ECONOMIC VIEWPOINT

Canada's Economy Risks a Trump Slump After the US Presidential Election

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- With the US presidential election just around the corner, we've dug into the candidates' policies and looked at the potential impacts of various election outcomes on the Canadian economy.
- We assumed a Harris–Walz victory with a divided Congress as the status quo baseline in this analysis as well as our September 2024 Economic and Financial Outlook. We also presumed that a Democratic sweep wouldn't look much different from a policy perspective, so we didn't explore that scenario in depth in this report.
- In contrast, a Republican sweep would likely lead to lower global and US real GDP over the forecast. When combined with higher tariffs on US imports, this would reduce demand for Canadian non-energy exports. That said, the deeply integrated nature of North American supply chains gives us hope that some exceptions to blanket tariffs could be negotiated.
- Energy is one possible group of commodities that could avoid the sting of higher customs duties. But the expected ramp-up in production under a Trump administration would likely mean lower prices, reducing aggregate corporate profits and household incomes in Canada.
- While the external economic environment would weigh on the Canadian economy in the event of a Republican sweep in November, the impact on financial markets could be another story. Corporate income tax cuts and deregulation in the US would likely boost equity values there and abroad, including in Canada. Lower growth in Canada would weigh on inflation, possibly prompting the Bank of Canada to cut the policy rate more quickly and deeply. A bigger spread between US and Canadian interest rates would further weaken the Canadian dollar. All of these factors would have the impact of partially offsetting the drag from weaker trade.
- Taken together, the level of Canadian real GDP could be as much as 1.7% lower by the end of 2028 relative to the Harris–Walz base case in the event of a Republican sweep. And while a recession may be narrowly avoided, it can't be ruled out. With that in mind, businesses and policymakers would be well advised to hope for the best but plan for the worst.

As the US presidential election fast approaches, questions abound as to what the implications may be for the Canadian economy. In our recent note on the impacts of various US election outcomes on the American and global economies, we flagged the stagflationary implications of another Trump presidency. These would be particularly pronounced if there is a Republican sweep. That stands in contrast to little expected change in direction if Kamala Harris moves into the White House, in the event of a Democratic sweep or, more likely, a divided Congress. As such, our Harris–Walz economic policy baseline forms the basis of the Canadian forecast in our most recent Economic and Financial Outlook. It's against this forecast that we compare another four years of Trump policies.

NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.
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US Election Impact on Canadian Trade

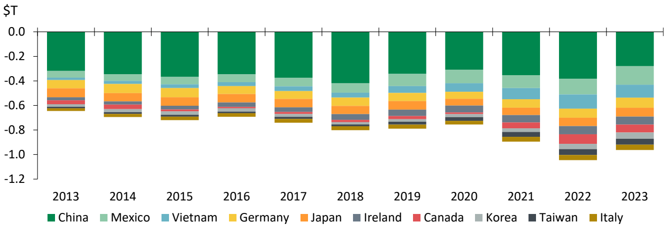
A second Trump presidency would have pronounced impacts on Canadian trade, most notably exports to the US, particularly in the event of a Republican sweep.

Taking Tariffs to New Highs

While Canada has a relatively small trade surplus with the US when compared to other major trading partners (graph 1), it won't remain unscathed in the event of a second Trump presidency. Trump has committed to applying a 10% tariff to all US imports without exception, in addition to a 60% tariff on all imports from China. The former president at times also entertains the idea of imposing across-the-board 20% tariffs, but we have opted to not include that in the analysis presented here. That said, the impact of such tariffs on the Canadian economy would be much worse than the estimates and forecasts presented here.

Graph 1
Canada Is a Relatively Small Contributor to the US Trade Deficit

10 largest country-specific US trade deficits*



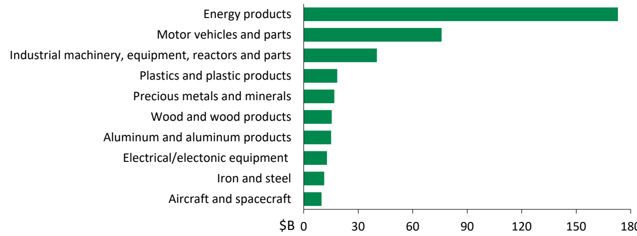
*In order from largest to smallest trade surplus with the US.
US Census Bureau and Desjardins Economic Studies

The US is the destination for roughly three quarters of Canadian exports. Commodities and manufactured goods sectors are particularly exposed to US tariffs (graph 2). And while we will touch on the implications of another Trump presidency on oil and gas later in this note, other key commodities at risk of higher tariffs include precious metals; wood and wood products; aluminum and aluminum products; and iron and steel. Most of these have been subject to trade disputes in the past. In manufacturing, motor vehicles and parts are highly exposed to tariffs, as are industrial machinery, equipment, reactors and parts; plastics and plastic products; electrical and electronic equipment; and aircraft and spacecraft.

