WEEKLY ECONOMIC COMMENTARY

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A friend of mine was recently complaining to me about his neighbors. There have apparently been disagreements centered on noise levels, sidewalk snow removal and the alleged leavings of the family dog. Civil discourse has given way to angry e-mails threatening to seek penalties from the village.

As he described the situation, I realized that I have been blessed in this regard. We've had the same neighbors for decades, and we are very close to them. That latter spirit has long governed the relationship between Canada and the United States, neighbors in North America who share the longest unfortified border in the world. But tensions between the two are rising. The ultimate resolution of the stress will have substantial implications for economic performance in North America, and it will be a harbinger for trade relations elsewhere in the world.

The recent flurry of activity in Washington has been difficult to keep up with. When asked to make sense of it, I counsel care in separating signal from noise. Threatened extremes often give way to more moderate resolutions; overreacting at an early stage ultimately does little good. But interested parties are preparing for the worst.

U.S. Imports from Canada

Source: Tradeimex

For the economies of North America, the worst case is the 25% across-the-board tariffs that the U.S. has proposed for Canadian and Mexican exports, effective February 1. While economic relations between the U.S. and Mexico have experienced ups and downs, the more neighborly relations between the U.S. and Canada have allowed the development of very deep economic ties. The United States purchases more than two-thirds of Canadian exports; Canada accounts for 17% of total U.S. exports. New tariffs levied by one country against the other would therefore be very impactful.

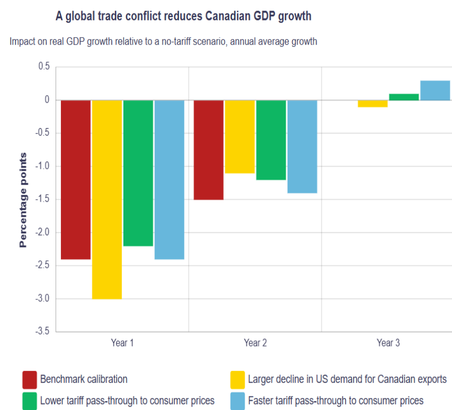
The two largest categories of Canadian shipments to the U.S. are energy and autos. Canada produces more than three million barrels of oil each day, almost all of which travels south. While only about one-quarter of daily U.S. production, it is a substantial amount that would be difficult to replace in the short run. And while Canada could attempt to sell its crude at more advantageous terms elsewhere, the logistics of doing so would be very challenging.

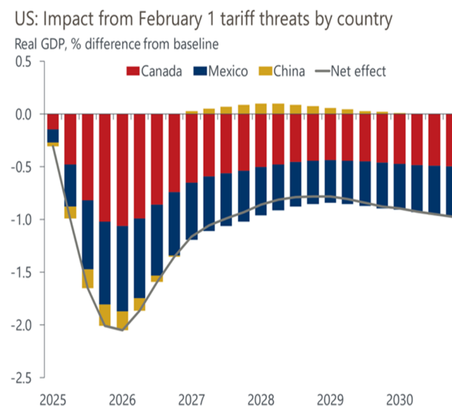
Trade in autos between the two countries represents deeply intertwined supply chains. Components for some vehicles travel back and forth across North American borders several times, and finished products include important fractions of Canadian and Mexican content. Tariffs would be very disruptive to assembly logistics, and would be difficult to work around. Costs for cars would likely rise substantially, and sales would fall.

Tariffs would be very disruptive to supply chains that cross North American borders.

Given Canada's greater reliance on exports to the United States, simulations of tariff outcomes find greater impacts for Canada's economy. The Bank of Canada estimates that trade conflicts would reduce the rate of growth in gross domestic product (GDP) by about 2.5% in the first year.

The immediate impact to the U.S. economy would be modest, but retaliatory action would introduce a more significant layer of damage. Ottawa has promised a "dollar for dollar response," which might include new levies on agricultural products and curbs on energy exports. Countermeasures from China and Mexico, the two other main tariff targets, would bring the damage to U.S. real GDP to more than 2% annually.





Sources: Bank of Canada, Oxford Economics

Continental tariffs would raise prices in all three countries. Simulations from Oxford Economics suggest that core inflation in the U.S. would rise by 0.5% from its current path. That would be enough to raise the trajectory of interest rates, which would have a dampening effect on growth and market performance.

This week, central banks on both sides of the 49th parallel met to consider monetary policy. The Federal Reserve paused, after reducing interest rates by one full percentage point late last year. During his press conference following the meeting, Fed Chair Jerome Powell declined to speculate on the impact of tariffs, but acknowledged that trade policy was among the factors creating uncertainty around the outlook.

In Ottawa, by contrast, the Bank of Canada addressed the issue head-on. After reducing interest rates by a quarter-point, Governor Tiff Macklem cited the prospect of U.S. tariffs as a motivation for the move. "A long-lasting and broad-based trade conflict would badly hurt economic activity in Canada," he said. The bank's staff produced a piece of extensive research on the topic.

