Intelligence MEMOS

From: Daniel Schwanen

To: Trade Observers

Date: January 17, 2025

Re: **MR. TRUMP'S RUINOUS TRADE WAR (PART TWO)**

As we saw in yesterday's Memo, the United States runs a large finished goods manufacturing trade surplus with Canada. And it imports from Canada large amounts oil and other materials needed to keep its own industries competitive. These imports more than offset the US surplus with Canada in other sectors.

Such accounting niceties will not prevent Mr. Trump from thinking that Canada treats the US unfairly because Canadian businesses spend less in the United States than the other way around.

Hence, Canada, ironically one of the few countries with which the United States runs a large manufacturing trade surplus, is caught in the net of Mr. Trump's tariff strategy to reduce the huge US manufacturing trade deficit.

This strategy cannot work for many reasons. The central one is the US dollar's reserve currency status around the world. Mr. Trump has vowed to maintain this status, but this practically requires the US to run a trade deficit – to purchase more from the rest of the world than it sells, to meet the demand for dollars abroad. It certainly enables the United States to consume more than it produces – and run its large budgetary deficits.

Even tariff boosters admit it will not work if it does not result in rebalancing US economic incentives away from consumption and toward production. The plan is meant to boost US industrial output. Although Canada can rightly assert that the tariffs will not work, it still needs to be seen as supportive of US growth objectives.

Tariffs, however, will significantly weaken the Canadian economy – and by doing so will make a recovery in US manufacturing more difficult to achieve. Already in 2017, during Mr. Trump's first presidency, a C.D. Howe Institute study showed that, partly because of the integration of the two economies – in many sectors such as autos and food we make things together rather than compete – tariffs will reduce economic activity on both sides of the border. That study was predicated on 10-percent US tariffs – a 25-percent tariff would make things that much worse.

If, as it seems, Mr. Trump seeks to relocate much of this manufacturing activity to the United States, this "working and making things together" argument may not have a lot of sway with him.

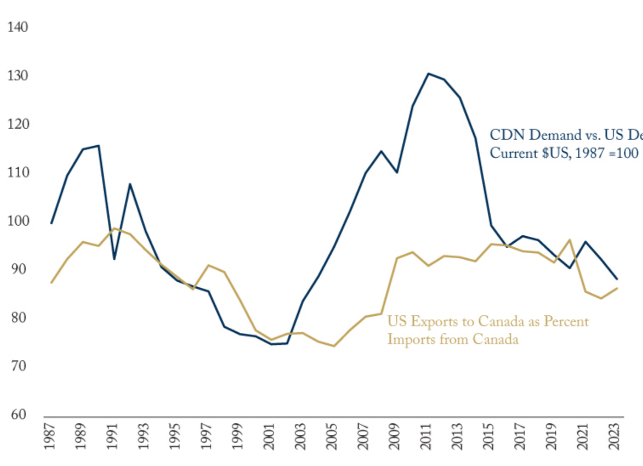
Hence, Canada's core arguments need to include an often-overlooked dimension: That a weaker Canadian economy will almost certainly result in a bigger US trade deficit with Canada, and that in the end hurting one of their best customers will mean a setback for US industrial growth.

The gist of this argument is contained in Figure 1. Here we see that when Canadian domestic spending (consumption, government spending and investment) strengthens relative to that of the US, the US trade balance with Canada improves as we import more from them. When it weakens, the US sells less to Canada, and so its trade balance with us weakens. The relationship between the two is not perfect: For example, the US started importing a lot of oil from Canada in the early 2000's, which partly explains both the 2002-2014 Canadian boom and the smaller reduction in the US trade deficit with Canada during that period than would have occurred otherwise. But the relationship is unmistakeable.

This observation could help refocus the US mindset from Canada being part of the problem, to how it could be part of the solution.

The message here should be that Canada can be a much better customer for the United States – in part by boosting its own economic performance, which would reduce our trade surplus with the United States, in part by getting down to business well ahead of the planned USMCA review in June 2026 to seek to resolve existing bilateral irritants.

Figure 1: How A Healthy Canadian Economy Boosts US Exports



Source: Statistics Canada, US Bureau of Economic Analysis, Federal Reserve Bank of St. Louis (for the exchange rate), and author's calculations.

From that perspective, there is a deal to be made, which could be called "A framework for growth, security and balanced trade between the United States and Canada." Inevitably, this would involve some form of managed trade, such as we have seen in the past with the Auto Pact or the Defence Production Sharing Agreement; agreements that do recognize the need to maintain balance while allowing trade to flow relatively efficiently to the benefit of both countries.

None of this is to suggest that Canada should not impose retaliatory measures if the United States starts the war. Ideally, these will not jeopardize our long-term position as a trusted supplier to the United States but will focus

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