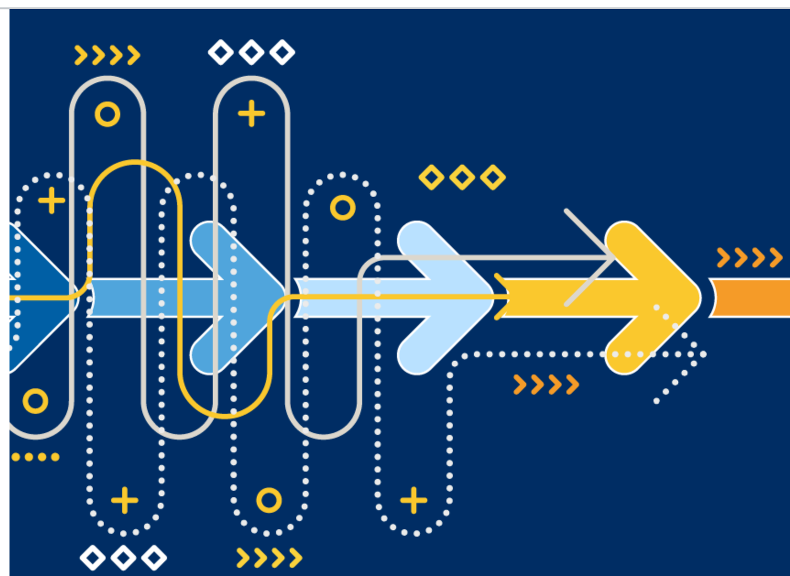
A playbook for how to measure a tariff shock in Canada



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U.S. President Donald Trump has taken office, and understandably, there is growing concern about what threatened American tariffs could mean for the Canadian economy.

Economists have a head start this time around—it isn't our first pass at assessing the impact of tariffs on the modern Canadian economy. For example, we learned a lot from tariffs on softwood lumber in 2017, and steel and aluminum tariffs in 2018. Now, however, the size and scope of tariffs could dwarf those previous experiences—and, the magnitude and details could make the past far less prophetic.

As Canadians prepare for the potential economic impact, it is very tempting to want to give a single figure "hit" to growth or jobs from a threatened tariff to neatly summarize the narrative. But, the reality of a tariff shock is trickier and messy. U.S. tariffs in the size that they have been floated, or even, a fraction of that size, could filter into the Canadian economy immediately, significantly and then, persistently for many years (they would also be damaging to the U.S. economy). Just how much and through what main channels would depend on a massive range of fluctuating and, sometimes, unpredictable variables—including the size of the tariff and goods impacted, the Canadian dollar's reaction, how central

banks may choose to respond, and how governments may choose to retaliate or provide support to industries impacted, among other factors.

As the threat of tariffs loom over Canada, and households, businesses and policymakers manage through this next chapter, they will need more than a simplified round number to understand how the economy will evolve. They will collectively need a playbook on how tariffs filter through the economy, over what timelines and through what channels. Here is a framework that will guide economists—and everyone else—through the complicated path ahead.

Seven ways a U.S. tariff would likely flow through Canada's economy

Before the tariff is applied…

1. Uncertainty about the future could result in Canadian business activity and investing pausing as companies struggle to make big plans and investments without clarity on their future environment.

2. Americans are likely to stock up on impacted Canadian goods, temporarily boosting growth on both sides. If a tariff is announced, but doesn't come into effect for a period of time, past experience suggests that companies can (and do) stockpile inventory ahead of a price increase. That has the effect of initially bolstering trade activity (and growth) on both sides of the border, but at the expense of future growth. This can also occur under threatened (but not realized) tariffs.

