



When your neighbour starts a trade war

BY JOHN LORINC

In a world filled with exquisitely complicated consumer electronics and digital networks that seem capable of performing miracles, few of us likely spend much time thinking about the lowly car seat and what, if anything, makes it special. Yet these outwardly pedestrian components of every vehicle tell a concise story about how things get made in the world today.

Flavio Volpe, president of the Automotive Parts Manufacturers' Association, effortlessly itemizes the ingredients: a metal or hardened plastic frame, highly regulated foam cores, exterior fabric, a rail and some power electronics, heating and cooling elements, and possibly even sensors capable of adjusting the seat under certain driving conditions.

"That's like six different suppliers," he says matter-of-factly. "It gets assembled wherever the seat plant is, but the cut and sewed material probably comes from Mexico. They almost always do the power electronics. If it's a simple motor, it might be from North America, but probably from an Asian country. The stamped components are probably Canadian.

And then the rest are a really good mix of American, Canadian, maybe Eastern European, maybe from other Asian countries, such as China or those that are part of the Trans-Pacific Partnership, like Vietnam and Malaysia."

But, he adds, under so-called compliance matrices set out in the U.S.–Mexico–Canada (USMCA) trade agreement, "a really big bulk of those components, 65 to 75 per cent, have to be sourced from the three countries." If the seat manufacturer can organize its supply chain to nose above that country-of-origin threshold, which the vast majority of firms work very hard to do, then the tariffs, per USMCA, amount to virtually zero, even though most of the ingredients in said seat have moved across North American borders several times.

The serpentine supply chains that delineate virtually all modern manufacturing are the outgrowth of successive operational innovations over the past four decades—the Japanese quality assurance revolution of the 1980s, the just-in-time revolution of the 1990s, the logistics revolution of the 2000s and

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so on. But they’re also the physical manifestations of the international rules-based free (or free-ish) trade system that prevailed for decades and which today seems to be fraying badly under President Donald Trump’s America First-ism.

Case in point: In early February, Trump first threatened and then promptly delayed 25 per cent tariffs against Canada and Mexico. The Trudeau government promised \$155 billion in counter-tariffs, and China, still the target of a 10 per cent tariff, vowed it would take legal action at the World Trade Organization. Trump’s move triggered widespread condemnation, boycotts of U.S. goods, the cancellation of U.S. orders by provincial liquor boards and promises by the premiers and federal politicians to tear down interprovincial trade barriers. It seems unlikely that the ill feeling will abate anytime soon, and the president’s mercurial tactics may well alter the long-standing Canadian-American alliance, and its promise of stability, for years to come.

“If you stand back, it’s basically a threat to wage economic war on Canada, and a departure from over 150 years of our shared history,” says Lawrence Herman, trade lawyer and a Senior Fellow of the C.D. Howe Institute. Yet, as University of Toronto business historian Dimitry Anastakis observes, “The tariff threat is something that Trump has utilized before, to great effect.”

As Volpe notes, a 25 per cent across-the-board levy on exports would upend the automotive industry’s intricate North American supply chain networks—all of them structured to optimize the provisions of existing trade agreements—which have grown up over decades. A broad-based, and prolonged, tariff poses an existential threat, he predicts. “Nothing will be built. The industry will come to a halt within a week or two.”

Needless to say, no one knows for sure how the tariff drama will play out—whether Trump’s

aggressively unpredictable conduct is merely meant to set the stage for the required renegotiation of USMCA next year or if the threatened across-the-board levies will lead to more targeted tariffs, such as the 25 per cent tariffs he imposed in mid-February on all steel and aluminum entering the U.S. Or maybe they will become a fixture of some kind of permanently altered economic relationship between Canada and the United States, as is the case with America’s now seemingly entrenched tariffs on Chinese imports.

However the tariff jockeying settles out, there’s little mystery about the consequences of a trade war for the Canadian economy: A Royal Bank of Canada evaluation of the first tariff volley, published in early February, predicted that the impact could tip Canada into a recession, bring GDP declines of three to four per cent, and add two to three per cent to national unemployment rates. “While the precise impact depends on a variety of assumptions—including monetary and fiscal policy responses—this is a significant negative shock to Canadian growth and poses a serious risk of unemployment rate increases,” commented RBC chief economist Frances Donald and assistant chief economist Nathan Janzen.

The intensity and duration of the coming negotiation is not in doubt. CPA Canada chief economist David-Alexandre Brassard says that even prior to Trump, the United States “has often managed to get its way when dealing with Canada because they’re such a big player.” He cites the long-running feud over Canada’s softwood lumber exports. “The risk with Trump,” he adds, “is that he’s a win-lose kind of guy. We all know that’s why he negotiates so hard, and I fear he’s going to use his dominant position even more strongly than in the past.”