While our research shows that the tariff impact on the overall US trade deficit could be marginal, the higher cost of US imports from Canada would weigh on demand for Canadian export volumes. However, we don't assume an eventual broad-based 10% decline in non-energy export volumes from Canada to the US in the event a 10% tariff is applied to imports from Canada. First, unlike when targeted tariffs were levied against Canada in the past, a blanket tariff on all imports to

Graph 2
Canada's Exports to the US Are Led by Commodities and Manufactured Goods

Top 10 Canadian commodities exported to the US by value, 2023



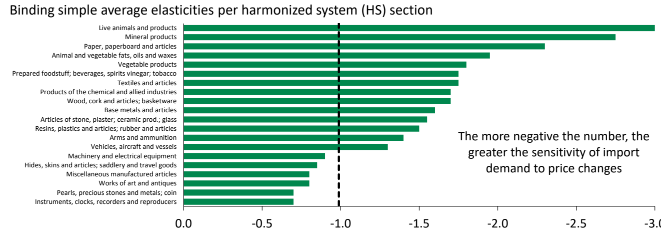
Statistics Canada and Desjardins Economic Studies

the US would lead to less substitution of Canadian exports with exports from elsewhere. Second, demand for some imports is more sensitive to price changes than demand for other imports. For example, according to the Vienna Institute of International Economic Studies (wiiw, 2016), US demand for imports of mineral products is much more sensitive to price changes than demand for imported works of art (graph 3). This suggests the US might not be able to rapidly substitute domestically manufactured products for those imported from abroad, particularly in some highly trade-integrated sectors.

Graph 3
US Import Demand Is Relatively Sensitive to Price Changes

US import demand elasticities*

Binding simple average elasticities per harmonized system (HS) section

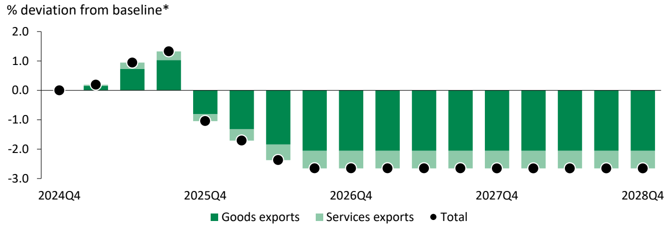


*Approximations based on N. Ghodsi, J. Grübler and R. Stehrer, "Import Demand Elasticities Revisited," wiiw Working Paper, No. 132, November 2016.
Note: Binding elasticities refer to estimates significantly different from zero at the 10% level.
Vienna Institute of International Economic Studies and Desjardins Economic Studies

Taking all of this into account, Canadian exports would probably increase just prior to the application of tariffs as US importers look to build inventories before tariffs are imposed. (See box 1 on page 3.) It would likely then take about a year for exports to fully reflect the new tariff regime. With this in mind, we've estimated that a blanket 10% tariff on non-energy imports to the US would reduce the level of real exports from Canada by nearly 2.7% as of the end of 2026 compared to the baseline scenario (graph 4 on page 3). That drag would continue for as long as tariffs remain in place. This would also apply to Canadian services exports, roughly half of which are destined for the US market and could be more easily substituted with domestic services than imported goods are.

Graph 4
Proposed US Tariffs Would Weigh Heavily on Canadian Exports

Forecast reduction in real exports due to proposed Trump tariffs on Canada



*The baseline projection is that presented in the September 2024 Economic and Financial Outlook.
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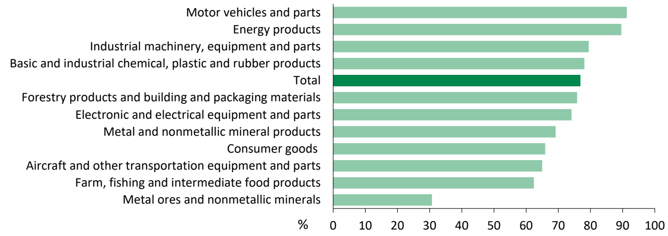
Graph 6
Canada's Auto Industry Is Highly Reliant on the US Market