Once the tariff is applied…

3. The price for Canadian goods rises for American importers, and demand for these goods likely declines. How much it declines depends on multiple factors.

a. Has the currency stabilized to make Canadian goods cheaper? A weaker Canadian dollar (and a stronger U.S. dollar) can offset some of increased costs created by the tariff for the American importer.

b. Are there U.S. (or other) lower-cost goods that can be substituted for the tariffed Canadian product? The hit to demand will be larger if there's an

option to alternate to a cheaper product. If not, demand remains more resilient.

c. Who is importing the good and can they absorb the cost? Producers, for example, might have sufficient profit margins to absorb higher costs without passing it onto consumers. Consumers may also be able to absorb a price increase (pricing power) without cutting back. The opposite can also be true, zapping demand.

4. Retaliatory measures may come into place at some point in this process, perhaps before or after the U.S. tariff is imposed. Retaliatory measures bring further economic implications, likely dampening growth and increasing inflation for Canadians, but the size and scope of the measures result in a range of economic impacts in turn.

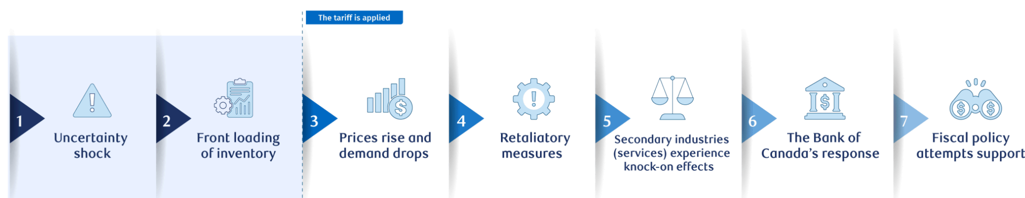
5. Secondary industries could start to feel the impact of reduced activity in the export sector, weighing on employment in areas of the economy that didn't have tariffs directly imposed. For example, consider a town that sees auto production pull back significantly, reducing employment in a plant that has knock on effects on the town's restaurants, movie theatres and other services.

6. The Bank of Canada response to tariffs can support or further dampen growth. Tariffs represent a complicated setup for central banks. They tend to increase costs (inflationary), but they also weaken an economy (deflationary). Most central banks have been clear that they are less likely to respond to inflation directly generated from tariffs, because they increase the price once, and then no longer contribute to year-over-year inflationary pressures. However, the follow on impact of rising inflation driven by a drop in demand could be more damaging. How the Bank of Canada will respond to this environment is not clear, but it has implications for other sectors like housing that could provide an offset from further interest rate cuts.

7. Fiscal support may soften the economic impacts of a tariff shock and affect near-term forecasts. How federal and provincial governments respond could create

further variability in the outlook. Near-term policies designed to support sectors and employees impacted by tariffs could help lessen the initial pain, but it's likely that more support would be needed to bolster the economy's longer term growth trajectory. Unlike the global financial crisis and the Covid-19 pandemic, Canada wouldn't be part of a global fiscal expansion in concert with its peers. It would likely be responding to a Canada-specific shock that would likely weaken its place relative to its fiscal peers . This could bring Canada's triple-A credit rating into debate as well, leaving the government to navigate difficult choices about its fiscal position.

How a U.S. tariff flows through the Canadian economy



Five assumptions we can make about tariff shocks without knowing the details yet

The tentacles and timelines of tariff shocks mean the paths the economy could take is wide, but there are several guideposts we can follow with high certainty even if we lack clarity on what is a threat or a policy ahead.

1. Trade-sensitive industries are the most vulnerable

Tariffs are effectively taxes on trade flows (the movement of goods), and not production. So, it's reasonable to assume the industries that are typically the most vulnerable are those that trade a lot relative to their production base.

Decades of free trade have resulted in tightly integrated cross-border industrial supply chains with the U.S., where intermediate goods often cross the border multiple times at different stages of production. Therefore, these goods are potentially subject to tariffs multiple times during the production process.

The auto sector is the poster child of this kind of integration. Canadian exports and imports of motor vehicles to and from the U.S. are a multiple of 10 relative to total Canadian GDP in the sector. But, more than 60% of the Canadian manufacturing sector has U.S./Canada trade flows that are at least twice their domestic Canadian production base.

