Trade Crisis Working Group

Communiqué

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# Inside the Tent or Out in the Cold? How Canada Should Navigate the Coming US Trade Demands

## Fourth and Fifth Meetings of the C.D. Howe Institute Trade Crisis Working Group

The Trump administration's tariff and trade policy announcements on April 2 – and the subsequent 90-day pause on proposed "reciprocal" tariffs, later revised by post-market customs guidance on April 11 to exclude up to $322 billion annually in consumer and producer electronics imports – offer salient lessons for Canada as it prepares for the possibility of negotiating a new trade and security agreement with the United States. Such a negotiation has been proposed by the two front-runners in the April 28 Canadian federal election and seems to align with the most recent pronouncements of the US Administration, namely that the US is interested in negotiating new trade arrangements with its closest partners and allies.

While Canada must prepare for such talks as a matter of priority, it should also actively pursue key courses of action discussed in earlier meetings of this group, which are now garnering a consensus across the country:

1. Canada needs to strengthen and de-risk its economy by unleashing major economically sensible projects, boosting its defences, diversifying its trade, removing internal barriers to trade, and adopting other measures to boost productivity and economic security.
2. Avoid retaliation or limit it to targeted and moderate retaliation (as well as clear messaging), which can impact Americans' perception of the costs of arbitrary barriers to trade.
3. Support the resiliency and continuity of businesses (and the jobs therein) affected by US tariffs, for those businesses which would otherwise be competitive in the US market.
4. Carefully consider pursuing alliances with like-minded nations to enhance and protect international rules-based trade, in a context where many of our trade partners will want to reach their own deal with the United States.

These were the key conclusions of the fifth meeting of the C.D. Howe Institute's Trade Crisis Working Group, which met on April 7, building on a prior meeting of the group on March 19.

## Ongoing Work Program

### *Strengthening and De-Risking*

On strengthening and de-risking the economy, the group reviewed the Institute's work program and alignment with strengthening Canada's ability to respond to the crisis. This work program has

| Table: US International Balance in Services Trade with the World and Canada, 2024 | | |
|---|---|---|
| **Type of Service** | **US Balance with the world (US$ Mn.) 2024** | **US Balance with Canada (US$ Mn.) 2024** |
| Transport | -50,244 | 528 |
| Travel | 37,284 | 11,956 |
| Insurance | -46,769 | 2,751 |
| Financial | 129,544 | 6,853 |
| Intellectual Property Payments | 86,437 | 6,386 |
| Telecoms, computers, information services | 18,839 | -3,162 |
| Other Business Services | 111,124 | 10,622 |
| Personal, cultural and recreational services | -8,708 | 282 |
| Other services | 17,650 | -1,274 |
| Total Services | 295,153 | 34,942 |
| Memo: Total Goods | -1,212,989 | -70,603 |

been bolstered recently, and it includes notably recent and forthcoming work on trade diversification, removing internal Canadian trade barriers, and strengthening Canada's infrastructure and attractiveness for investors and innovators. The Institute will also hold a conference on defence spending in the fall, and the Trade Crisis Working Group will add a discussion on a proposed list of major projects that could both support trade diversification and enable Canada to benefit more from its comparative advantages to the agenda for its next meeting.

### *Retaliation and Communications*

The group continues to recommend avoiding retaliatory actions that could harm Canada – we cannot win a tit-for-tat war. The group recognizes that retaliation may be politically necessary from an optics perspective ("dignity" as one member put it), and in a few cases, can help strengthen the Canadian domestic market for businesses affected by US tariffs by making it harder for US products to sell in Canada. However, we should avoid gestures that would both hurt Canadian consumers or businesses (by raising prices) and would potentially turn the US public and businesses against Canada, when in fact the US public and businesses are our biggest potential allies (our "boots on the ground" as one member said), since they directly feel the pain from the administration's tariffs. Boycotts by individual Canadians are saying as much, if not more, than official retaliation could.

In that vein, the group noted with interest that the more the United States arbitrarily and unilaterally sets tariffs against its trade partners' goods, the more vulnerable it is to boycotts of its brands and products, affecting both US goods and US services. US balance of payments statistics show that the United States records a large surplus in services trade, albeit much smaller than its deficit in goods (see Table).