Many suspect that the extremes being kicked around will never be realized. The expressed reasons for U.S. concern are border security and narcotics, not fair trade. These issues are much more pronounced along the southern border of the U.S., but Canada has pledged additional investment in border surveillance and interdiction in an effort to avoid trade sanctions. An overly strident posture from the U.S. might lead Canadians to select a hardline prime minister during elections set for the first half of this year, an outcome Washington would like to avoid.

Even if trade disputes are resolved, the uncertainty they create is bad for business.

But until matters are settled, businesses are engaged in contingency planning, and investments aimed at deepening North American trade ties have been deferred. As documented by the International Monetary Fund last year, uncertainty over trade policy is pernicious in itself, even if ultimately resolved.

In 2017, I was heading up to British Columbia to see clients when the first Trump Administration escalated a long-running trade dispute over Canadian lumber, imposing a 24% duty. I received a chilly reception, and was excused only after promising to get the measure reversed.

As luck would have it, I will be traveling to Canada to see clients next week. If the tariffs go into force on Saturday as promised, I'm expecting at least an hour in the frosted glass inspection room adjacent to customs. Let's hope that the longtime neighbors work things out amicably before then.

Cut A Deal

Long ago, I had a coworker whose hobby was sculpture. He spent his weekends sawing and whittling wood and ice. His toolset ranged from a chainsaw to shape a massive ice block, to the finest chisels for details.

Some of those working to set a budget for the U.S. federal government have been tempted to reach for a chainsaw. In fiscal year 2024, Washington spent $6.75 trillion, funded by tax receipts of $4.91 trillion. The deficit was bridged with debt, the total balance of which now exceeds $36 trillion. The federal government is the nation's largest single employer, with its three million workers representing almost 2% of total employment. How can we trim down a bureaucracy of such a size?

A plank of the Trump platform was to establish a Department of Government Efficiency (DOGE). Proposed as an outside advisory organization, DOGE promised $2 trillion of annual spending cuts, a lofty and likely impossible target. Reductions of such a magnitude would require trimming Medicare, Social Security and defense spending, all political non-starters.

Slashing spending is a popular idea and hardly novel. As far back as 1883, the Pendleton Act made sweeping reforms to dismiss unqualified government workers (undoing the spoils system, which doled out patronage jobs as political rewards). More recent presidential administrations have made their own attempts at rationalizing federal expenditure.

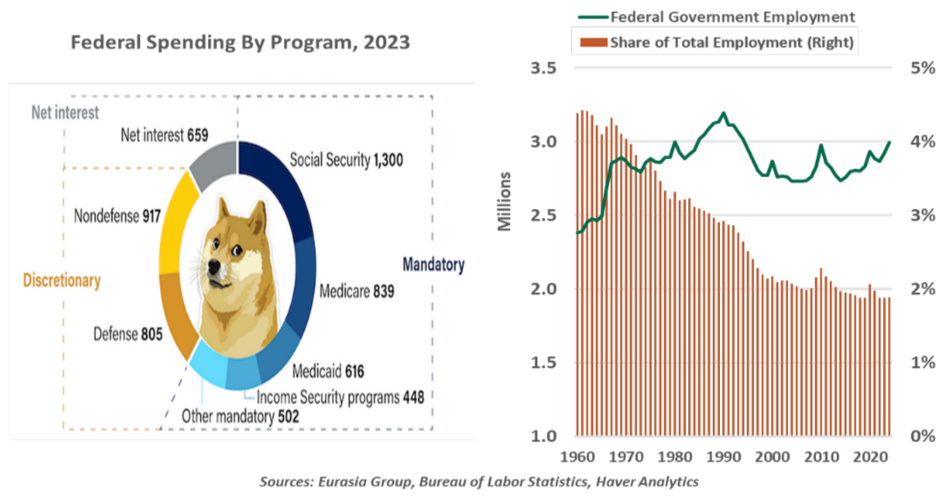
In 1982, Ronald Reagan tapped business leader J. Peter Grace to "drain the swamp" of waste and inefficiency in the government—a motto and mission similar to the DOGE. Bill Clinton chartered a National Performance Review, led by Vice President Al Gore, to offer ideas to reinvent government. Barack Obama appointed the Simpson-Bowles Commission, named for the bipartisan political veterans who chaired it.

Each of these efforts met their mandate, identifying opportunities for significant budget reductions. The Grace Commission famously publicized bizarre Department of Defense cost allocations totaling $436 for a hammer and $600 for a toilet seat; Al Gore made a mockery of procurement rules like the ten pages of technical specifications for ashtrays. These were just the salient

highlights of reports that promised billions in annual savings.