Top 15 industries with trade/GDP ratios of 200% or more

Industries by GDP size

1/2

Industry	Share of GDP (%)	Trade/GDP ratio (%)	Employment thousands (% of total)
Primary Metal Manufacturing	0.64	324.9	55 (0.3)
Petroleum and Coal Product Manufacturing	0.54	330.6	16 (0.09)
Plastic Product Manufacturing	0.39	251.6	84 (0.47)
Motor Vehicle Parts Manufacturing	0.38	532.3	74 (0.41)
Aerospace Product and Parts Manufacturing	0.32	287.1	46 (0.26)
Pharmaceutical and Medicine Manufacturing	0.27	263.0	34 (0.19)
Basic Chemical Manufacturing	0.22	423.0	13 (0.07)
Motor Vehicle Manufacturing	0.21	1888.2	38 (0.21)
Miscellaneous Manufacturing	0.2	313.1	55 (0.31)

Agricultural, Construction & Mining Machinery Mfg	0.2	372.8	33 (0.18)

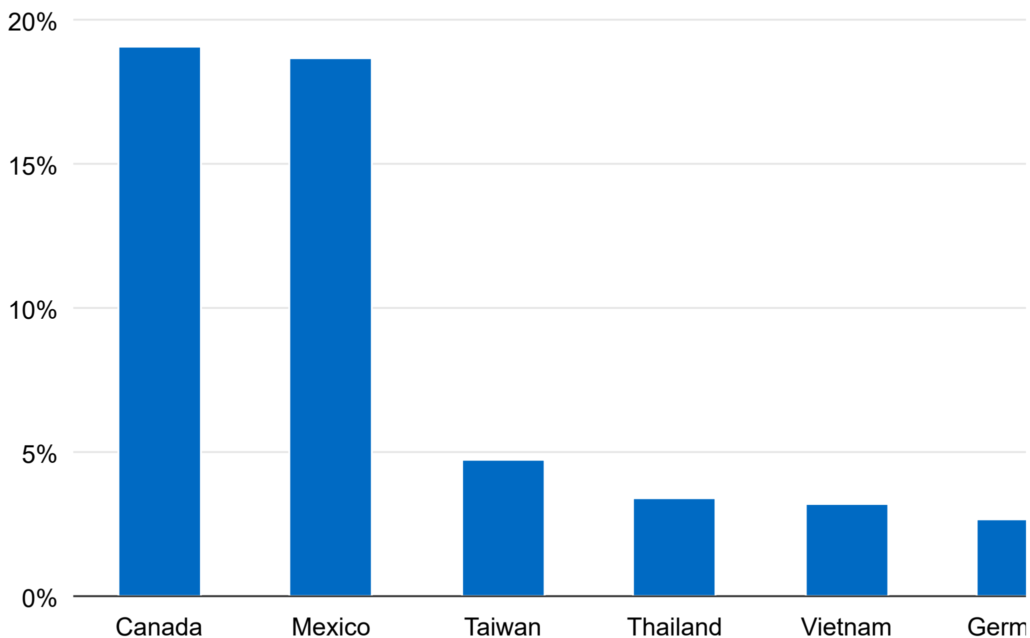
Source: Industry Canada, Statistics Canada, RBC Economics

2. Tight industrial integration means tariffs don't need to be reciprocal for businesses to suffer

U.S. producers and consumers initially and directly pay U.S. import tariffs. But, since trade flows between Canada and the U.S. (and Mexico and the U.S.) are so integrated, raising tariffs on U.S. industrial imports would also raise costs for U.S. exporters, and in turn, feed through to higher Canadian import costs.

The U.S. is its own fourth largest source of imports in the manufacturing sector (and third largest in the motor vehicle sector), according to the OECD, when you account for industrial integration, and U.S. imports that were initially produced in the U.S. and exported at an earlier stage of the production process.

Since trade between the U.S. and Canada (and Mexico) is so tightly integrated, tariff hikes potentially have more impact raising costs (and reducing competitiveness) of the North American industrial sector than offshore production chains in Asia and Europe.



