Economics

# IN FOCUS

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# Canada's tariff troubles: Recession trumps inflation as the worry

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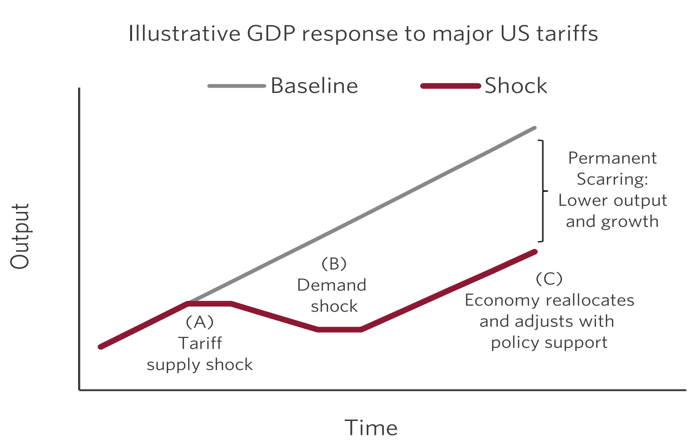
The trade war could begin tomorrow, or maybe we will get a delay. A lot remains unclear and if it begins, no one knows how long it will last, or whether further rounds of retaliation are in store. Our base case forecast calls for cooler heads to prevail and trade hostilities ending after Q2 (See "Trade War: Shock but not awe. A first look at forecast impacts"). We now expect growth of 0.7% in 2025 and rebound to 2.8% in 2026 compared to our prior forecast of 1.8% and 2.6%. Inflation should peak at about 3% in 2025 but fall below target in 2026, and the Bank of Canada will bring rates down to 2.25% by Q2 and hold them there, expecting fiscal policy to play a helping hand.

But what if this is our new reality? In this piece, we do our best to pin down order-of-magnitude impacts on growth and inflation, and the sectors and provinces most at risk in that worst case scenario of a long-lasting trade war. We also look at other alternatives to what has been announced so far, should the US elect to keep but lower tariffs.

Chart 1: A long-lasting tariff will permanently scar the economy




Source: CIBC

Answering these questions is a challenge. A former Bank of Canada Governor recently told a CIBC capital markets audience that anyone who claims they can accurately measure the Canadian economic impacts of a major trade war "is lying", and he has a point. Our statistical tools are inadequate for the task, lacking either recent precedents of high two-way tariffs to use as benchmarks, or models that have the detailed industry-level data across sectors and countries needed for accurate simulations.

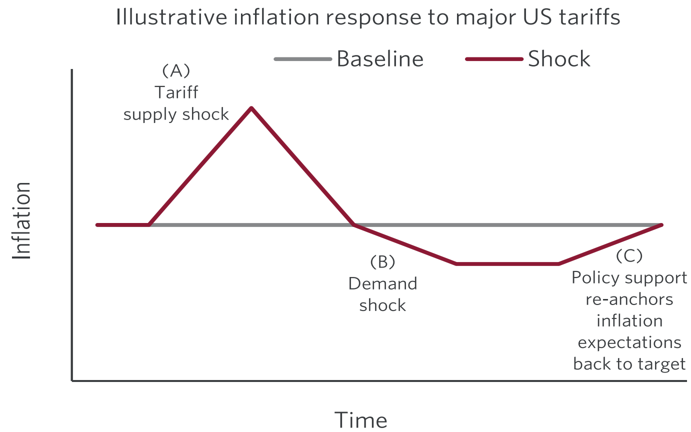
With that caveat in mind, we find that the downside risks to growth would trump what would be temporary and soon-reversed upside risks to inflation, so that policymakers could have a clear focus on stimulating domestic demand as exports and investment struggle. The hit to the level GDP could be 5% from long-lasting tariffs of 25% and 10% on energy, though fiscal and monetary policy could cushion that somewhat. While inflation would rise to the top of the control band in this year, it could fall below in 2026 as price level impacts fade and slack remains.

