NATIONAL BANK OF CANADA
FINANCIAL MARKETS

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The trade war risks exposing other vulnerabilities

By Jocelyn Paquet

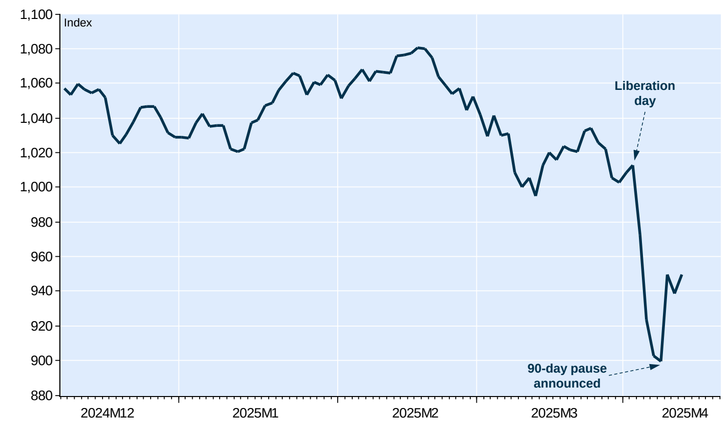
Summary

- The weeks since the last edition of this monthly monitor have been marked by twists and turns on the international stage. After focusing its attention on three of its most important trading partners (Canada, Mexico, and China) at the beginning of its term, the U.S. administration has significantly broadened its protectionist agenda, firing salvo after salvo at the international trading system.
- No country will be completely spared by these developments, but some will fare worse than others. Starting with the U.S., where a sharp rise in average tariffs will likely lead to a marked increase in core inflation and a slowdown in growth below its potential in the second half of the year.
- Economies that are highly dependent on exports of goods to the U.S. are obviously also at risk, as are those exposed to fluctuations in natural resource prices, as they are likely to suffer from a slowdown in global growth and a corresponding decline in demand for commodities, particularly oil.
- We have significantly lowered our global growth forecasts to reflect a much more protectionist environment than we had originally anticipated. We now expect global GDP to grow by only 2.8% in 2025 (down from 3.0% last month) and 2.7% in 2026 (down from 3.1%). We remain ready to revise this scenario upward if the tariff rhetoric de-escalates.

The weeks since the last edition of this monthly monitor have been marked by twists and turns on the international stage. After focusing its attention on three of its most important trading partners (Canada, Mexico, and China) at the beginning of its term, the U.S. administration has significantly broadened its protectionist agenda, firing salvo after salvo at the international trading system. The assault began on March 12, when Washington announced the imposition of 25% tariffs on steel and aluminum imports. An identical surcharge was then applied to cars built outside the U.S. and considered for the auto parts sub-sector.

Then came April 2, "Liberation Day." Two things were announced on that occasion: a 10% base tax on most products entering the United States and tariffs described as "reciprocal," whose stated purpose was to respond to trade barriers faced by U.S. exporters abroad. While the first measure came into effect on April 5, the second was postponed for 90 days to allow time for negotiations, but above all to calm the stock and bond markets.

World: Market ructions wins 90-day reprieve on reciprocal tariffs
MSCI World Stock Index

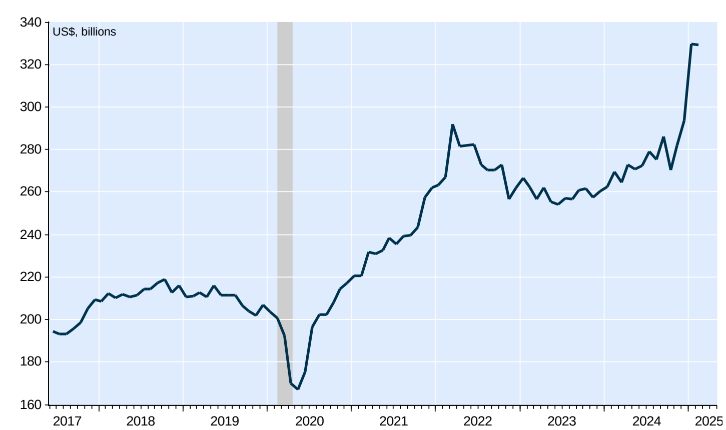


NBC Economics and Strategy (data via Refinitiv)

