ECONOMIC VIEWPOINT

The US Launches a Trade War

After a one-month reprieve, the 25% tariffs on US imports from Mexico and Canada (except 10% on Canadian energy and critical minerals) came into effect this morning at midnight. These tariffs stem from the February 1 executive orders aimed at reducing fentanyl trafficking at the northern and southern borders and illegal immigration from Mexico. The only notable change from the original executive orders was the reinstatement of the exemption for de minimis imports (imports of US$800 or less). Here's a quick overview:

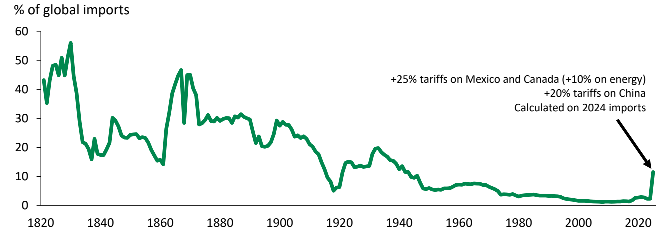
- A 25% tariff has been added on all US imports of goods from Canada, excluding energy, where a 10% tariff applies. Energy is defined as crude oil, natural gas, liquefied natural gas, refined petroleum products, uranium, coal, biofuels, geothermal energy, hydroelectricity and critical minerals.
- A 25% tariff has been added on all imports of goods from Mexico.
- Regarding China, a 10% tariff was already added on February 4 on all imports of goods from that country. Noting that the Chinese government has not taken adequate measures to mitigate the fentanyl crisis, a new executive order signed on March 3 increased these tariffs to 20%.
- The de minimis tariff and tax exemptions (up to $800 of imports) that were already in effect remain applicable until adequate processing and collection systems are in place.

We already discussed the potential economic and financial implications of tariffs in an Economic Viewpoint published on February 3, before the reprieve. The tariffs applied today are similar to those outlined for the first time in the February 1 executive orders, so the outlook remains essentially the same. Here are the main takeaways from that report, updated with the new information available so far. A complete update of our Economic and Financial Outlook will be published later in March.

Implications for the US Economy

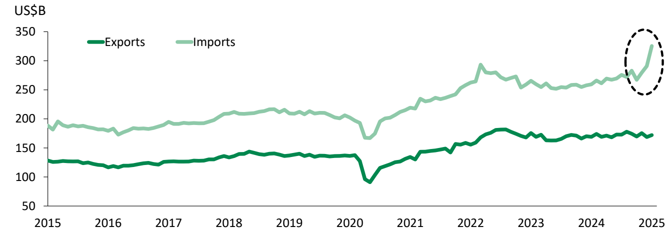
The tariffs on US imports of Mexican and Canadian products as well as the 20% increase in tariffs on China will surely have significant consequences for the US economy. The tariffs that took effect today would be some of the largest in history if applied to 2024 import levels (graph 1). It remains to be seen how American importers will react, as they will be the first to face these additional costs. Importers started anticipating Trump's promised tariffs in January with a very sharp increase in US imports in recent months (graph 2).

Graph 1
The Trump Administration's Tariff Hikes Are Some of the Steepest in US History
United States – Effective tariffs



U.S. Census Bureau, U.S. International Trade Commission, Douglas W. Irwin, Peterson Institute for International Economics and Desjardins Economic Studies

Graph 2
US Imports Rose Sharply in December and January
United States – Trade in goods based on preliminary data



U.S. Census Bureau and Desjardins Economic Studies

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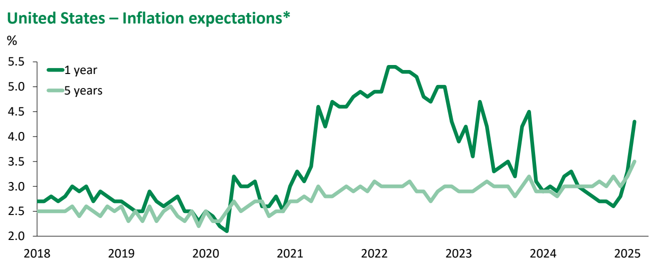
Importers will also decide whether they can pass on the cost to their customers and, ultimately, to American consumers. Sooner or later, importers could also reduce their orders of goods from China, Canada and Mexico. However, with other countries also facing the threat of tariffs starting in April (the so-called "reciprocal tariffs"), it will be difficult to find other suppliers not affected by Donald Trump's protectionist fervour. It would also be surprising if American producers were able to quickly substitute all the tariffed goods without causing internal pressures on supply chains. Americans will therefore pay a price. Retaliatory measures by countries affected by US protectionism will also impact American exporters.

