Crossfire Hurricane: Canada in a Time of Trade War

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We have long been sceptical that the U.S./China trade negotiations would end well, owing to the extremely high bar for change that the U.S. was demanding of China. Having been initially pleasantly surprised at the positive tone surrounding the talks in the first four months of the year, the cold hard reality of open hostilities in the past three weeks are much more in line with our initial impressions. Looking ahead, we are not optimistic, and suspect the best that we can realistically hope for is a tempering of the rhetoric, with perhaps a narrow deal possible at some point, at least on the trade front. Our FX Strategy group provides some guidance on the odds of various scenarios by the middle and end of this year in the attached table (*Table 1*). But, the main message is that there is better than a 50-50 chance of an unfavourable outcome—in contrast, financial markets were likely assuming roughly 90% odds of a favourable outcome as recently as late April.

What are the implications for Canada if U.S./China relations sour further? In a nutshell: not good. Some have made the case that Canada could potentially see some benefits from a prolonged battle, based on possible long-term trade diversion (likely coming from the U.S. sourcing imports from anywhere but China). While that may provide a partial offset, we suspect the obvious negatives would far outweigh any support on this front.

In our estimates of the trade war **impact on the U.S. economy**, we've considered the loss of real consumer purchasing power, retaliatory actions by China hitting U.S. exports (see the farm sector) and less confidence. All told, we judge that the U.S. economy could be hit by roughly 0.6 ppts, all else equal, from the current and threatened action between the two countries. While there's always debate about who 'wins' in such a dispute, the reality is that a negative supply shock (as the textbook would characterize it) is bad for growth and inflation, while leaving both trading partners worse off overall. True, the U.S. arguably has less to lose, with shipments to China coming in at less than 1% of GDP, while China's shipments to the U.S. add up to more than 3% of the economy (*Table 2*). But, the U.S. imports more than 20% of its goods from China, leaving the consumer on the hook—substitution

Table 1
Trade War Scenarios

(% probability of each outcome)

Before G20 on June 28-29:	
Additional tariffs imposed	30
No new tariffs imposed	65
Grand bargain	5
By year's end:	
Not even talking	20
Still talking, new tariffs imposed	35
Still talking, no new tariffs	15
Small deal, talks for more	20
Grand bargain	10

Source: Greg Anderson, Head BMO FX Strategy

Table 2
The Trade Picture — 2018

			(US$ blns)	(% of total)	(% of GDP)		(US$ blns)	(% of total)	(% of GDP)
Imports	**Canada**	with United States	301.5	64.9	17.6	with China	35.8	7.6	2.1
Exports			334.0	73.9	19.5		22.4	5.0	1.3
Balance			32.4	n.m.	1.9		-13.4	79.5	-0.8
Imports	**United States**	with Canada	318.5	12.5	1.6	with China	539.5	21.2	2.6
Exports			298.7	18.0	1.5		120.3	7.2	0.6
Balance			-19.8	2.3	-0.1		-419.2	47.7	-2.0
Imports	**China**	with Canada	28.4	1.3	0.2	with United States	115.1	7.3	1.1
Exports			35.2	1.4	0.3		478.4	19.2	3.5
Balance			6.8	1.9	0.0		323.3	91.9	2.4

n.m. = not meaningful

Sources: national statistical agencies

is possible, but unlikely at current prices.

Canada is largely an observer for now, but it's often the case that as goes the U.S., so goes Canada. We've estimated that a 0.6 ppt dip in U.S. growth could ultimately pull down **Canadian growth** by about 0.3 ppts, all else equal, especially if it is business confidence and real consumer spending that take the brunt of the impact. Overall, the U.S. still accounts for almost three-quarters of Canadian exports versus just 5% for China. From a regional perspective, Central Canada is most exposed to trade flows with the U.S. and most closely correlated to U.S. real GDP growth. But, commodity-heavy regions of the country would certainly feel the hit if the trade war triggers a broader slowdown in global growth, resource demand and prices. And, while we are largely ignoring the current state of affairs directly between Canada and China for now, consider that British Columbia sends almost as much to Asia as it does to the United States, with 15% of its exports flowing directly to China.

Of course, there are potential **offsetting factors** beyond just trade diversion. First, as we've seen in recent days, it appears that the U.S. setting its sights more squarely on China has allowed progress on the all-important North American trade relationship. Steel and aluminum tariffs, a key holdup to USMCA ratification, were removed this week, which is an encouraging step. (Arguably, removal of the metals tariffs more than offsets the hit from China's recent restrictions on Canadian goods (e.g., canola).) Meantime, any economic shock of such magnitude will also impact interest rates and the currency, providing some further buffer.

The **Bank of Canada** has viewed the U.S./China trade spat as a two-sided risk. If the downside is realized, it's hard to see the BoC not seriously contemplating rate cuts. The April MPR estimated that the economy already has a 0.25% to 1.25% output gap, and a further hit to growth would widen that more. The disinflationary pressure suggests the next move for the BoC would be a rate cut. However, Governor Poloz has discussed the trade-war scenario in the past and noted that, due to the potential inflationary impact of higher tariffs, he might not be inclined to cut rates at all. While that might be possible for a few months, we believe the BoC would ultimately capitulate, especially if the Fed were leading the way down the easing path.

Lower policy rates amid a weaker growth backdrop likely won't be friendly to the **Canadian dollar**, even if the Fed is cutting as well. As we have long contended, the loonie has never met an international crisis that it didn't want to join. So far this year, oil prices have risen and, more recently, Canada-U.S. rate spreads have moved in Canada's favour, yet the currency has barely benefitted. That suggests sentiment toward the loonie is quite bearish. A full-blown trade war would be a negative for risk assets, commodities and likely positive for the U.S. dollar. That combination would hit the loonie hard and a move toward C$1.40 (or 70 U.S. cents) would not be unreasonable.

The Bottom Line: Despite being largely a spectator to the U.S./China trade war, the collateral damage to Canada could be meaningful. And, that's before considering the impact of Canada's running spat with China. Trade wars drag on global growth and this episode is no different. Fortunately, unlike some other regions, Canada has some leeway to cushion the blow with monetary policy and a potentially weaker currency, as well as a solid fiscal position should a policy response be needed on that front.

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