Institute staff noted that it will soon launch an information campaign on the trade crisis – including on this large surplus on services trade – and will be doing more to reach potentially receptive audiences in the United States. Leverage can be exercised by engaging and contributing to the evidence-based toolbox of American business and thought leaders who feel Trump is hurting businesses and consumers with tariffs.

### *Continuity and Resiliency*

The large parts of Canada's industrial base which would be competitive in the US market, except for the new tariffs, need to be supported through the crisis. In this respect, the group noted programs being rolled out by federal and provincial governments providing liquidity and other support, such as tax deferrals, to Canadian businesses. There also needs to be a strategic focus on restoring fair access to the United States for these industries by highlighting their contribution to the US's own competitiveness and growth.

Members warned that the potential for products from third countries finding themselves with reduced access to the US market, and flooding the Canadian market as a result, is real, and that there is a need to monitor the situation and preserve the integrity of the Canadian market against potential surges of imports due to deflection from the US market through safeguards if necessary.

The group also reviewed in detail the situation of highly integrated North American auto production chains. In the short term, this integration means that without some accommodation for Canada and Mexico on auto tariffs imposed by President Trump under Section 232 of the 1962 *Trade Expansion Act* (on grounds of US National Security), the United States is shooting its own economy in the foot. Likewise, for steel and aluminum, which are also affected by s. 232 tariffs, the US does not have a lot of immediate substitutes. The group noted that the President and his advisors chose not to withdraw the United States from the Canada-United States-Mexico Agreement (CUSMA/USMCA). They also observed that tariffs on Canadian goods critical to US industrial competitiveness – such as energy and potash – are expected to drop to zero once the President declares the national emergency at the Canadian border over. In addition, many products from Canada and Mexico continue to enter the US tariff-free, provided they meet the North American rules of origin under the agreement.

The group therefore remains hopeful that zero or lower duties, as well as greater clarity on the scope of the tariffs (e.g. for auto parts), can also be achieved through the forthcoming negotiations for the range of products subjected or soon to be subjected to s. 232 tariffs.

That said, a clear-eyed view of the situation is that access to the United States market from Canada is now forever tainted by the threat of tariffs, a situation of uncertainty which will mean a probable sharp

drop in the type of investment in Canada that was predicated on that access. In that context, members are reviewing a paper on a "plan B" for Canada's auto industry. This plan would involve returning to a pre-1965 Auto Pact situation with the United States, with Canadian tariffs (i.e., duties) imposed on countries imposing tariffs on us, accompanied by a duty remission scheme for manufacturers assembling cars in Canada. Members are divided on the wisdom of this proposal, which will be further refined as comments are received on it.

### *Building Coalitions*

The group discussed in depth possibilities for collaboration and cooperation with like-minded trade partners to keep up a functioning rules-based system, and reviewed proposals to that effect.

Canada's paramount interests in maintaining open trade, and its need for trade diversification, require that we be very active in supporting and engaging with such a group of economies, which would ideally involve all the ones with which Canada already has a trade agreement, notably the European Union, plus other small open economies. This could help Canada and its partners cushion the effects of US tariffs by not dismantling and perhaps strengthening the network of rules-based agreements they have among themselves.

However, it was noted that the United States expressed opposition to any grouping that does not extend the trade benefits of the group to itself, at least not "in a manner that threatens the economic and national security interests of the United States." In other words, the United States no longer appears willing to extend "most favoured nation" (MFN) treatment – a bedrock of World Trade Organization (WTO) rules – to its trading partners. However, it may still expect those partners to grant such treatment to US businesses and, more broadly, seek to secure for itself the benefits that other countries negotiate among themselves. Key questions here will be the attitude of China and India toward such a "coalition of the willing," in contrast to the US view.

## Preparing for Negotiations with the United States

Unlike the 25 percent *International Economic Emergency Powers Act* tariffs against Canada, or the s. 232 tariffs against specific products, the administration has not tied its calculation (that are "mindless", according to *The Economist*) of "reciprocal" tariffs to any specific barrier or issue; they are meant to roughly punish trade partners for the sum of all unfair policies attributed to them, which are said to be the root cause of the US deficit. By that "standard", the US has determined that the reciprocal tariffs on Canadian products would be 12 percent (zero percent for energy and potash), once the border emergency, which triggered the general 25 percent tariff, has been lifted.