Not all countries benefited from this reprieve. China, which had responded to the reciprocal tariffs by imposing a surcharge on U.S. products and restricting exports of certain rare earth minerals to the United States, instead embarked on a spectacular escalation that culminated in the imposition of 145% tariffs on Chinese exports to the U.S. and 125% tariffs on U.S. imports to China. Washington was then forced to exempt computers and mobile phones from these measures, at the risk of angering U.S. consumers and tech giants such as Apple, but maintained most of the other taxes.

Even before these announcements were made, companies around the world rushed to bring forward their deliveries to the U.S. to avoid any surcharges, temporarily boosting manufacturing output and leading to a sharp increase in exports of goods to the United States.

World: Tariff threat led businesses to frontload their shipments to the U.S.
Goods imports to the United States



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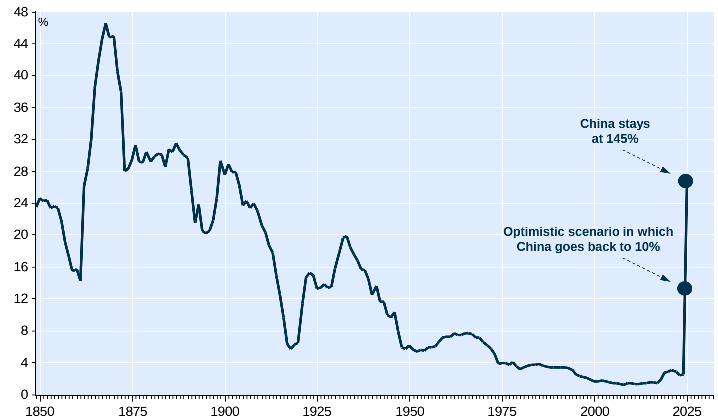
Unfortunately, this surge in activity is likely to be temporary, as the stagflationary impact of tariffs is set to be felt more and more strongly in the coming months. No country will be completely spared, but some will fare worse than others. Starting with the U.S., where a sharp rise in average tariffs will likely lead to a marked increase in core inflation and a slowdown in growth below its potential in the second half of the year. The latter will probably reflect a slowdown in business investment amid high uncertainty and weaker consumption associated with a negative wealth effect.

U.S.: Unprecedented increase in average tariff rate threatens stagflation
Custom duties as a percentage of total imports



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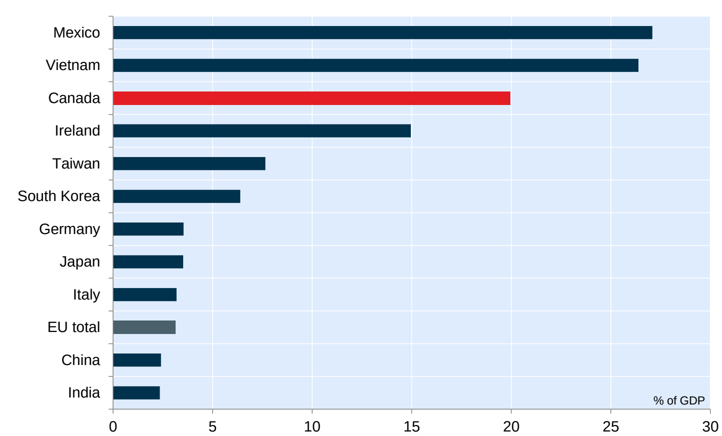
Economies that are highly dependent on exports of goods to the U.S. are obviously also at risk. Examples include Mexico and Canada (although these are currently facing lower average tariffs), but also Vietnam, Ireland, Taiwan, and South Korea.

