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#Canada / #Politics / #Globalisation

Carney wins Canadian election amid tariff turmoil

US tariffs have significantly impacted the Canadian election held on Monday. The Liberal Party, led by Prime Minister Mark Carney, won over Pierre Poilievre's Conservatives. But, despite the victory, the policy agenda will be constrained by the impacts of tariffs and a possible Canadian recession.

Key Takeaways

- Mark Carney's victory in Canada's election on 28 April was partly due to the recent US trade policy volatility, which helped drive an exceptionally rapid shift in the polls towards the Liberal Party.
- Approximately 80% of Canadian exports to the US are covered by the USMCA free trade agreement and currently not tariffed, and this share is likely to rise further over time. However, Canada faces steep 25% sector-specific tariffs on some of its key exports to the US. And the future of the USMCA itself is uncertain as the deal is due to be renegotiated later this year.
- In our tariff baseline, the continuation of the USMCA may just about allow Canada to avoid a recession but not a severe slowdown. And the economy is extremely vulnerable to further US tariff increases.
- Carney's plans to remove internal trade barriers and increase infrastructure investment may help boost long-term growth prospects, but this is all likely to be swamped by tariff uncertainty for now.
- As such, having paused in its rate cutting cycle in April, the Bank of Canada will likely continue lowering interest rates.

The election provides an interesting case study in how US President Donald Trump is reshaping the domestic political scene of other countries.

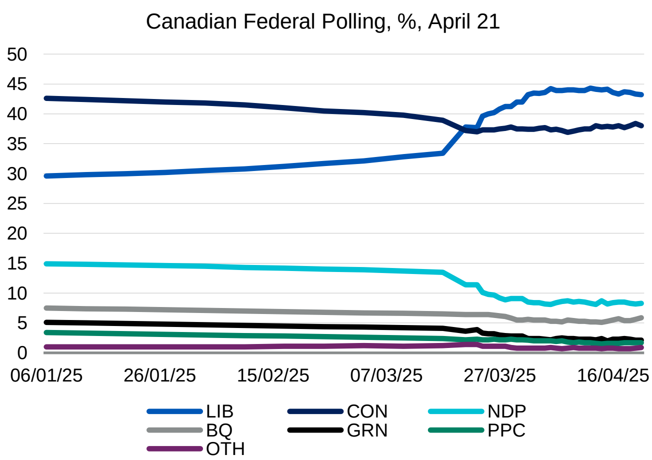
Liberals fall short of a majority government

Under Mark Carney, who replaced former Prime Minister Justin Trudeau, the Canadian Liberal Party experienced a dramatic turnaround in its polling performance, culminating in the election victory against Pierre Poilievre's opposition Conservatives (see Figure 1).

Still, the Liberal Party has won 169 seats, falling short of the 172 required for a majority, meaning it will need to work with smaller parties to pass legislation.

After the win, Carney reaffirmed his commitment to defending Canada's sovereignty.

Figure 1: Liberal polling momentum since Trudeau's resignation



Source: Aberdeen, CBC, April 2025

Helping the party achieve this victory was the perception that Carney, given his experience as former governor of both the Bank of Canada (BoC) and the Bank of England (BoE), is more capable of handling the economy and relations with the US amid heightened trade policy uncertainty and Trump's substantial tariff increases.

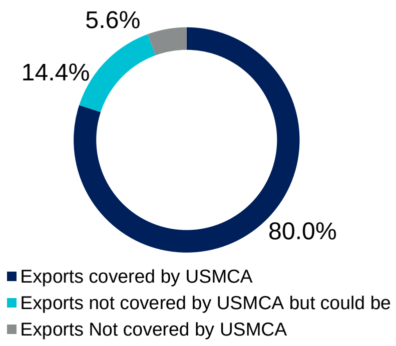
US tariffs dominate the political and economic landscape

Canada, alongside Mexico, has avoided inclusion in the reciprocal tariffs list, remaining relatively unscathed compared to other major US trade partners on "liberation day".

