed the new 50% tariff. The President relied on provisions in a 1930 trade act that had never been used in this fashion, and are therefore untested in the courts. Some legal analysts have said that the scale of the new US tariffs is excessive in size and sectoral breadth relative to what the legislation envisages. Moreover, that statute deals with tariffs on countries unfairly discriminating against US products relative to those of other countries. But most of what the executive action cited in that regard were measures applied to the US (and not to other countries) in retaliation for the US 2025 sectoral tariffs on Canadian autos, metals and lumber, a retaliation that is the typical tool when an existing trade agreement like CUSMA is violated by the other side. Should legal action succeed however, it would likely be after a drawn out process that required lower court rulings to be sustained all the way up to the Supreme Court.