In addition, there are the disruptions caused by the uncertainty surrounding tariff policy. This uncertainty is already showing up in the US economy. The February ISM Manufacturing index survey clearly reflected respondent apprehensions about the tariffs announced or promised by President Trump. The new orders component of the index suffered its worst monthly decline (excluding the first months of the pandemic) since December 2018. Even small businesses, which have been rather optimistic since the November election, expressed a high degree of uncertainty. The leading consumer confidence indexes also fell sharply in the first two months of 2025, and there's been a worrying resurgence in inflationary expectations (graph 3).

Graph 3
In a Worrying Trend, Consumer Inflation Expectations Are Rising Again



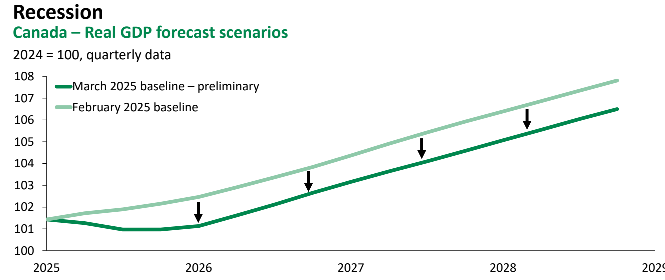
* Based on the University of Michigan's consumer confidence survey.
University of Michigan and Desjardins Economic Studies

The US economy will therefore be negatively affected, as anticipated in the alternative scenarios we presented in December. This adds to an already fragile situation for the first quarter of 2025. In January, we observed weakness in real consumption and construction as well as a slight slowdown in hiring. After approaching 3% in 2023 and 2024, US real GDP growth is expected to fall well below 2% this year. We expect a re-acceleration of inflation in the coming quarters. The situation remains fluid, however. The degree of difficulty will depend, among other things, on the duration of the tariffs put in place today (we expect them to remain in place until the end of this year), the extent of the so-called reciprocal tariffs to be imposed, in addition to non-trade-related decisions by the Trump administration.

Canadian Economy: Higher Inflation and a Recession Are Likely

The impact of 25% tariffs on all US goods imports from Canada (apart from 10% tariffs on energy and critical minerals) should be felt quickly. Driven primarily by a decline in exports to the US, the Canadian economy could tip into recession as early as Q2 2025. By our estimate, the recession could last for several quarters. This is likely to be exacerbated by a drying up of business investment, particularly in export-oriented sectors of the economy such as manufacturing. In all, unless these tariffs are rolled back quickly, the Canadian economy risks being set on a lower path of economic activity going forward due to persistent trade barriers and reduced business investment. That said, if tariffs are dialled back at some point in the not-too-distant future—as they are in our preliminary March 2025 baseline from 25% to 10% at the beginning of 2026—some of this potential lost output could be recovered (graph 4).

Graph 4
US Tariffs on Canadian Imports Are Likely to Push Canada into Recession



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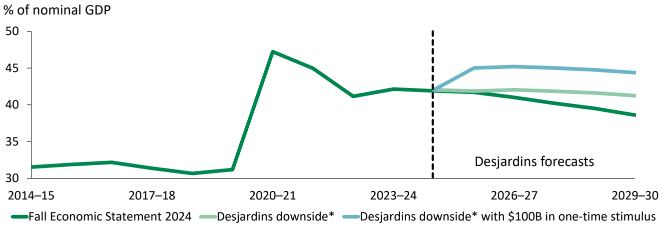
With output slowing, the Canadian labour market is expected to weaken as well. The unemployment rate should start to rise in March, accelerating through the year on escalating layoffs. The unemployment rate could approach 8% nationally. With household incomes likely to be challenged, consumers may be more cautious, leading to a much slower pace of consumption going forward than the torrid advance that ended 2024. Residential investment should also slow, due in large part to job losses and slower income growth.

The Government of Canada has responded to US tariffs with retaliatory tariffs, first on $30B of imports on March 4 and another $125B in 21 days. That will add to the economic drag and inflationary impact of the US tariffs. We've estimated that altogether, the trade war is likely to push Canadian inflation beyond 3% y/y before the end of 2025, above the 2.0%–2.5% expected in our February 2025 Economic and Financial Outlook. No goods price may be left untouched, as a weaker Canadian dollar and retaliatory tariffs on everything from fresh food to intermediate inputs push up prices across the board. This should further constrain the budgets of Canadian households already struggling with affordability challenges, thereby putting additional downward pressure on consumption. Business investment could be further hampered as well.

To support Canadian households and businesses hit by tariffs and counter tariffs, we've estimated that the federal government could provide a one-time $100B in fiscal support and keep the debt-to-GDP ratio below its pandemic peak (graph 5). However, the federal government is limited in its ability to respond to tariffs as long as Parliament isn't sitting. Parliament is set to return on March 24, following the selection of a new leader of the Liberal Party of Canada and, by extension, Prime Minister on March 9. A federal election may also be called in the near future, further delaying meaningful action by the Government of Canada.