World: Exposure to the U.S. a red flag in the current context
Merchandise exports to the U.S. as a percentage of 2023 GDP



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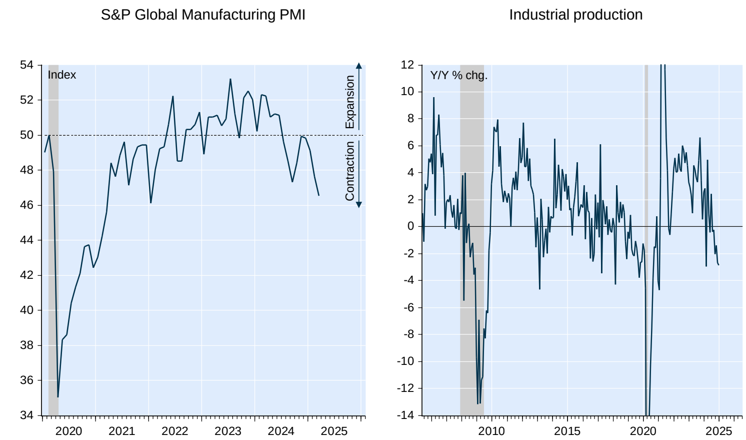
Within this group, Mexico is likely to be the first to experience problems, simply because its economy had already begun to slow significantly even before the trade war began. Real GDP indeed fell by 0.6% in non-annualized terms in the country in the fourth quarter and could decline again in Q1, judging by the latest economic indicators. These show that weakness in the manufacturing sector is beginning to weigh heavily on industrial production...

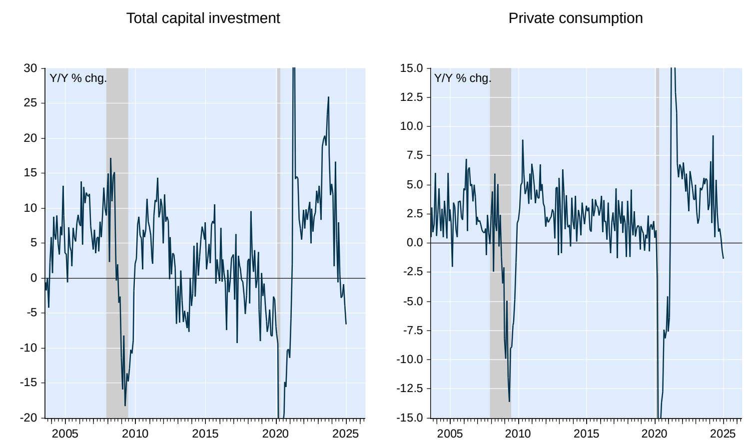
Mexico: Economy already looked weak before tariffs (1)



NBC Economics and Strategy (data via Bloomberg)

...which is slowing business investment and, through lower hiring, consumption.

Mexico: Economy already looked weak before tariffs (2)



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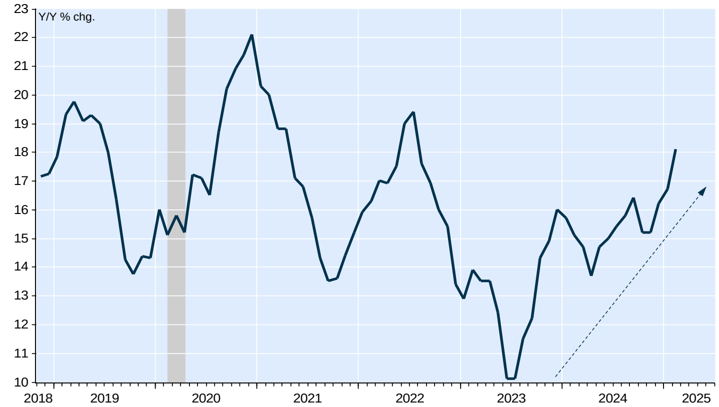
China is another emerging economy that risks suffering disproportionately from Washington's protectionist shift. Although the country does not depend heavily on goods exports to the U.S. (see chart above), the very level of tariffs imposed on it raises concerns about its growth model, which still relies heavily on external demand.

Like Mexico, China is also entering the current period of turbulence in a weak position, having spent the last few years trying unsuccessfully to revive the real estate market and stimulate household consumption. And while the measures put in place to achieve these goals are beginning to be reflected in the data – notably in the form of increased public spending – they may still prove insufficient to address the new challenges emanating from Washington.