## The tariff-shock roller coaster

If we set aside magnitudes, the direction of the shocks to growth and inflation in a two-way tariff war are relatively clear, although there would be three distinct phases to these adjustments (Chart 1). Phase "A" will see GDP growth slow due to a contraction in trade, while tariffs take inflation higher. That initial slowdown is magnified in a recession or something close to one in Phase B as job losses in the trade sector, and higher prices facing consumers, slow real consumption, investment and employment across the economy.

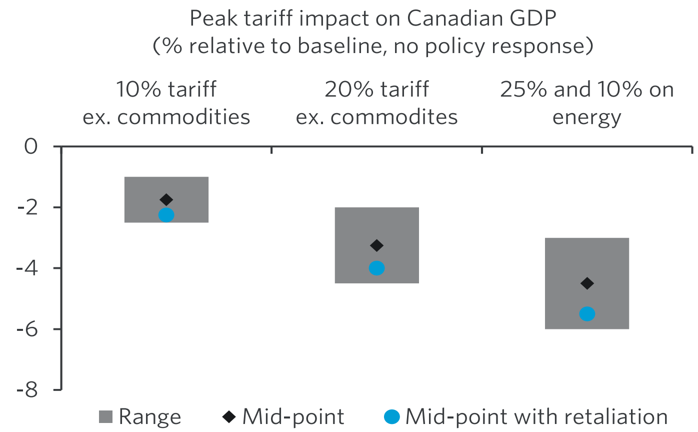
The final phase is the reallocation and recovery phase. Export volumes could at least partially rebound as exporter margins are compressed and the Canadian dollar weakens, while imports remain on a slower track due to those same exchange rate effects. With domestic demand supported by fiscal and monetary stimulus, labour and capital would be partly reallocated away from the export sector towards meeting Canadian needs.

Chart 2: Inflation could spend more time below 2% than above




Source: CIBC

Chart 3: GDP hit to Canada is 2-5% across the range of tariff scenarios, including retaliation




Source: CIBC calculations

But there will be no magical elixir that governments or central bankers can offer to fully return the economy to its prior growth path. A world in which two-way trade takes up a smaller share of GDP is one in which each country shifts away from what it was relatively good at making, and was exporting, towards activities where it is relatively less competitive, and had previously relied on imports. Moreover, even a temporary tariff would raise uncertainties for those contemplating Canada as a location for serving the US market, thereby casting a long shadow on future investment flows. All of this means a slower speed limit for Canada's trend rate of growth, and that potentially could have implications for the neutral rate too.

Inflation will also go through a multi-stage ride (Chart 2). Prices would move higher in the short-run, possibly above the top end of the Bank of Canada's control range if tariffs go through and remain in place for sometime. But as those initial price level effects pass, the weakness in overall economic activity, softer consumer spending power, and higher unemployment will depress price growth later on. As we discuss below, we see a high chance that inflation could be below 2% for longer than its temporary move above 2% in the first phase of the shock.

Central bankers with sufficient foresight could look past the one-time lift to the CPI, and focus instead on growing economic slack that threatens to send inflation below their targets over the medium term.

## Ballparking the initial shock

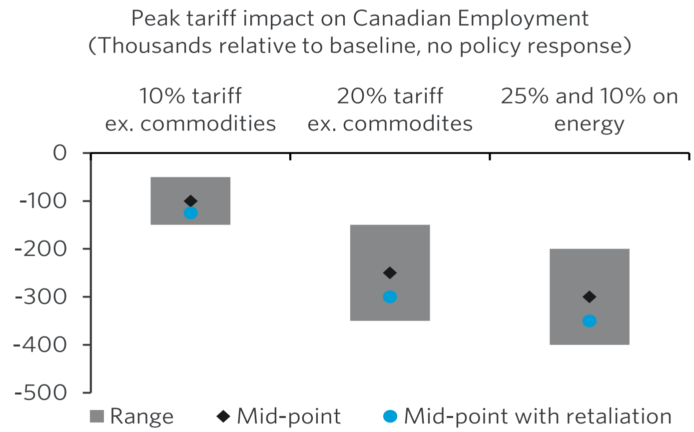
Now comes the hard part. What can we say about the magnitudes of the GDP and inflation moves through these various phases? Given what we noted about the limitations of any of the various models, we're really looking for ballpark orders of magnitude, not decimal places of precision, and we caution that our estimates should be used in small doses with an accompanying grain of salt.