However, although the United States could have chosen to withdraw from CUSMA/USMCA, it hasn't done so, and zero tariffs remain in effect for products which are certified as being of North American origin under the CUSMA/USMCA rules of origin, and which are not affected (or not yet) by s. 232 tariffs. Indeed, certification under those rules continues to be granted, although firms that previously had duty-free access to the US market in MFN zero tariff lines now have to obtain a preferential rules of origin certificate, which raises the dead-weight costs of trade.

That said, we know that the United States has a list of specific beefs against Canada, and it now looks likely that these will be put before Canadian negotiators before too long, as part of an accelerated review of the CUSMA/USMCA (originally scheduled to take place by July 2026). Furthermore, the April 2 tariff reveal, with its special punishment of countries with which the US runs a trade deficit, and subsequent comments by administration officials, lend weight to earlier pronouncements by Mr. Trump that his "end game" is a reduced trade deficit. We also know that, more generally, negotiations with partners to remove the tariffs against them will be dependent on trading partners taking "significant steps to remedy non-reciprocal trade arrangements and align sufficiently with the United States on economic and national security matters," which opens the door very wide as to what the United States may want in exchange for reducing arbitrary tariffs.

Even as the group could make little sense of the US's proposed tariffs, the pretexts invoked for imposing most of them, and disregard for existing agreements – other than as ways to exercise leverage – most participants felt that Canada should prioritize its bilateral relationship with the US, especially because that is what dozens of other countries are doing following the April 2 tariff reveal (no doubt a reaction the administration had hoped for). The United States warned against retaliation, and indeed, it transpires, as announced, that countries that did not retaliate or retaliated mildly seemed first in line to negotiate the "reciprocal tariffs" down.

While some believed that it would be best to keep negotiations with the US narrow and targeted, many felt that a broader discussion was inevitable. For example, negotiators would need to take into account the implications for Canada of broader US economic policies, such as those embodied in the recent "Restoring America's Maritime Dominance" Executive Order, calling for cabinet secretaries and agency heads to engage "treaty allies, partners and other like-minded countries." Tactically, there was general agreement that focusing on the most pressing issues and aligning Canada's negotiating strategy with what matters most to the US was key, and this did not necessarily require trying to make sense of all US policy actions.

That said, Canada also needs to set the bar high. It needs to counter the narrative that its trade with the United States detracts from the latter's industrial strength, when by and large it is doing exactly the opposite. As discussed in earlier meetings of the Trade Crisis Working Group, Canada's objectives need

to include: securing zero tariffs; ensuring certainty – or at least greater stability – than what is provided under CUSMA/USMCA, ideally through an agreement approved by the US Congress; and preserving autonomy in its domestic policies and international relationships, including trade with the EU, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), and Mexico, as well as our own defence and security arrangements.

In discussing what could make it attractive to negotiate with Canada on that basis, one proposal put forward by Institute staff would rely on a "macro" solution that could aim at balanced trade with the United States over time. While balanced trade, key to the administration's vision, is an impossibility with each country (unless under a Soviet-style countertrade system), it is conceivable between Canada and the United States, and has happened historically at times when the Canadian economy was relatively strong.

Measures to strengthen the Canadian economy, increase its defence spending – focusing especially on securing both our northern and southern borders – and developing critical minerals and other major projects would be key to the adoption of such a "win-win" framework for Canada-US negotiations. This, in turn, could also see Canada as being "inside the tent" with respect to the contribution of its materials and auto industries to the revival of the US industrial base and its national and economic security, providing a lever to reduce or alleviate the targeting of Canadian industry under s. 232 tariffs.

While members considered the macro-economic difficulties with this approach, given especially that the US cannot easily close its trade deficit if it is also engaging in a large fiscal stimulus (like tax cuts), and the fact that a balanced trade target with that country would need to carefully and separately consider plausible scenarios for resources, manufacturing and services, Institute staff will continue to develop this for consideration by policymakers. The general point is that a revival of Canadian economic growth can be expected to boost Canada's imports from the US.

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Members participate in their personal capacities, and the views collectively expressed do not represent those of any individual, institution, or client.

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