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Trade War: Shock but not awe. A first look at forecast impacts.

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Table 1: Canadian forecast assuming tariffs dropped after Q2 2025

	24Q4F	25Q1F	25Q2F	25Q3F	25Q4F	2024F	2025F	2026F
Real GDP growth (q/q% annualized)	1.5	0.2	-2.4	3.2	3.2	1.3	0.7	2.8
Prior forecast	*(1.5)*	*(1.8)*	*(1.9)*	*(2.0)*	*(2.7)*	*(1.3)*	*(1.8)*	*(2.5)*
All items CPI (y/y% change)	1.9	2.2	2.7	2.5	2.3	2.4	2.4	1.3
Prior forecast	*(1.9)*	*(1.8)*	*(1.4)*	*(1.5)*	*(1.9)*	*(2.4)*	*(1.6)*	*(2.0)*
Unemployment rate (%)	6.7	6.9	7.2	7.0	6.7	6.4	7.0	6.2
Prior forecast	*(6.7)*	*(6.8)*	*(6.7)*	*(6.5)*	*(6.2)*	*(6.4)*	*(6.5)*	*(5.8)*

The US has launched the first salvos in what could be an all-out trade war or merely a shorter-lived skirmish with Canada and Mexico, and deepened existing trade barriers with China. The 25% tariff on Canada (10% on energy products), 25% on Mexico, and 10% on China was well telegraphed, but without precedent among allies in the modern era. This is a shock, but there's nothing to be in awe about here. It will entail a significant economic hit to what we've always thought was America's close ally to its north, and will serve to raise prices and slow growth in the US itself. But the announcement has by no means cleared up the uncertainty over what comes next if Canada addresses Trump's concerns over migrants and drug flows across the border. Moreover, a negotiated end to this 25% levy would still leave Canada at risk of being included in a subsequent tariff on all US imports, or to targeted tariffs designed to address any grievances the US unveils over Canada-US trade in a review scheduled for completion on April 1st. We also can't completely rule out a court challenge in the US, since we understand that the act the President has used to invoke these measures has been used for sanctions rather than tariffs in the past.

In a separate research piece to be released shortly, CIBC economics provides estimates for the much more extensive damage that would be wrought in the Canadian economy by a permanent two-way tariff war with the US at various levels, including a scenario on the US side that's in line with what was announced this past weekend. In that outcome, the level of real GDP could be 5% lower than in our prior forecast by the end of 2026, and while that outcome could be cushioned with a sufficient monetary and fiscal response (including a recycling of tariff revenue), the level of GDP at full employment will be permanently on a weaker path due to the reduced two-way trade.

But at this point, we're not ready to give up on the ability of Canada and its allies in the US and the business sector to reach a more favourable resolution. For our base case economic forecast, we're assuming that the tariff on Canada, and the retaliatory tariffs on the US, are lifted at the end of Q2 through efforts at the negotiating table, lobbying by affected US businesses and states, and actions by Canada that make the case that its border is secure. A hit to business confidence and capital spending would then linger due to remaining uncertainties over further trade issues.

Call that a bit of wishful thinking if you will, but it reflects the room for such a deal that was explicitly laid out in the testimony of Trump's Commerce Department Secretary, and the on-again, off-again period of tariffs and NAFTA talks during Trump's first term. The Q2 date would be consistent with Canada getting a favourable review in the analysis of border issues being prepared for the President for April 1st, including actions taken to address US concerns. We also hope that the review on Canada-US trade matters opens the door to negotiations rather than an immediate imposition of tariffs on selected sectors.

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. For each of these variables, our prior forecast is indicated in parenthesis below the new outlook. Growth turns negative during the tariff period, but the subsequent growth pick-up doesn't make up for all the lost ground in the level of real GDP, 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. Inflation is lifted by the combination of 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 reverses course once the tariffs are lifted as price level impacts fade and slack remains.

While we would favour a monetary policy easing as part of the initial response, our existing call for a 2.25% overnight rate by the end of Q2 may be all we see from the Bank of Canada if the tariffs end at that point. The Governor appeared to be concerned about feeding into inflation expectations with a more aggressive stance. Should tariffs persist beyond Q2, recession-style job losses and the reduction in spending power would put enough downward pressure on prices to cancel out the initial upside, and thereby leave the Bank of Canada an easy decision to ease rates more aggressively. It's hard to believe that inflation expectations would shoot higher with significant slack in the economy and so much uncertainty looming over Canada's long-run growth prospects. It would take a lot of fiscal stimulus to substitute for monetary policy, and a combination of accommodative rates and targeted fiscal support would likely be part of the response.

The immediate reaction in the currency market will be to add to what we've already seen as markets priced in a higher risk, but not a certainty, that Canada and Mexico would be hit by US tariffs. Our initial projection in such a scenario was that dollar-Canada would approach the 1.50 mark, rather than in a no-tariff forecast, in which the end of such risks would have seen the loonie recover some of its lost ground in upcoming quarters. With tariff uncertainties likely to remain even after Q2, we could see a more limited rebound than we earlier projected.

Our US forecast will also be impacted by the tariff war, if again mostly on a temporary basis. We'll have higher inflation from the pass-through of tariffs to US consumers. Growth will be somewhat slower due to the impact on consumer spending power, the disruptions to supply chains, and the hit to exports from retaliatory tariffs and a stronger US dollar. Our hope is that these impacts will be sufficiently visible to add momentum towards a negotiated end to the trade war.

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