The starting point of our analysis is to assess how much of the tariff passes through, net of exchange rate movements, into the US import price of Canadian goods. Then we estimate how much Canada's US-bound trade by industry would be lost based on the ability of US industries' to substitute to domestic production for a given increase in import prices. Differences in these elasticities of substitution were a key reason why

Table 1: Main assumptions around GDP impact

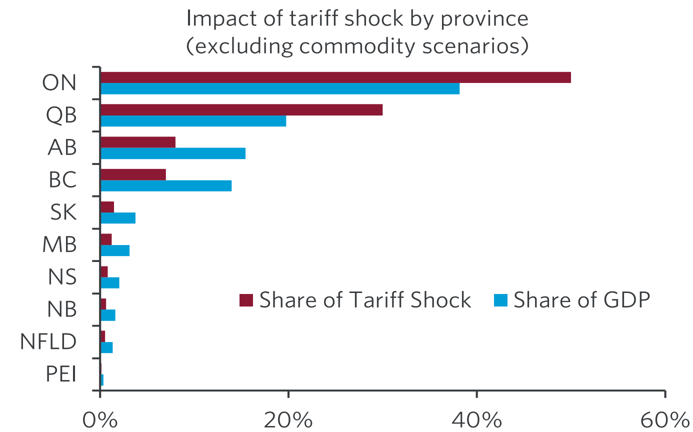
| Assumptions | Details |
|---|---|
| Tariff pass-through | 75% |
| FX Depreciation | 3% - 5% |
| Industry-level Trade Elasticities | Ahmad and Riker (2019);<br>Bohem and Levchenko (2023) |
| Input Output Linkages | Statistics Canada Derived Multipliers<br>(Table 36-10-0013-01) |
| Uncertainty impact | 50% of direct impact (Boer and Reith, 2024) |

Chart 4: Relative to a pre-tariff trend, there could be 150K to 350K fewer jobs in the economy




Source: CIBC calculations

Chart 5: Ontario and Quebec would bear about 80% of a tariff excluding commodities




Source: Statistics Canada, CIBC calculations

Canada's aluminum sector weathered US tariffs during Trump's first term better than what the steel sector felt.

That initial hit to exporters then hits other sectors of the economy as exporters reduce employment and what they buy domestically, which we approximate using Statistics Canada's industry level input-output multipliers. The last layer is the role of uncertainty and weaker business confidence, which we assume is about half the direct impact based on estimates from the academic literature.

Our results are shown in Chart 3 and some of the main assumptions are listed in Table 1. The bottom line is what you would expect, and within the same order of magnitude to what the Bank of Canada estimated for the one scenario they modelled. A 25% tariff and 10% on energy, with the retaliation on about 25% of our imports could reduce GDP by about 5%. If ultimately we end up with lesser tariffs of 10% or 20% with carve outs for all commodities, the hit to the economy would range from 2-4% assuming we retaliate in those scenarios as well. Considering the economy is already about 1% below its potential level, long-lasting tariffs could bring Canada into a material recession with a 25% tariff on the order of magnitude of 2008-09 financial crisis shock.