Nevertheless, Trump had previously imposed a 25% rate on goods that did not comply with the US-Mexico-Canada (USMCA) free trade agreement and a 10% tariff on energy and potash.

Currently, USCMA-compliant goods make up 80% of exports to the US (see Figure 2), but this share will likely increase to perhaps 95% by 2026 through completion of certification of origin paperwork.

Figure 2: Canadian exports to US



Source: Aberdeen, Capital Economics, April 2025

Canada is also subject to sector-specific tariffs of 25% on key sectors such as autos, steel, and aluminium. Taken together, this results in an effective tariff rate of roughly 8% right now, but this will fall below 5% if further trade becomes compliant with the USMCA and Trump decides that Canada has appeased his border concerns.

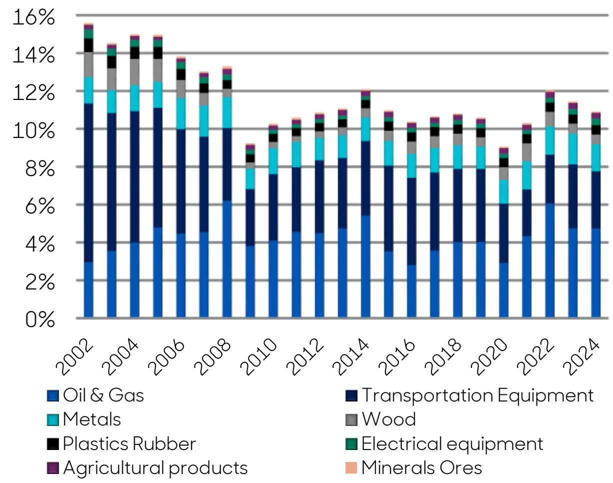
In response, Canada has enacted retaliatory tariffs. The first phase, which became effective on 4 March 2025, included 25% tariffs on C$30 billion worth of US goods, but this has now been expanded to cover C$155 billion of goods that are not compliant with the USMCA. Additionally, Canada has implemented countermeasures mirroring the US' auto tariffs.

Canada's tariff retaliation is an interesting contrast to, say, the EU's initially more restrained strategy of postponing a response, or Mexico's focus on negotiation and diversification. In part this simply reflects timing – Canada retaliated before Trump's 90-day reciprocal tariff pause. But it also reflected the need to play to the domestic audience ahead of the election – an incentive that the EU will start to feel as negotiations with the US wear on.

With tariffs as they are, a Canadian recession may just about be avoided. But high tariffs on the vehicle sector and uncertainty about the USMCA's future mean GDP growth is likely to slow significantly.

But there continues to be a meaningful risk of a more severe economic downturn, triggered by a wider application of tariffs on Canada. After all, Canadian exports to the US are more than 10% of GDP (see Figure 3). The BoC modelled a tariff scenario that wasn't even as severe as our downside scenario, yet still showed the economy contracting for four quarters and growth averaging -1.2% over that period.

Figure 3: Canadian exports to US (%, GDP)



Source: Aberdeen, Haver, April 2025

Carney will likely tackle USCMA renegotiations

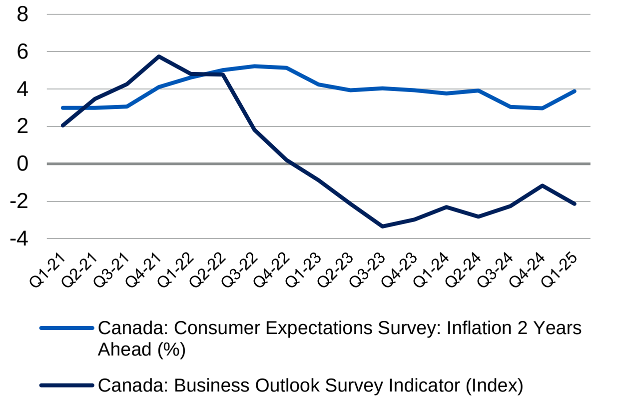
The Trump administration is likely to bring the review of the USMCA forward from mid-2026 to late 2025.