Whatever the endpoint, Trump’s bluffs and feints have shone a bright light on the profoundly, and perhaps problematically, integrated state of the

\$1.3 trillion/year Canada–U.S. trading relationship, especially with respect to the export of manufactured goods, which now account for two-thirds of Canada’s southbound trade and almost 90 per cent of imports from the United States.

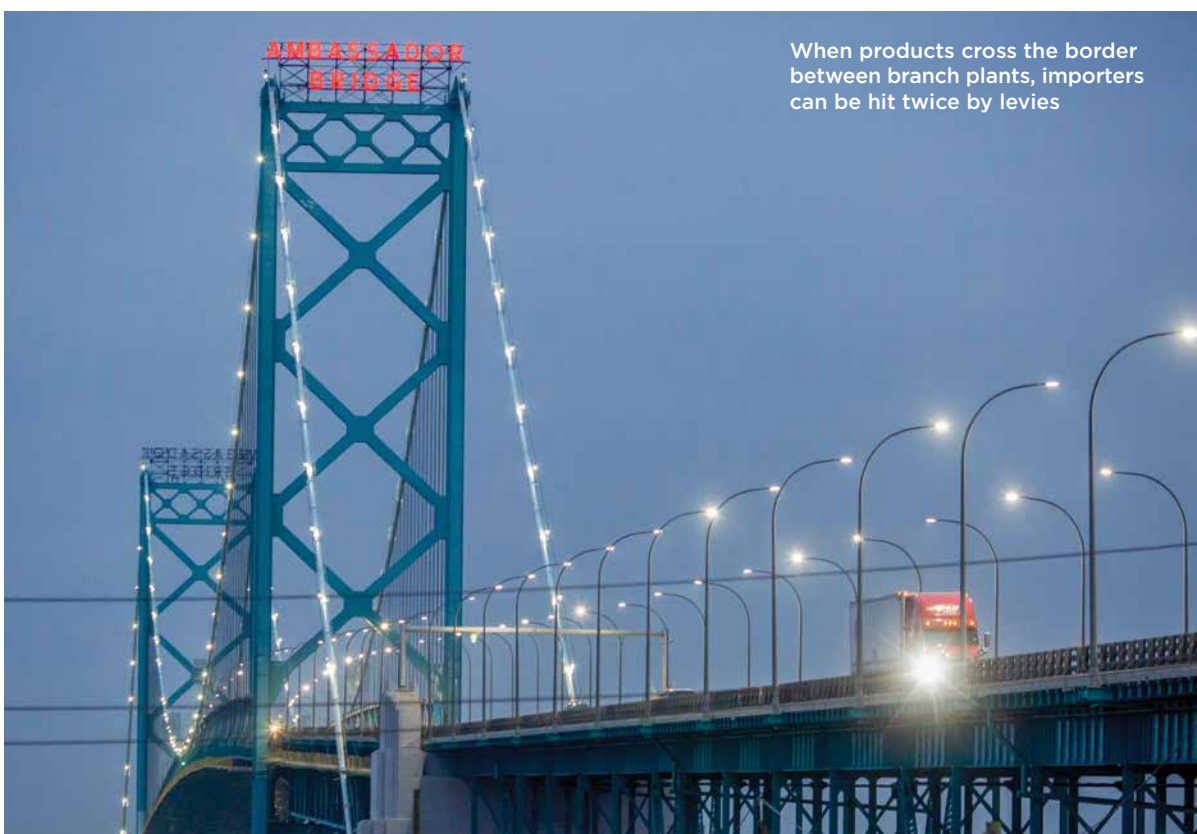
According to an October 2024 analysis by University of Calgary economist Trevor Tombe and commissioned by the Canadian Chamber of Commerce, our exports to the U.S. of “intermediate” or “value-added” goods—in other words, processed materials or manufactured components that become part of some larger product—amounted to US\$319 billion (2019 figures), of which US\$38 billion actually originated in the U.S. Likewise, Canadian firms exported US\$24 billion in components to the U.S. that became part of larger products that were subsequently imported to Canada. (The chamber says an auto part typically crosses North American borders no fewer than eight times before final assembly.)

What’s more, almost half of Canada’s exports to the United States are actually transactions between related parties, for example branch plants or subsidiaries—a detail that further complicates the

tariff picture, given that new levies will effectively hit importers twice. Such details, Tombe observes, “significantly change how one views the trade balance between the two countries.”

“Because something like 80 per cent of what we share back and forth are intermediate goods,” adds Dennis Darby, president and CEO of Canadian Manufacturers and Exporters, “[tariffs] have an inflationary effect on both sides. If you suddenly put a tariff in a supply chain that has been built on having free movement of the goods, then you automatically start to add inflation [and] increased costs. In the case of Canada, [it] obviously makes us less competitive.”