Share of Canadian nominal exports to the US, 2023



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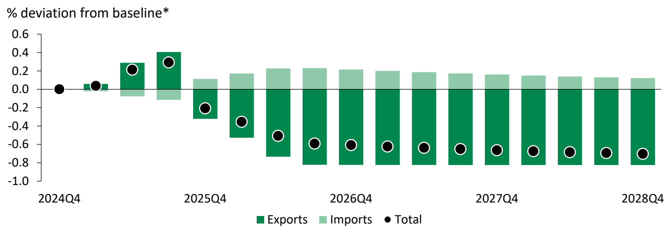
Notably, lower exports due to the proposed US tariffs don't subtract dollar-for-dollar from real GDP. That's because of the import content of exports. As such, while the tariff hit to exports would leave the level of real GDP about 0.7% lower by the end of 2026 than in our baseline, lower imports would offset this drag by 0.2 percentage points (graph 5).

Graph 5
Lower Imports Wouldn't Offset the Tariff Drag On Exports and Real GDP

Forecast reduction in real GDP due to proposed Trump tariffs on Canada



*The baseline projection is that presented in the September 2024 Economic and Financial Outlook.
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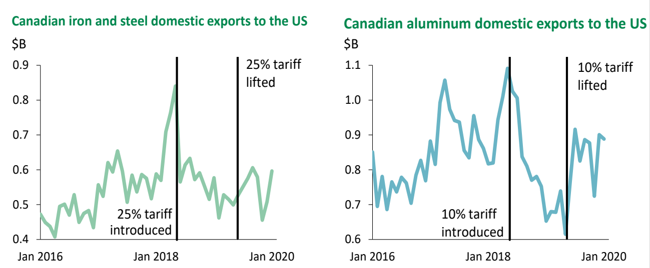
But there's hope that some exports would be exempt from tariffs. For instance, the Canada–US–Mexico Agreement (CUSMA), formerly known as the North American Free Trade Agreement (NAFTA), is still in place. According to Joshua P. Meltzer (2024), a senior fellow at the Brookings Institution, "the Canadian government is the least noncompliant party to CUSMA." Brookings has also determined that over 17 million jobs are supported by exports across North America.

The deeply integrated nature of North American supply chains also gives us hope that some exceptions to blanket tariffs could be negotiated. For example, some manufacturing sectors, like autos (graph 6), are supported by longstanding trade agreements such as the Canada–US Auto Pact. Other sectors with a history of close, cross-border ties include oil and gas, refined products, aeronautical products, pharmaceuticals and medicines, and steel. Should CUSMA be abolished, many of these sectors would undoubtedly be subject to substantial tariffs.

Box 1: Export Impact of One-Off Tariffs

A 10% tariff on Canadian exports to the US would likely play out like past tariff episodes, such as when tariffs were applied to steel and aluminum. Statistics Canada (2019) observed that the value of these exports rose abruptly just before the tariffs were imposed and fell sharply thereafter (graph 1-1). In the case of steel, the rise and subsequent decline was roughly in line with the size of the tariff (e.g., nominal exports of steel were down about 25% from a year earlier a few months after the tariff was introduced). The same was true after the US imposed a 10% tariff on aluminum imports from Canada. However, it should be noted that this impact was the result of targeted tariffs on one type of good imported from Canada alone as opposed to a blanket tariff on imports from all countries. As such, the impact of a broad-based tariff applied to all US imports is likely to have a much more muted impact on Canada specifically.

Graph 1-1
Previous US Tariffs Have Weighed on their Targeted Canadian Exports



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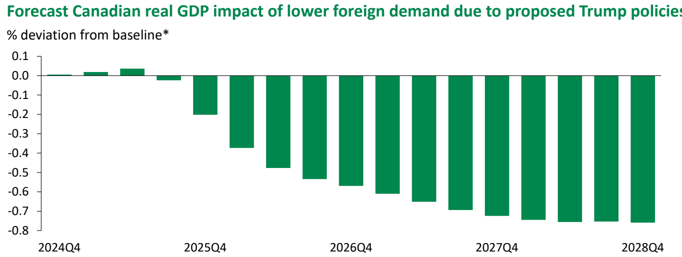
The Drag from Weaker US and Global Demand

But there is more in store for Canadian trade. The Trump policy impact on Canada's economy will also be felt through weaker overall US and global economic activity beyond just the tariff-specific impacts on Canadian trade. That should slow demand for Canadian exports south of the border and further afield. Indeed, we've estimated that that impact alone would cause the level of Canadian real GDP to be nearly 0.8% lower by the end of 2028 than in our Harris–Walz policy baseline (graph 7). And that's exclusive of any tariff-specific economic impacts.

