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Rules of Thumb for Estimating the Impact of U.S. Tariffs on Canada

- The note aims to provide some rough rules of thumb derived from our macroeconomic model for estimating the impact of potential tariffs on the economy, inflation, interest and exchange rates in Canada and the U.S.
- Generally, tariffs disrupt the optimal allocation of resources, increase production costs and supply bottlenecks, and increase the price of imports. They also increase uncertainty and can lower investment, consumption, and trade, ultimately reducing economic growth while also impacting currency markets and monetary policy.
- By virtue of these impacts, raising tariffs would weaken U.S. GDP and generate inflation there, putting upward pressure on the Federal Funds Rate. In Canada, the outcome would differ based on whether the Canadian government retaliates or not. While GDP falls either way, if Canada retaliates to a certain degree, then tariffs would be inflationary and lead to a higher Bank of Canada policy rate. On the other hand, if Canada does not retaliate, then demand side factors dominate, leading to lower inflation, and, in turn, a lower Bank of Canada policy rate.
- In Canada, there is a retaliation threshold that, once crossed, would not require the Bank of Canada to hike rates. If the government keeps its retaliation to below half the tariffs imposed by the U.S., the Bank of Canada would not need to hike rates.
- U.S. GDP could decline by roughly 0.2% for each 5% increase in tariffs, while Canada could see sharper declines of up to 1.1% with full retaliation or 0.8% with no retaliation. These losses of economic activity are higher the higher the tariffs are. Under 25% tariffs, albeit we don't think this a plausible scenario, the loss of U.S. GDP could increase to up to 0.9%, and up to 5.6% in Canada with full retaliation or 3.8% without.

There are many uncertainties about the economic outlook as President Trump is set to take the helm of the United States. Those range from uncertainty about the policy actions he will take to uncertainty about the impact of those very policies. A case in point is the recent statement that he would implement tariffs hikes of 25% on all imports from Canada and Mexico, and 10% on imports from China. While we do not believe these tariffs will be implemented (see [here](#)), it is very likely that over the next several months, economic forecasts will need to present some alternative paths for the economy around a central scenario. Those alternative scenarios are likely to represent choices made by forecasters as to which policy assumption to include in their forecasts. Only when policy measures will actually be announced and implemented will uncertainty around the policy environment diminish. Given its critical nature to Canada and other trading partners, and to the U.S. itself of course, we thought it would be helpful to provide some rough rules of thumb for estimating the impact of trade policy changes on Canada and the U.S. These rules of thumb, derived from our macroeconomic model of the U.S. and Canadian economies, while by no means meant to be exact, are designed to help provide a quick and dirty assessment of the impact of changes in tariffs on the economy, inflation, and interest rates in both countries.

In general, tariffs would slow economic growth in both economies, at any tariff level, whether Canada retaliates or not. Tariffs would reduce potential GDP as they distort optimal allocation of resources, increase the cost of imported inputs for production, and create supply bottlenecks and supply chain disruptions. This reduces economic growth and creates inflationary pressures. These inflationary pressures are further exacerbated by the one-time inflationary effect of tariffs which would make a country's imports more

expensive and, to some extent, feed into inflation expectations. Tariffs also generate a fall of aggregate demand because of the elevated uncertainty related to trade policies (see [here](#)) and potentially a fall of net exports, particularly for a net exporting country. The unemployment rate increases in response to weaker aggregate demand. On the whole, such tariffs are inflationary for the U.S., and the Federal Reserve would have to increase its policy rate in response to them (see Box 1 on page 4). In Canada, the overall effect on inflation and the policy rate depends on whether Canada retaliates or not. If the Canadian government decides to retaliate, our simulations show that tariffs behave as a negative supply shock and are therefore inflationary, and, as a result, the Bank of Canada would have to increase its policy rate (Box 1 again). If Canada does not retaliate, then the increase to its imports' prices is substantially smaller, and the fall of potential GDP is diminished. In this case, the demand side factors dominate, leading to lower inflation, and, in turn, a lower Bank of Canada policy rate. In all cases, the U.S. dollar appreciates against other currencies because of the elevated uncertainty and the safe-haven effect, while the Canadian dollar depreciates. The latter helps dampen somewhat the fall of Canadian aggregate demand and GDP, but does not entirely offset it.

We report these rules of thumb as the peak effect on key variables in Canada and the U.S. in response to tariffs imposed permanently by the U.S. on Canada and Mexico—starting with 5% and going up in five percentage point increments up to 25%. While we do not expect the 25% tariffs will be implemented, these aim to provide useful estimates of the sensitivity of the U.S. and Canadian economies to different tariff levels. Please refer to tables 1 to 4 and accompanying text.