A pair of unflattering epithets long dominated the narrative of Canada’s exports: For generations, we were “hewers of wood and drawers of water” and then graduated to become a “branch plant economy.” On the eve of the Second World War, when Britain accounted for slightly more than a quarter of our exports, Canada’s main outbound products were wheat and pulp and paper for newsprint. Through the 1960s, Canada’s manufacturing base grew



When products cross the border between branch plants, importers can be hit twice by levies



Conservative leader Pierre Poilievre said he would push for an exemption to “Buy American” trade policies

significantly, with a burgeoning two-way trade in cars, as well as a domestic industry for household durables, like furniture and appliances.

The 1965 Auto Pact—negotiated after Ottawa imposed controversial duty remission schemes on U.S.-made components like transmissions to reduce a massive trade deficit—set the stage for the supply chain integration between southern Ontario and Michigan. That arrangement, however, did not prevent then-president Richard Nixon from imposing broad-ranging 10 per cent tariffs on all imports in 1971 as part of a broader strategy, which included abandoning the international gold standard, to fortify the U.S. economy in the face of inflation (see sidebar, page 28). While the tariffs remained in place for only four months, they had the effect of reducing Canadian exports to the United States by 2.6%.

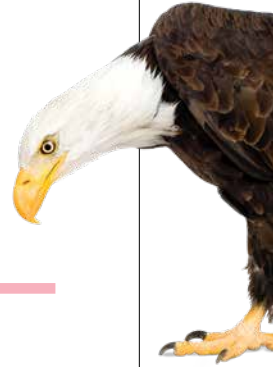
The 1980s, however, saw the emergence of a growing consensus around free trade. The 1988 U.S.–Canada Free Trade Agreement and then the 1992 North American Free Trade Agreement, which came into effect in 1994, begat dramatic shifts in the two-way relationship. Canada is now America’s largest supplier of crude oil, which is sent for processing in refineries in Illinois. The two countries also have extensive ties in sectors like aerospace, food processing and chemicals. Wood products,

by contrast, represent a much smaller part of Canada’s export picture than even 15 years ago.

Today, neither of those old putdowns apply, and the elaborate network of North American manufacturing supply chains means that 1.4 million Americans earn their living making products that are exported to Canada, some of which will then be re-exported back to the U.S. So while successive Canadian governments, especially Stephen Harper’s Conservatives, have sought to diversify Canadian exports through trade deals in the Asia-Pacific block, Europe and Latin America, the reality is that the United States is by far Canada’s largest customer, accounting for 77 per cent of all exports by dollar volumes. The entire Asian region, which is the next-highest destination for Canadian goods and services, generates just over 10 per cent, according to 2023 StatCan data.

In the anxious weeks prior to the launch (and then delay) of Trump’s attack on the Canadian economy, federal officials in Ottawa were busy leaking details of Canada’s retaliation options, among them counter-tariffs on strategically selected exports such as orange juice, ceramics and even electricity. (A published itemization of the first wave of counter-tariffs included hundreds of

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categories of imports, from turkeys to cigarettes to running shoes.)

Yet some Canadian exporters weren't leaving anything to chance, and were taking steps to mitigate the risk they saw coming their way. “For some companies that rely heavily on exporting to the U.S. market, where they're [selling] 60, 70 or 80 per cent of their volume, in industries where margins are not above 25 per cent and where there are alternative domestic suppliers or other international ones, this could be devastating,” says Jim Kilpatrick, Deloitte's global supply chain and network operations leader. He describes the U.S. move as a “geopolitical conflict” because Trump has linked tariffs to border security, drug trafficking and trade imbalances.

David-Alexandre Brassard points out that CPAs, as business advisers, necessarily play an important role in helping their clients take a measure of the commercial peril they'll be facing in the coming months or years. For such firms, he says, “I'm sure their CPAs are looking at the importance of the U.S. on their balance sheets, and how important is it in their P&L statements. It's really [about] risk management.”

Kilpatrick says that the supply chain disruptions during the pandemic offered a preview of what could happen, and the inherent risk of over-reliance on specific suppliers or regions. “As we exited COVID, unfortunately attention turned pretty quickly to financial performance, driving unnecessary inventory out of supply chains, looking at ways to take cost out, looking at ways to compress excess capacity. We didn't really address the resilience challenge.”

Facing the prospect of imminent tariffs, some exporters began stockpiling goods in U.S. depots or doubling up orders with U.S. customers. Kilpatrick recommends that firms with exposure to a sudden tariff hike should first take stock of the risk and impact to the business under various plausible

scenarios, and then begin to scope out a response. “What flexibility do you have to reconfigure your supply network, to move inventory in a different way, to change manufacturing locations to mitigate or alleviate the impact of these tariffs,” he says. “In some cases, you might require collaboration with your customers and with your suppliers to be able to make changes that are above the norm.”