China: Stimulus efforts starting to show in the data… still insufficient
All-system government bond stock



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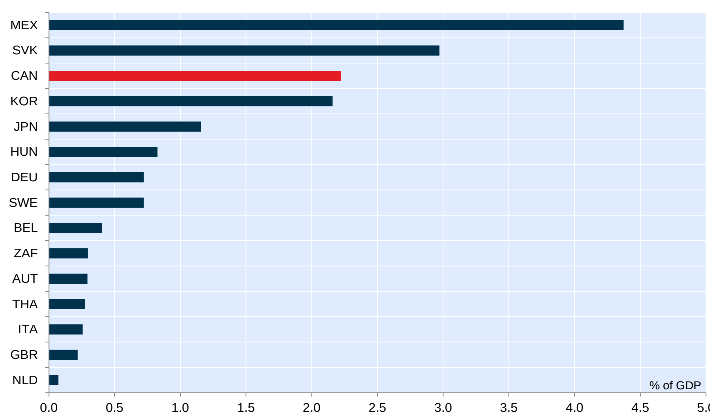
Given the high tariffs imposed on the automotive sector, countries for which exports of vehicles and parts to the U.S. account for a disproportionate share of GDP will also be among the victims of the Trump administration's policies. Canada and Mexico are once again included in this group (although they have been granted certain exemptions), along with Slovakia, South Korea, Japan, Hungary, and Germany.

World: Who's exposed to auto tariffs?
Motor vehicles and parts exports to the United States as a percentage of GDP (2023)



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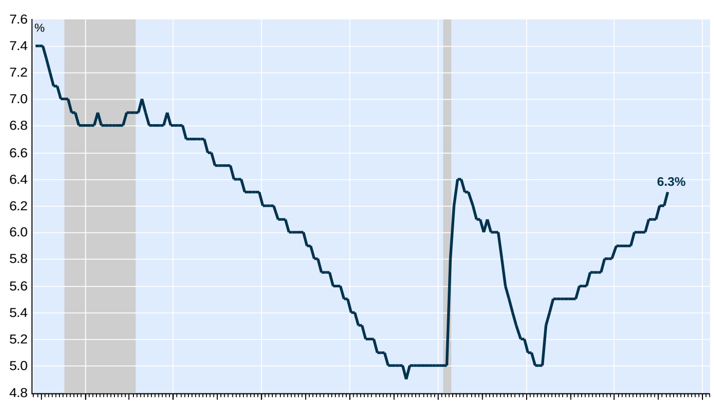
In the latter case, the increased difficulties in the automotive sector will do nothing to help a labour market that is already showing signs of weakness. And although the German government has already announced a significant fiscal stimulus package, it will probably come too late to completely offset the economic damage caused by a trade war.

Germany: Auto sector woes unlikely to help an already-weak labour market
Unemployment rate



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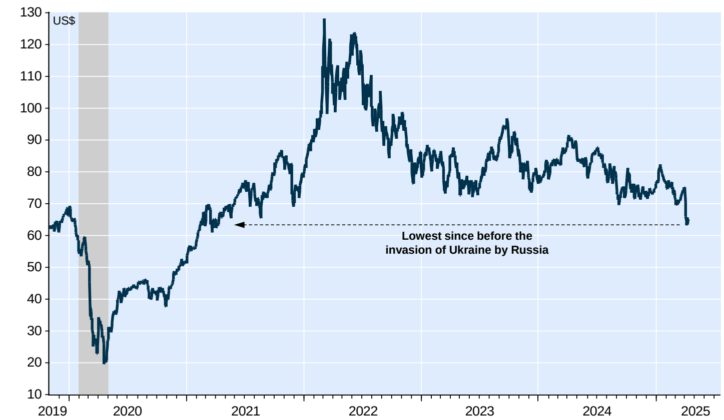
Other potential victims of tariff barriers include countries rich in natural resources. These could suffer from a slowdown in global growth and a corresponding decline in demand for raw materials, particularly oil. Brent crude is already trading at its lowest level since Russia's invasion of Ukraine.