3. Tariff shock will depend on finding substitutes or other markets for products

Somewhat counterintuitively, natural resource producing industries can be less sensitive to international trade disruptions despite being heavily reliant on exports for revenue. The reason is that natural resource products are often more "fungible" than manufactured goods. For example, prices for key agriculture commodities are essentially set globally and can be shifted to alternative markets in response to tariffs relatively quickly, if not easily.

Shifting to alternative customers and suppliers is typically much slower in the manufacturing sector, but it does happen over time, and can eventually reduce the impact of tariff increases. About 40% of the about 1.5 percentage point increase in the average U.S. tariff rate during the first Trump administration has reversed, largely through reorientation of trade flows away from China to other emerging Asian economies and Mexico to avoid tariffs on Chinese imports that are still largely in place.

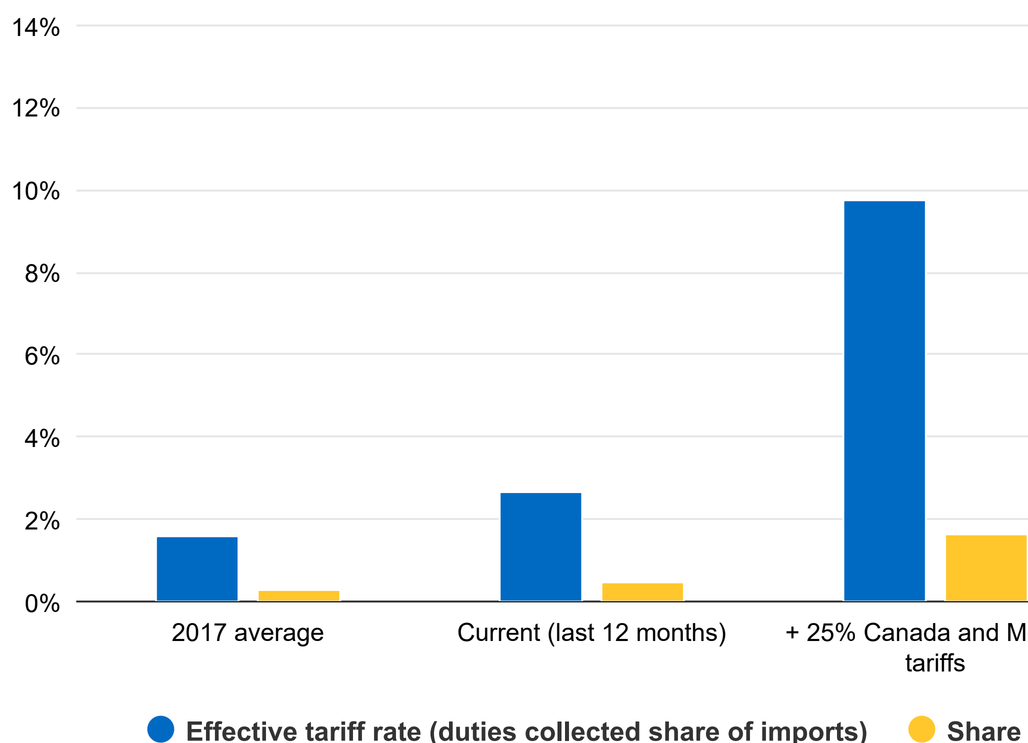
4. Magnitude of tariff increases matters

The lack of an increase in consumer price inflation during the tariff hikes of the first Trump administration has, sometimes, been used as evidence that foreign exporters (not domestic importers) ultimately paid the cost of U.S. import tariffs at the time. But, the reality is that those tariff increases

were consistently less drastic than threatened, and added up cumulatively to roughly a 1.5 percentage point increase in the average U.S. tariff rate.

Given that imports are a relatively small share of U.S. consumer spending (roughly 70% of U.S. spending is on services), it is not surprising that there was limited impact on broader U.S. inflation measures from those increases, even with most estimates including here, suggested that U.S. producers and/or consumers paid the bulk of the increased costs.