Graph 7
A Weaker US and Global Economy Under Trump Would Hit Canada Hard



*The baseline projection is that presented in the September 2024 Economic and Financial Outlook.
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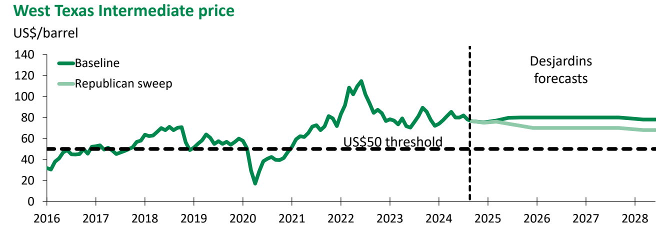
Trump Wants a New Era of "Drill, Baby, Drill"

A second Trump administration would likely boost oil and gas production, partially offsetting weaker foreign demand and higher tariffs. Trump wants to bring back the record-low energy prices seen during his first term. We assume he is referring to a WTI price below the US$50 threshold and not the -US$37.63 per barrel reached in March 2020. To bring the WTI price to sub-US$50 per barrel, a Trump administration would have to lift the ban on federal leasing and fracking as well as remove some environmental regulations. It would also have to reinstate the five-year offshore oil and gas leasing program. All of that would work to increase US oil production and reduce energy prices.

But how low could the Trump administration send oil prices? The market has changed since Trump left office in 2021. Production costs have gone up and global supply is rising, especially with OPEC+ producing above their target. US producers would likely manage their output to prevent prices from falling much further than US$70 per barrel (graph 8) to avoid any financial losses, which would be a US$10 discount per barrel from our baseline. Moreover, a second Trump administration would have only four years in office, and producers would exercise caution in case a more energy transition-friendly administration followed. The impact on Canadian producers would come in the form of a larger WTI–WCS spread as stronger US production would

Graph 8
A Trump Administration Would Likely Result in Lower Energy Prices



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heighten competition between Canadian and American crude for the limited North American refinery capacity. Export volumes could, however, remain unchanged as the new TMX pipeline would help alleviate some of the potential bottlenecks caused by higher US crude production.

Given our expectation that a Trump administration likely wouldn't levy tariffs on US energy imports to avoid higher costs for consumers, the impact on energy export volumes from Canada should be marginal. However, lower energy prices could impact Canada's energy production as well as corporate profits and household incomes, thereby weighing on overall economic activity in Canada.

One Good Tariff Deserves Another

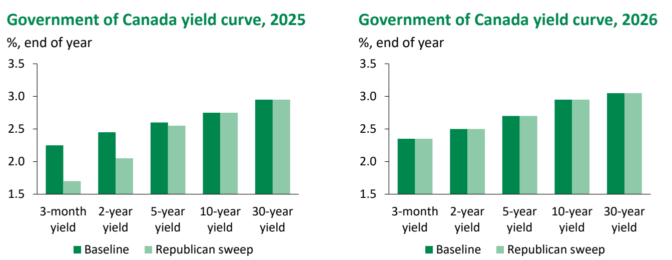
Of course, Canada is unlikely to let new US tariffs go unanswered. As was the case during the previous Trump presidency, Canada is expected to apply reciprocal tariffs to goods that would have the greatest impact on the US economy, such as manufacturing inputs. Research by the US Federal Reserve (2019) found that "U.S. manufacturing industries more exposed to tariff increases experience relative reductions in employment as a positive effect from import protection is offset by larger negative effects from rising input costs and retaliatory tariffs."

But while this may hurt the US economy, it could be just as damaging to Canada. Tariffs raise the level of prices, leading to temporarily higher inflation if unchanged. The Bank of Canada would likely look through this price impact as it would be short-lived, although the drag on economic activity would probably be more prolonged. Tariffs on goods coming into Canada would increase costs for consumers and businesses, further weighing on exports while slowing the pace of consumption and business investment. We have incorporated these considerations into our forecast of the tariff impacts on real GDP.

US Election Impact on Canadian Markets

The reaction of global financial markets to the outcome of the US presidential election will also spill over to Canadian markets and the broader economy. The drag from exports on Canadian economic activity from a Republican sweep would likely push the Bank of Canada to ease policy more quickly and result in a deeper rate cutting cycle. Our estimates suggest an additional 50bps of easing by the end of 2025 would be appropriate. The Canadian yield curve would probably steepen as a result, led by falling front-end rates (graph 9). This would provide a tailwind to real GDP growth, albeit likely a quite modest one compared to the drag from lower external demand for Canadian exports.