The impact of tariffs on the U.S. (Table 1): A 5% tariff reduces U.S. GDP by 0.2% at its peak in Q2-2026 relative to a scenario without such tariffs, leaving it 0.1% lower at the end of Trump's presidency relative to a no-tariffs scenario. Inflation, as measured by core PCE, would be 0.2 percentage points higher and in turn the policy rate would be 11 basis points higher. The U.S. dollar could appreciate by 1.7% in Q1-2025 (relative to scenario with no tariffs) before it walks back some of these flight-to-safety driven gains. The unemployment rate would show a minimal increase of 0.1 percentage points at peak impact. These effects are larger the higher the tariffs that are imposed by the U.S., with 25% reducing GDP by a full percentage point at peak impact, and shaving off 50 bps of cuts in the policy rate.

Table 1: Impact of Tariffs on United States						
	Peak Impact by Tariff Size					Quarter of Peak Impact
	5%	10%	15%	20%	25%	
GDP (%)	-0.2	-0.3	-0.5	-0.7	-0.9	Q2-2026
GDP Impact by Q4-2028 (%)	-0.1	-0.2	-0.3	-0.4	-0.5	
Core PCE (pps)	0.2	0.4	0.6	0.7	0.9	Q2-2025
Policy Rate (bps)	11	22	32	43	54	Q3-2025
Exchange Rate (%)	1.7	3.4	5.1	6.7	8.4	Q1-2025
Exchange Rate Impact by Q4-2025 (%)	0.8	1.6	2.5	3.3	4.1	
Unemployment Rate (pps)	0.1	0.1	0.2	0.3	0.4	Q4-2026

Source: Scotiabank Economics.

Canada's economy faces sharper impacts, which differ depending on whether Canada retaliates with similar tariffs or not.

The impact of tariffs on Canada with full retaliation (Table 2): At 5% tariffs, if Canada fully retaliates, then we are looking at a peak GDP decline of 1.1% (Q1-2027). Core inflation would be 0.8 percentage points higher (Q3-2025), and the policy rate 56 basis points higher. The unemployment rate would 0.6 percentage points higher in this scenario (Q4-2025). The Canadian dollar would be weaker, mirroring the flight-to-safety driven strength in the U.S. dollar. Similar to the U.S., these effects are more severe the higher tariffs imposed by the U.S. are. At 25% tariffs with full retaliation, Canada's GDP could be as far as 5.6% lower in Q1-2027.

Table 2: Impact of Tariffs on Canada (With Retaliation)						
	Peak Impact by Tariff Size					Quarter of Peak Impact
	5%	10%	15%	20%	25%	
GDP (%)	-1.1	-2.3	-3.4	-4.5	-5.6	Q1-2027
GDP Impact by Q4-2028 (%)	-0.9	-1.8	-2.7	-3.6	-4.5	-
Core Inflation (pps)	0.8	1.7	2.5	3.3	4.1	Q3-2025
Policy Rate (bps)	56	112	168	224	280	Q3-2025
Exchange Rate (%)	4.2	8.4	12.6	16.8	20.9	Q1-2025
Exchange Rate Impact by Q4-2025 (%)	2.2	4.4	6.5	8.7	10.9	-
Unemployment Rate (pps)	0.6	1.2	1.8	2.4	3.0	Q4-2025

Source: Scotiabank Economics.

The impact of tariffs on Canada with partial retaliation (Table 3): If Canada retaliates to half of the U.S. tariffs, the effect on Canada's economy would be slightly smaller. Under 5% tariffs, GDP would be 0.9% lower than in a no-tariffs scenario (Q4-2026). Core inflation would be 0.4 percentage points higher, and the policy rate only 16 basis points higher. These impacts would again be larger the higher the tariffs Canada is facing and half retaliating to. At 25%, Canada's GDP could be 4.7% lower than in a no-tariffs scenario.

Table 3: Impact of Tariffs on Canada (With Half-Retaliation)						
	Peak Impact by Tariff Size					Quarter of Peak Impact
	5%	10%	15%	20%	25%	
GDP (%)	-0.9	-1.9	-2.8	-3.8	-4.7	Q4-2026
GDP Impact by Q4-2028 (%)	-0.7	-1.4	-2.2	-2.9	-3.6	-
Core Inflation (pps)	0.4	0.8	1.2	1.6	2.0	Q2-2025
Policy Rate (bps)	16	33	49	65	82	Q3-2025
Exchange Rate (%)	4.0	8.1	12.1	16.1	20.2	Q1-2025
Exchange Rate Impact by Q4-2025 (%)	2.1	4.3	6.4	8.6	10.7	-
Unemployment Rate (pps)	0.5	1.0	1.5	2.0	2.5	Q4-2025

Source: Scotiabank Economics.