Graph 5
Even One-Time Stimulus of $100B Would Leave the Debt-to-GDP Ratio Below the Pandemic Peak
Federal debt (accumulated deficit) forecasts



* Includes Desjardins's preliminary March 2025 baseline economic scenario, increased defence spending to the 2% NATO target by 2032 and the return to a 50% capital gains inclusion rate.
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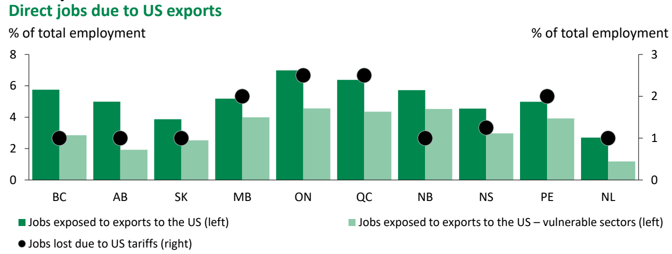
In contrast to the federal government, provincial governments are ready and able to respond to the impact of tariffs. For instance, the Government of Ontario committed roughly $20B in tariff relief in the recent election campaign, part of $40B in broader election commitments. The Government of Quebec has signalled it will introduce a short-term loan program for businesses provided by Investissement Québec, similar to programs totalling $1.2B in support during the pandemic. Other provinces are expected to respond in kind. Taken together, we've estimated that provincial governments have a collective $100B in fiscal room to respond to the impact of tariffs while keeping their aggregate level of net debt below 35% of nominal GDP.

All Canadian provinces will experience profound economic impacts from the tariffs, but some will be more acutely affected due to higher exposure in sectors vulnerable to a decline in US demand. Central Canadian provinces, namely Ontario, Quebec and Manitoba, are likely to face a recession later this year, as 6% to 8% of their output is directly linked to US exports. Oil-producing provinces such as Alberta, Saskatchewan, and Newfoundland and Labrador have a substantial share of their output exposed to the US, primarily due to their significant oil exports. However, excluding the oil and gas sector, which is subject to a lower tariff rate, these provinces rank among the lowest in terms of US export exposure, providing a buffer against the trade shock. Nova Scotia and BC look to have the least exposure to tariffs.

The labour market impacts of US import tariffs will be significant, as a sizable proportion of jobs are directly tied to US exports, with two-thirds in what we consider to be vulnerable sectors (graph 6). Direct job losses could reach 2% to 3% of total employment in central Canada and Prince Edward Island, pushing the unemployment rate to recessionary levels, while other regions may narrowly avoid a recession. Other industries could eventually suffer from ripple effects if tariffs lead to a broader economic slowdown. The national unemployment rate could rise to approximately 8% later this year, with Ontario at 9% and Quebec at 7%—similar to the job losses observed during the Great Financial Crisis.

Graph 6
Central Canada, Manitoba and PEI Have Outsized Job Exposure to US Exports
Direct jobs due to US exports



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Rates: More Significant Cuts Are Expected in Canada

The broader implementation of tariffs as a policy tool will weigh on global growth at a time when economic activity is vulnerable. All of this should keep bond yields moving lower as expectations for central bankers to reduce rates build. Some central banks have more scope to ease than others. In Canada, inflationary pressures remain muted and the unemployment rate has been elevated for some time, offering policymakers more room to cut interest rates. While monetary policy is not the best tool to handle the impacts of a trade war, it can help dampen some of the negative growth effects. As such, the Bank of Canada is likely to cut rates by 25 basis points at its upcoming meeting in March and continue easing policy throughout the year. That's in contrast to the US, where economic activity remained resilient until recently. Therefore, Fed officials will need to be more in tune with resultant inflationary pressures, especially given the recent rise in inflation expectations. In light of that dynamic, the imposition of larger tariffs should only modestly alter the path for US monetary policy in favour of slightly more easing.

Canadian Dollar: Limited Fallout in the Near Term, but Risks Are Skewed to the Downside Beyond

Unlike the manic volatility experienced on February 1, we expect the fallout for the Canadian dollar to be contained this time. Market participants, including Canadian corporations, have had time to hedge their exposures, at least for the next few months. Moreover, investor sentiment towards the US economy has deteriorated, with growing evidence that tariff uncertainty is negatively impacting US business and consumer confidence. This has weakened support for the US dollar, which has declined by 1.5% in broad trade-weighted terms compared to last month. However, assuming that the tariff hike is maintained for a significant amount of time, the recessionary conditions likely facing the Canadian economy would put the Canadian dollar under more pressure.

In short, the market situation today is very different than it was a month ago. We do not expect a significant weakening of the Canadian dollar in the next month, but there could be more pressure down the line.