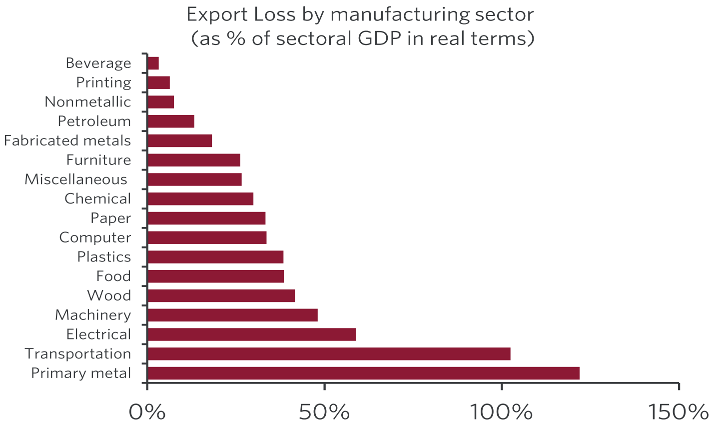
Workers could feel the pain of an employment drop that would be concentrated, but not isolated, in the export sector. Our estimates range from 150K to over 350K fewer jobs in the economy depending on the severity and coverage of the tariffs (Chart 4). That would lift the unemployment rate by about half-percentage point to over 1%-point higher, even after allowing for some discouraged workers dropping out from that tally as they leave the labour market altogether.

Of course, our exercise doesn't take into account the role of monetary and fiscal policy that would, with a lag, lean against these recessionary forces. But we're also not capturing a negative feedback loop through more stressed credit conditions. Nor are we accounting for the longer term impacts associated with businesses opting to relocate south of the border as a hedge against further or deeper trade wars.

Table 2: Key assumptions behind inflation impact

| Assumptions | Details |
|---|---|
| US PPI pass-through into Canadian PPI (in CAD terms) | 0.4 |
| US import content in Canadian CPI | 15% |
| Domestic producers opportunistically raising prices | 25% of tariff effect (Amiti et al, 2019) |
| FX pass-through | 0.9 for 10% change (Devereux et al, (2017); Alexander and Reza (2022); Forbes et al (2020)) |
| Inflation expectations | Remained broadly anchored throughout |
| Slope of the Philips Curve | 0.3 (annualized q/q) |
| Dynamics | Tariff-driven price-level impacts pass-through by three quarters; Output gap troughs by mid-2026 and policy support helps slack dissipate thereafter |

Chart 6: Primary metal and transportation would be the hardest hit manufacturing sectors



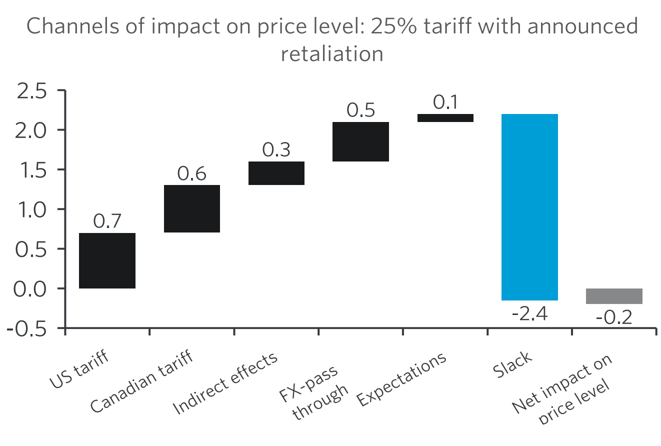

Source: CIBC calculations

Ontario and Quebec would bear the brunt of the shock, particularly if the US opts to exempt commodities in order to avoid a hit to US gasoline consumers and American manufacturers that rely on imported materials. These two central Canadian provinces would bear 80% of the hit from a tariff that excluded commodities, versus their 60% share of Canadian GDP (Chart 5). Within manufacturing, sectors like beverages with low US weightings as a share of their output, or less room for US production to supplant their exports, see less of a hit than sectors like primary metals, transportation equipment (including autos), wood products, electrical equipment and machinery (Chart 6).

## Jump, but how high? And for how long?

There's truth in the conventional wisdom that a two-way tariff war would initially lift Canadian consumer prices. Yes, prices would jump, but how high, and for how long? Translating the tariff pass-through, currency depreciation, and economic slack into their inflation impacts requires drawing on prior estimates

Chart 7: The influence of slack would outweigh the impact of temporary price level increases




Source: CIBC calculations

and, we concede, some further assumptions, including how long it takes for the GDP hit to materialize, and when slack starts to dissipate with some policy support (Table 2).