World: Commodities hit by trade war risks
Price of a barrel of Brent crude oil



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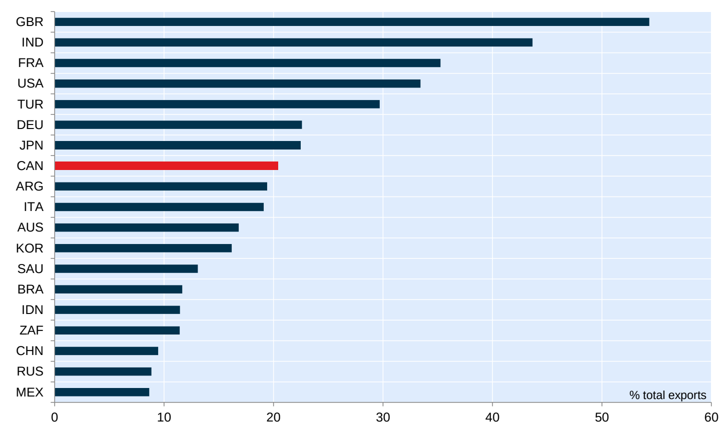
While certain factors will be a handicap in an environment of high tariffs, others will make some countries more resilient. A service-oriented export sector, for example, could help protect certain countries from the worst effects of a trade war. In this regard, the United Kingdom, India, and France appear to be well positioned, at least on a relative basis.

World: Exposure to services could offer a degree of protection
Share of services in total exports (2023)



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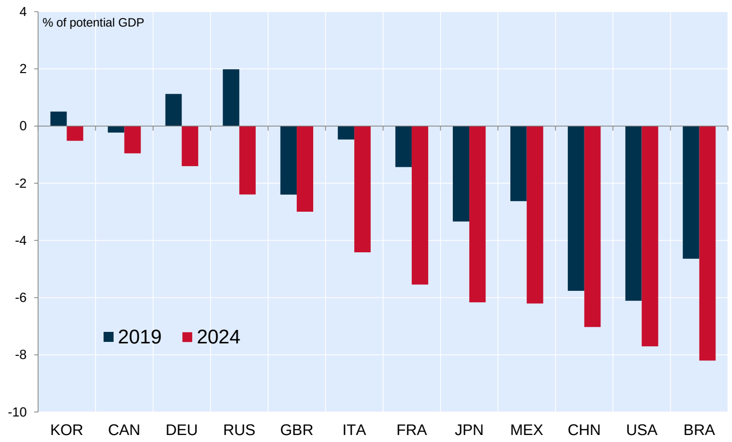
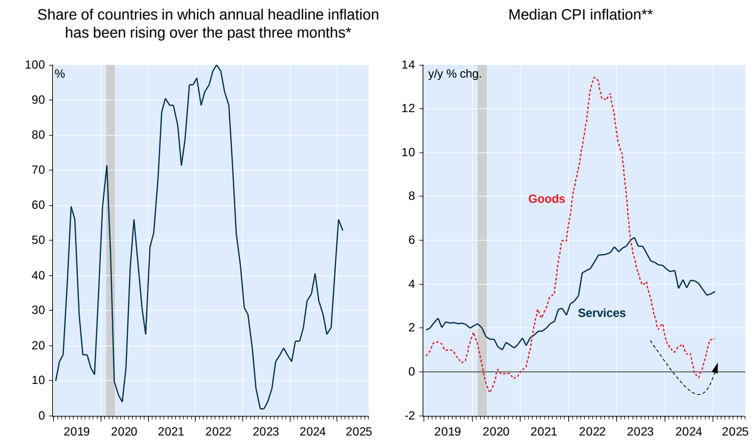
But overall, a less open international trading system is likely to weigh on growth almost everywhere. And tariffs may not be the only culprit. The rise of protectionism threatens to bring other underlying problems in the global economy to the surface, notably the precarious fiscal situation of many countries. While it is virtually impossible to know with certainty whether the current rejection of free trade will tip the global economy into recession—we continue to believe that this can be avoided—it seems almost inevitable that it will lead to a deterioration in public finances. A slowdown in growth is bound to reduce government revenues, while the programs announced by many governments to support businesses affected by tariffs are likely to increase spending. All this at a time when deficits are already very high in several regions.