We have previously noted that threatened tariffs on Canada, Mexico, and China would add up to an effective tariff hike of roughly 10 percentage points—about seven times larger than what was imposed during the first Trump administration.



Source: Haver, US Census Bureau, RBC Economics

5. Tariffs are unlikely to have desired impact on U.S. economy that policymakers are hoping for

For one, narrowing the U.S. trade deficit may prove trickier than expected, even with aggressive tariffs. We have argued that the core driver of a large and persistent U.S. trade deficit is hefty net borrowing from abroad. As long as that net borrowing remains, then it is unlikely that the trade deficit will get smaller.

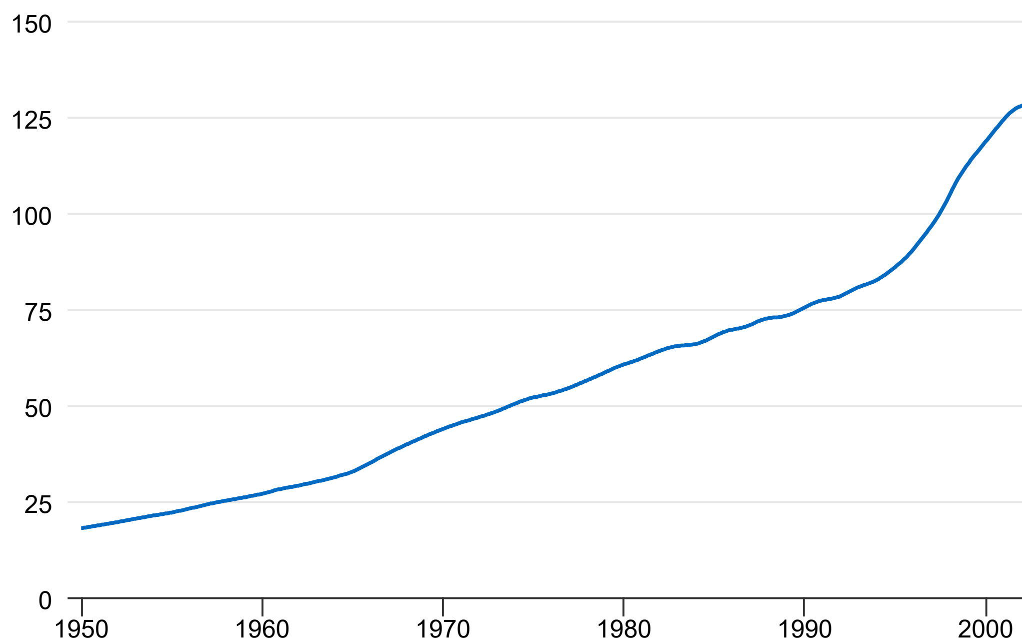
The largest net U.S. borrower is the federal government and a budget deficit running 6% to 7% of gross domestic product is expected to stay large, and potentially get bigger under the second Trump administration. The only way for net trade to balance would be if the private sector buys less imports and saves more—which typically only happens during U.S. recessions.

Furthermore, there's the reminder that tariff increases that began in the first Trump administration were not successful at reducing the U.S. trade deficit. The U.S. reduced the deficit with China, but increased deficits with other emerging Asian economies and Mexico.

Second, tariffs are intended to reshore production at home without reducing production elsewhere. But, the unemployment rate is already very low, and a threatened crackdown on immigration would further limit the number of workers. U.S. manufacturing production capacity fell by about 2% in 2018 and 2019, and at last count, it's still about 1% below 2017 levels ahead of potential tariff hikes.

There is opportunity for the U.S. to reshore and expand production in specific industries deemed critical for national security. But, those expansions will pull productive resources from elsewhere in the economy, and are more likely to be driven by government subsidy "carrots" like those in the IRA and CHIPS and Science Act versus the "stick" of import tariff hikes.

If those investments are deficit financed, and if at least a portion of that financing comes from abroad, then ultimately, those investments could actually increase the trade deficit rather than shrink it as noted here.



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