Others are doing the same work with less fanfare. The Government Accountability Office publishes an annual report of duplication in federal programs, identifying hundreds of millions in potential savings. Think tanks like the Committee for a Responsible Federal Budget, Tax Foundation, Tax Policy Center and American Enterprise Institute offer boundless options for better fiscal balance.

Identifying potential cuts is the easy start of a difficult process.



Sources: Eurasia Group, Bureau of Labor Statistics, Haver Analytics

Putting those ideas into action is easier said than done. The executive branch has some discretion over spending and staffing, but more significant reform requires acts of Congress. In this forum, proposals will meet opposition. Many rules were passed for good reason, even if they are costly; others are inefficient, but incumbents will lobby to preserve them. Legislators may be less eager to cut spending when it entails a loss of benefits to their constituents or fewer jobs in their own district.

Given the foreseeable difficulty of attacking spending, the new DOGE has already changed tack. A day-one executive order chartered DOGE as the new name of the U.S. Digital Service, a small agency created in 2014 to improve government technology. The order does not mention costs, and instead focuses on modernizing federal technology systems. This mandate is better aligned with the agency's technology-veteran leadership. While systems enhancements can reduce costs and improve productivity, they require up-front investment and a great deal of planning and project management. Lower costs may be some ways away, and unlikely to amount to trillions.

Campaign promises to take a chainsaw to government spending will get applause. In practice, a chisel might be the better choice. We hope our leaders will choose the right tools to craft a more attractive design.

Plug The Hole

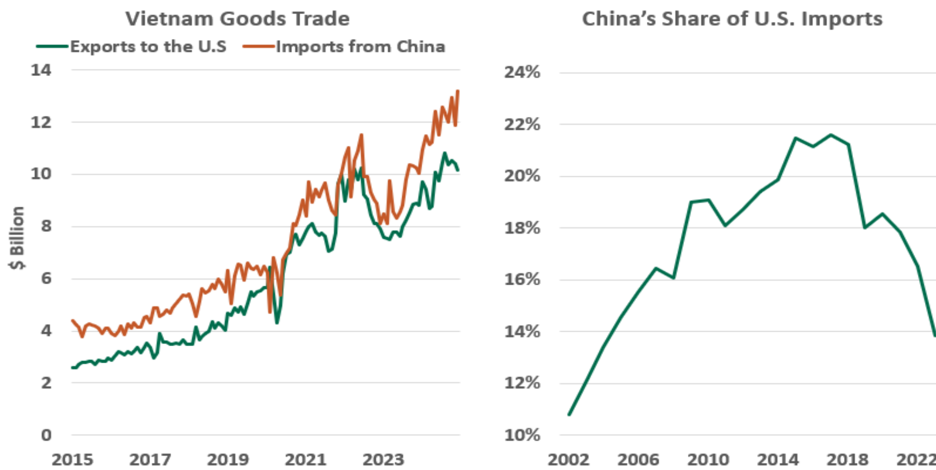
President Trump's return to the White House has raised the specter of a renewed round of import tariffs. But eliminating revenue leaks, caused by countries evading American levies, must be an important element of U.S. trade policy.

White labeling or entrepot trade is the most common way of avoiding tariffs. In this tactic, goods make their way into the U.S. through Chinese-owned facilities in countries like Mexico and Vietnam that face lower duties. Rerouting is most obvious in data from Vietnam, with the value of exports to the U.S. almost matching Vietnamese imports from China in recent years.

Evasion can take other forms. Buyers may simply under-report quantities of imports, mislabel the

origin of products, or take liberties classifying goods as similar items that are not subject to tariffs. Chinese exporters have also skirted levies by utilizing America's "de minimis" exemption trade rule, which allows tariff-free entry of directly-shipped packages worth less than $800. As per U.S. Congressman Greg Murphy, nearly two-thirds of all parcels under this law arrive from China.

All of this helps to explain why China's role as a global exporter has not diminished, despite a substantial drop in direct imports to the United States. China's share of U.S. imports has declined from about 21% in 2018 to 14% in 2023, implying a $240 billion reduction in arrival of Chinese goods. Yet, China's share of global export volume remains at a record high.



Efforts to weed out tariff evasion could bring more trade partners into Trump's firing line.

Tariff evasion and exemptions have had a sizable impact on reported U.S. trade data. As per calculations performed by *The Economist*, America's goods trade deficit with China is 13% larger than official numbers show. Goldman Sachs estimates that the 2018-19 trade war led to tariff evasion of $110-$130 billion on imports from China in 2023, a customs revenue loss of $15 billion.

The Trump administration will advance tariffs not only on principle but as a means to refill government coffers. To succeed, trade officials must focus on weeding out trade malpractice. Plumbers and pipeline inspectors sometimes rely on x-rays to identify leaks and weak points; supply chains leading to the U.S. can expect a similarly intense level of scrutiny.

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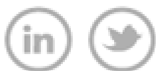

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