World: The great fiscal slide
General government structural balance



NBC Economics and Strategy (data via the IMF)

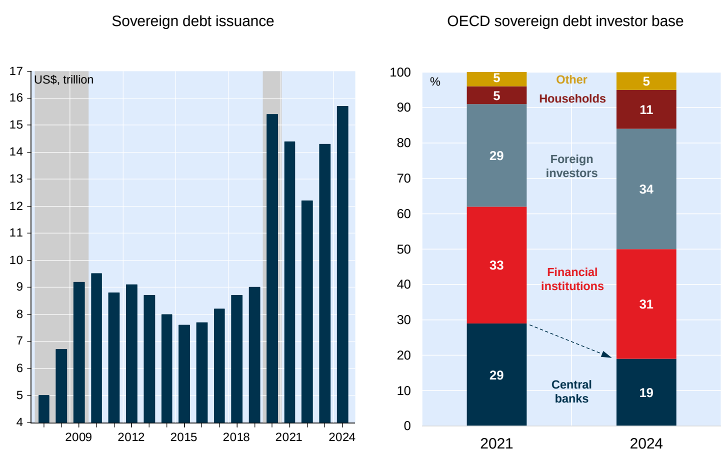
OECD: Is inflation staging a comeback?



*Based on 52 economies up to January 2025 and 38 economies for February 2025
**Based on 28 OECD countries
NBC Economics and Strategy (data via the OECD)

Higher deficits will lead to increased debt issuance, which could prove problematic in the current environment. It should be remembered that the amount of sovereign bonds issued by rich countries in 2024 already reached a historic high; any increase in supply from these levels is likely to lead to higher interest rates. This is particularly true given that central banks, which are generally less price-sensitive buyers, have significantly reduced their purchases in this segment and could continue to do so in the future if tariffs keep inflation above their target, even in a less buoyant growth environment.

OECD: A lot of debt to finance… less help from central banks



NBC Economics and Strategy (data via the OECD)

Foreign buyers of sovereign debt could also become more cautious. In the past, many of them have recycled their export earnings (mainly foreign currency) into foreign debt. Any reduction in exports that could result from an increase in tariffs is therefore likely to reduce this demand.

It will therefore be up to financial institutions and households to absorb this debt. They may be willing to do so, but we fear that they will demand greater compensation in the form of higher interest rates if they believe that protectionism risks keeping inflation above central banks' targets. This is why it will be extremely important to monitor price developments in the coming months. Inflationary pressures already appeared to be intensifying in the goods sector even before the tariffs were imposed and could quickly become problematic if companies decide to pass on their higher costs to consumers.

In our view, a resurgence of inflation caused by punitive tariffs is the main risk to the global economy. In addition to reducing consumer purchasing power, this could limit the ability of central banks to cut rates in the short end of the curve and lead to longer-term rates remaining higher than they would otherwise be. Although we have not yet fully priced this risk into our scenario, we have nevertheless revised down our global growth forecasts to reflect a much more protectionist environment than we had originally anticipated. We now expect global GDP to grow by only 2.8% in 2025 (down from 3.0% last month) and 2.7% in 2026 (down from 3.1%). We remain ready to revise this scenario upward if the tariff rhetoric de-escalates.

World Economic Outlook

	2024	2025	2026
Advanced Economies	**1.8**	**1.3**	**1.0**
United States	2.8	1.7	0.8
Eurozone	0.9	0.8	0.9
Japan	0.1	1.1	0.6
UK	1.1	0.9	1.0
Canada	1.5	1.1	0.9
Australia	1.1	1.9	2.1
Korea	2.1	1.0	1.5
Emerging Economies	**4.2**	**3.9**	**3.8**
China	5.0	4.5	4.2
India	6.3	6.2	6.2
Mexico	1.5	-0.4	0.7
Brazil	3.4	1.8	1.6
Russia	4.3	1.5	1.0
World	**3.2**	**2.8**	**2.7**

NBC Economics and Strategy (data via NBC and Consensus Economics)

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