Initially, there would be several channels through which prices would climb. Universal tariffs in the US would raise production costs in Canada, given the interdependency and integration of supply chains. Retaliatory tariffs in Canada, and a weaker loonie, would raise Canadian dollar prices for imports from the US. Domestic firms might opportunistically raise their prices to match the higher prices of import competitors, although economic slack and the weakness in demand would be a limiting factor.

But these one-time price level impacts would be less than the downward pressure on spending power and inflation from the weakness in the Canadian economy, judging by our estimated impacts (Chart 7). The increase in slack would push the price level slightly lower from where it would otherwise have headed over a two year period, assuming the peak impact on economic activity occurs about a year after implementation.

Across our range of tariff scenarios, there is a reasonable chance inflation could rise to or above the Bank's 1-3% control range after about a year of implementation. But as those price level impacts fade and the influence of slack remains, inflation would fall below target and remain below target for longer (Chart 8).

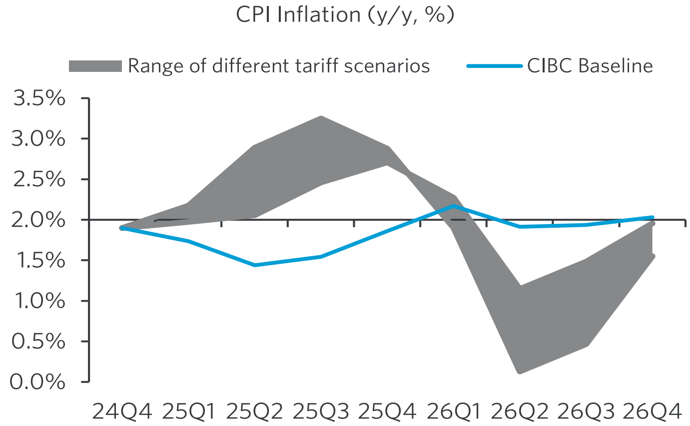
We're not as worried as the Bank of Canada about inflation expectations. True, expectations might drift up a little in the short-run, but as it becomes clear that the Canadian economy is in a heap of trouble with permanent tariffs, businesses' will have little ability to fully pass on sustained price increases to consumers over many years. This is a very different experience than the post-COVID era where the economy was running hot at the same time supply shocks were pushing up prices. The mix of ingredients won't be there to trigger the same type of knock-on effects to generate persistent inflation. Also, inflation doesn't look like it will soar above 4% initially, which is roughly viewed as the threshold to worry about in terms of de-anchoring expectations. In fact, if it failed to offer enough monetary stimulus to combat the recession, the BoC might need to worry about inflation expectations becoming anchored below the 2% target.

## This too will pass... or maybe not

At this point, there are more unknowns than knowns. We are hopeful that Canada should be able to take enough steps to convince the White House that it is taking border security seriously, making this a very short trade war. A temporary tariff would be a short-lived shock and with a negotiated long-term settlement plus policy support, we could get through without too much lasting damage.

While we hope for that outcome, there is a material a risk that we may settle with just a lower tariff. The administration is now reviewing accusations of unfair trade practices, perhaps as a part of the discussions surrounding the 2026 deadline for

Chart 8: Inflation could peak at the top end of the BoC's control range but fall below in 2026




Source: CIBC calculations

extending the trilateral USMCA deal with the US and Mexico. Trump clearly also views a universal tariff as a means of generating a revenue stream that will offset some of the fiscal hit from extending business and personal tax cuts enacted. Major tariffs on Canada could remain until we see the details on a major budget deal now being worked out between the Trump team and Congressional Republicans.

It's a tough road ahead for the Canadian economy and Canada gaining an exemption to this and future tariffs will depend on how they hurt both the US economy and American political opinion. So we'll be referencing this report in thinking about downside risks to our base case forecast, and as a guideline to where monetary and fiscal policy would need to turn to aid in a recovery.

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