Businesses in capital-intensive sectors are also confronting the possibility that they'll have to delay investments in new equipment, either on their own or on the instructions of an international parent company that will be calculating how to mitigate its own exposure to trade disruptions. “It will affect capital inflows into the country,” says Herman. “It has to have a negative impact on investment intentions, because if Canada is under threat, it belies the view that Canada is a good place to invest because it has open market access to the United States.”

When CME recently surveyed its members, Darby says, a full third reported that they were pausing their capital investments. Volpe is hearing the same message: “Anybody who's got an investment prospect for potential growth, like chasing a new customer in the U.S. southeast, for example, and is thinking, *Okay, Volkswagen is setting up a new plant in South Carolina and I want to win that business, I already have Volkswagen business, we're in a position to win it; let me go and secure land for the factory*—in that scenario, they are very likely to wait.”

With the auto sector in particular, Volpe adds, the bumpy transition to electric vehicles has further muddied the investment waters. Automakers and their suppliers are now tasked with building out EV lines while maintaining their internal combustion engine programs. “Adding this anxiety will only cause companies to make investments when they're absolutely sure they've got a volume customer on the other end.”

At a congressional committee hearing held last December to consider Trump's proposed tariffs, Erica York, senior economist and vice-president of the venerable U.S. Tax Foundation, offered up an analysis of what's to come by looking at what happened the last time the American government used tariffs to achieve an economic goal. The 2018–2019 tariffs, she told the members of the Joint Economic Committee, did not actually boost domestic manufacturing employment and nor did they drive domestic output. Manufacturing employment in the United States, she continued, has indeed fallen over many years. But, York explained, "the blame lies not with trade or other economic policies, but with greater productivity, often through automation, and greater consumer spending on services."

This assessment joins the growing chorus of expert analyses predicting that Trump's new tariff wall will

backfire by boosting prices for American consumers without providing any kind of countervailing benefit. A Congressional Budget Office brief predicted that across-the-board tariffs will boost government revenues, and thus shrink the deficit, yet they'll also serve to drag down productivity, decrease consumer spending and "reduce returns on new investments, especially for businesses that use imported goods in their production process."

However this nightmarish story resolves, there's little doubt the Canada–U.S. trading partnership—now revealed as a significant vulnerability for its lack of diversification and exposure to a political risk—will never be the same again. "It represents," says Lawrence Herman, "a sea change in our relationship with the United States, and that affects both CPA Canada's members and Canadian business generally. We need to address this as a most serious threat." ♦

How tariffs and counter-tariffs are imposed

When Richard Nixon slapped a 10 per cent tariff on almost all of America's imports, he invoked the Trading with the Enemy Act, and used a pretext—national security—not unlike the one Donald Trump invoked in 2018 when he



imposed levies on steel and aluminum. "The U.S. realized that it was a little ridiculous to use something called 'Trading with the Enemy' to go after France, Japan, Canada and other countries," says Carlo Dade, director of trade and trade infrastructure at the Canada West Foundation. "So [the law] was renamed the International Emergency Economic Powers Act, and some more restrictions were put on when it could be used and how it could be used."

Yet, Dade adds, Congress, in emergency situations, has broadly ceded the power to impose tariffs to the president, which is how the new tariff regime is being formally implemented. "If you need to declare a national emergency to gain tariff powers," he says, "I can't think of two better items than fentanyl and immigration. This calling us an enemy is about a piece of legislation that was written in a weird way, and it's the best thing they've got to use to do what they want to Canada."

As Lawrence Herman, a trade lawyer and C.D. Howe Senior Fellow, points out, "WTO panels have said, 'No, you cannot just self-determine whether there's

an emergency in international relations. There has to be an objective emergency. It doesn't necessarily have to be war, but there has to be the objective basis. So therein lies the crux of the problem. I don't think the Trump administration gives a damn about international law and international treaties. They're saying we have the right, under U.S. law, to apply exceptional tariffs against products when we in the executive branch determine there's a national emergency."

Although the wanton exercise of this kind of executive power appears troublingly high-handed, Dade points out that Canada has found itself in the crosshairs of U.S. trade offensives numerous times since Confederation—frequently enough, he adds, that Canadian exporters should know enough to plan not for the stability of free trade but rather the predictably erratic behaviour of our neighbour to the south. "We've always had this sword of Damocles hanging over our head," he says, adding that this awareness should push companies to build up their resilience by diversifying their export markets. "It's a feature of the system, not a flaw."