Graph 9
The GoC Yield Curve Would Likely Steepen in a Republican Sweep Scenario



GoC: Government of Canada
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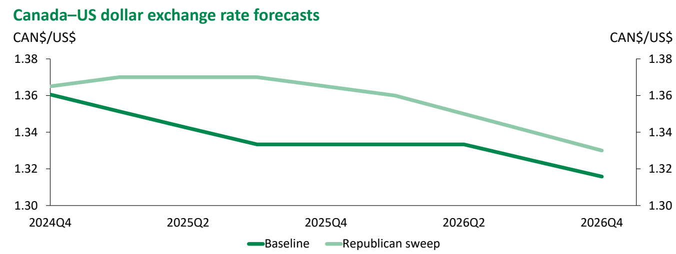
In the US, a Republican sweep would likely see the Fed's Federal Open Market Committee (FOMC) slow the pace of rate cuts by as much as 50bps by the end of 2025. While this would initially lead to a flattening of the yield curve, we would ultimately expect the US yield curve to steepen, led by longer-dated rates on the back of a worsening fiscal position. This assumes, of course, that the US Federal Reserve maintains its independence during a second Trump presidency, which is an open question. For the US, the impact of a Republican sweep on inflation and economic growth is expected to be mixed, likely causing a stagflationary shock that could lead US policymakers to delay the timing of rate cuts. Interest rate differentials would widen in this scenario, and we could see some additional weakness in the Canadian dollar as a consequence (graph 10). That would help to offset some of the tariff drag on exports, particularly for exports priced in US dollars, such as commodities.

That said, a Trump presidency would likely be positive for risk assets (like equities), which could further offset some of the weakness in the Canadian economy. Supported by planned corporate tax cuts south of the border, a rally in US equities could be expected to have some positive spillovers to Canadian equities in the short term. However, the S&P/TSX would likely underperform against US equities and struggle over time from lower energy prices and the drag on domestic growth.

Graph 10
The Canadian Dollar Would Probably Weaken in a Republican Sweep



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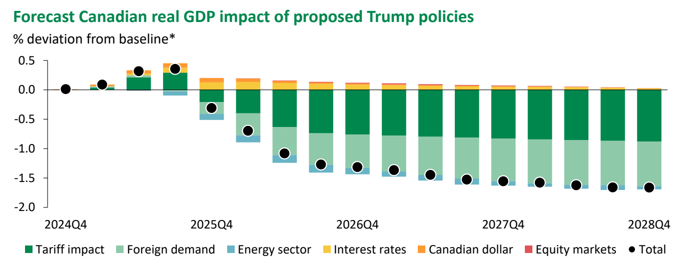
Wrapping Up the Forecast with an Orange Bow

Putting all of these pieces together, we've determined that Trump's proposed policies could boost the level of real GDP relative to the Harris–Walz baseline through the end of 2025. However, this tailwind would then reverse, with the level of Canada's real GDP ending 2026 at more than 1.3% below the baseline in the event of a Republican sweep. The gap would widen further thereafter as the offset from lower rates and higher equity values fades, with a shortfall in real GDP of nearly 1.7% by the close of 2028 (graph 11).

Graph 11
The Trump Policy Drag On Canadian Output Would Be Substantial



*The baseline projection is that presented in the September 2024 Economic and Financial Outlook.
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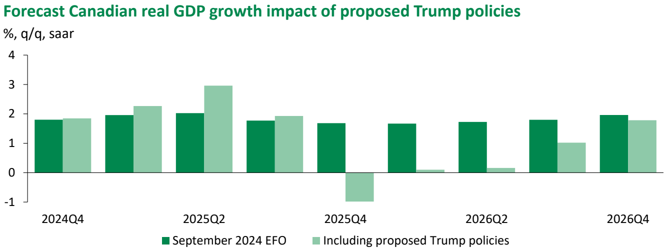
Looking at real GDP from a growth perspective, Trump's proposed policies would slow the pace of economic gains in Canada (graph 12 on page 6). And while a recession may be narrowly avoided, it can't be ruled out.

Graph 12
Trump's Proposed Policies Could Lead to a Recession in Canada



EFO: Economic and Financial Outlook
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Conclusion

With Kamala Harris and Donald Trump neck-and-neck in the race for the White House, it is anyone's guess who will be sitting in the Oval Office in January 2025. But the presidential candidates have been relatively clear on the economic policies they plan to pursue. And in the event of a possible Republican sweep, the outcome would be particularly poor for the Canadian economy. Fortunately, Canada has been down that road before, largely making it through with just some scrapes and bruises. With that in mind, businesses and policymakers would be well advised to hope for the best but plan for the worst.