Intelligence MEMOS

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To: Monetary Policy Observers

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Re: **Assessing the Impending Grunts and Twitches from the US Elephant**

Pierre Trudeau noted the challenges of sleeping next to the US elephant 55 years ago, and how Canada is affected by its every twitch and grunt. Now, unsurprisingly, the return of Donald Trump is sparking speculation about the next four years of twitches and grunts.

The President-elect's unpredictability makes this a herculean task.

But there are some elements of his economic plan that appear to be set in stone – sweeping tariffs and tougher border controls that may impede the flow of goods, services, and people across borders, and a tax and spend policy that will create an even bigger US debt hole. Determining what these two sets of policies mean for the Canadian economy – at a macro level – and for Bank of Canada interest rate settings is challenging, but not impossible.

Let's start with tariffs and a thicker border. New tariffs by the US are likely to be reciprocated by other countries – including ours. Given that tariffs are essentially a tax on imports that is paid by consumers and businesses, one can safely predict that they will dampen global trade and hence global economic activity.

This would translate into reduced demand for our exports. Canadian incomes would also suffer from the decline in commodity prices that would arise from such a negative economic shock since a chunk of our prosperity is derived from selling commodities. Making this worse is the risk of tighter border restrictions between Canada and the US – a thicker border – which could serve to further reduce trade between our two countries.

Countering the reduction in economic activity from tariffs will be the incoming administration's plans to cut taxes and increase spending – a major fiscal stimulus. According to the non-partisan Committee for a Responsible Federal Budget, candidate Trump's platform would see the **debt load increase** by $7.75 trillion. Americans would be receiving tax breaks without commensurate declines in spending.

Some of this fiscal stimulus would likely spill over into more demand for goods and services supplied by Canadian businesses. But the US economy is already running hot, as evidenced by the fact that the Federal Reserve's policy rate is almost one percentage point above the Bank of Canada's 3.75-percent policy rate. To the extent the US economy is operating closer to its potential, additional fiscal stimulus there may simply translate into upward pressure on inflation. Given that US inflation at 2.6 percent is currently above the Federal Reserve's 2-percent target, the creation of additional inflation pressures may force the Fed to recalibrate where monetary policy is headed. Tariffs that increase the cost of imports will only exacerbate that recalibration further upwards.

Where does that leave the Canadian economy and the Bank of Canada? It seems reasonable to suggest that the boost we may get from a stronger US economy as a result of their fiscal stimulus should help to alleviate some of the economic pain that will arise from higher tariffs. But that will be short-lived, and the net direction is clear: our economy is headed towards some choppy water.

For the Bank of Canada – notwithstanding the possibility of an initial lift to Canadian economic activity from US fiscal policy – heavy tariffs may cause a drag to Canadian output, requiring more stimulative monetary policy than there otherwise would have been to give our economy a boost. How much monetary stimulus will, in part, depend on the depreciation in the Canadian dollar stemming from potentially higher US interest rates and lower commodity prices. A weaker Canadian dollar would help to cushion the blow for the Canadian economy – and in such a way that distributes the pain more broadly – by making it cheaper for Americans to import Canadian goods, offsetting some of the tariff impact. It is only 25 years ago that Canada's Parliamentary Research Branch released a report entitled "**Monetary Union with the U.S.: Pros and Cons**". We are about to realize how thankful we are that the "Cons" won.

A cranky elephant south of the border will make it hard on the Canadian economy. It makes it even more important to have institutions with clear mandates and helpful economic structures. In the Bank of Canada and a flexible exchange rate, we have both.

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