The impact of tariffs on Canada with no retaliation (Table 4): If Canada doesn't retaliate at all, then its economy would be hit less by the 5% tariffs, albeit by a still significant 0.8% decline. Under a no retaliation scenario, the impact on Canada is simply a deflationary demand shock, therefore unlike the previous two scenarios, inflation and the policy rate would be lower here than a in no-tariffs scenario. Core inflation would be 0.2 percentage points lower in Q3-2026, and the policy rate 50 bps lower in Q4-2026. At 25%, Canada's GDP would be 3.8% lower than in a no-tariffs scenario.

Table 4: Impact of Tariffs on Canada (Without Retaliation)						
	Peak Impact by Tariff Size					Quarter of Peak Impact
	5%	10%	15%	20%	25%	
GDP (%)	-0.8	-1.5	-2.3	-3.1	-3.8	Q4-2026
GDP Impact by Q4-2028 (%)	-0.5	-1.1	-1.6	-2.2	-2.7	-
Core Inflation (pps)	-0.2	-0.4	-0.5	-0.7	-0.9	Q3-2026
Policy Rate (bps)	-55	-110	-164	-219	-274	Q4-2026
Exchange Rate (%)	3.9	7.8	11.6	15.5	19.4	Q1-2025
Exchange Rate Impact by Q4-2025 (%)	2.1	4.2	6.3	8.4	10.5	-
Unemployment Rate (pps)	0.4	0.8	1.2	1.6	2.0	Q4-2025

Source: Scotiabank Economics.

Box 1: Monetary Policy Response to Tariffs Shock

The tariff shock behaves as a negative supply shock for both Canada (with a retaliation to over half of U.S. tariffs) and the U.S.: inflation rises, and monetary policy reacts by temporarily increasing the interest rate for about six quarters. This goes against conventional monetary policy wisdom that central bankers should ignore the inflationary effect of a tariff shock due to its transitory nature. There are several factors in our simulations explaining why we believe the policy rate should react to higher inflation:

1. We assume that the tariff shock is permanent throughout Trump's administration. In the case of a short-lived temporary shock, monetary policy would not react.
2. Lagged inflation in our Phillips curve generates persistence in the inflation process, potentially reflecting partially adaptive expectations. As a result, the rise in import prices propagates somewhat persistently in inflation.
3. The shock creates a persistent fall in the growth rate of potential GDP and disruption of supply chains, which creates sustained inflationary pressure.
4. In Canada's case, trade-policy uncertainty associated with tariffs leads to a persistent depreciation of the Canadian dollar, further fueling inflation and feeding the somewhat persistent inflation reaction.
5. The persistent rise of inflation that began in 2021 was closely linked to supply disruptions associated with the Covid pandemic. It was a mistake for monetary policy to dismiss this as a mere supply shock at the beginning and not react. Monetary policy must now place greater importance on addressing supply shocks, such as Covid-induced supply chain disruptions or a permanent tariff shock, than it did in the past, to regain credibility. This widely recognized mistake has harmed the credibility of central banks, making it more likely for a short-term shock to persistently propagate on inflation expectations, particularly if monetary policy is perceived to not have learned from prior episodes.
6. Inflation starting points matter, especially considering central bank's lower credibility over the last few years. With inflation still some distance from target in the U.S., and considering the upside risks to Canadian inflation, central banks will have to take upside shocks to inflation more seriously than negative inflation surprises.

In both the Canadian case (with a retaliation to over half of the U.S. tariffs) and the U.S., our simulations indicate that the rise in inflation and inflation expectations generated by the tariff increase would lead to a fall in the real policy rate absent a tightening in monetary policy. Therefore, it is worth noting that even with retaliation, the real interest rate, i.e., the inflation-adjusted nominal rate, declines substantially, and monetary policy is in fact stimulative in its response to the shock. It is the real interest rate, not the nominal rate, that ultimately matters for economic activity and inflation. In Canada, however, the need for nominal rates to rise is reduced the smaller the retaliation is. In fact, there is a retaliation threshold that, once crossed, would not require the Bank of Canada to hike its policy rate. If the government keeps its retaliation to just below half the tariffs imposed by the U.S., inflationary pressures remain low enough for the Bank of Canada hold off raising rates.

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