Initial statements by the US Trade Representative highlight several key priorities for the US: trade deficits, labour standards, tightened auto manufacturing rules, and greater agricultural market access.

Both the Liberals and the Conservatives emphasised the need for a robust negotiating stance to protect Canadian interests. Given the declining sentiment in consumer and business surveys, clarity over the future of the USMCA is necessary to restore predictability in trade, while long negotiations will likely lead to further declines in business and consumer sentiment (see Figure 4).

Ultimately, the outcome of future USMCA negotiations hinges on whether Canada becomes more accommodative to the demands of the Trump administration. We expect this to be the case.

Figure 4: Canadian business and consumer sentiment remains weak through this period of uncertainty



Source: Aberdeen, Haver, April 2025

A shift away from US reliance?

Carney has stressed the need to diversify Canada's trade partners. But doing so will be challenging, given that 80% of the country's goods exports flow to the US.

Trade agreements such as the Comprehensive Economic and Trade Agreement (CETA), the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), alongside partnerships with the UK and South Korea, will never be able to substitute the relationship with the US.

Energy products continue to make up 27% of Canadian goods exports, equal to 6.7% of GDP. Pipeline infrastructure faces environmental, regulatory, and technical hurdles, compounded by dependence on US routes. In order to capitalise on alternative trade partnerships, significant investment would be required. Recent projects like the Trans Mountain pipeline expansion suggest that developing new pipelines and ports to connect to markets beyond the US would require a similar investment.

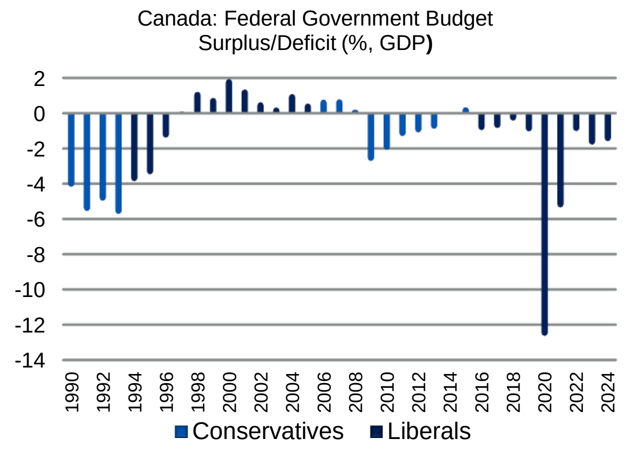
Port infrastructure is constrained by issues such as limited rail and container storage, expansion needs and competition with US ports necessitating significant investment to remain competitive.

Boosting interprovincial trade presents a more immediate opportunity. The IMF suggests that full internal liberalisation could boost GDP per capita by 4% over 10 years. Despite limited progress in the past, the severity of the economic threat may prompt federal and provincial politicians to act. In response to US tariffs, Ontario has announced plans to remove interprovincial trade barriers to help weather US tariffs.

Is a pivot away from Trudeau-era deficits truly achievable?

Carney has spoken of a long-term shift away from fiscal deficits run under the Trudeau government (see Figure 5). Whether this is ultimately achieved will depend on the specific policy strategy implemented.

Figure 5: Trudeau's government oversaw consistent budget deficits



Source: Aberdeen, Haver, April 2025

In the short term at least, fiscal policy will be moderately accommodative, to assist those worst affected by the tariffs. Carney has implemented a C$2bn 'Made in Canada' fund, to support tariff-affected auto workers including those at the Stellantis auto plant in Windsor, Ontario.

Over the longer term, Carney aims to split the federal budget into operational and capital segments, balancing the former and running a deficit in the latter.

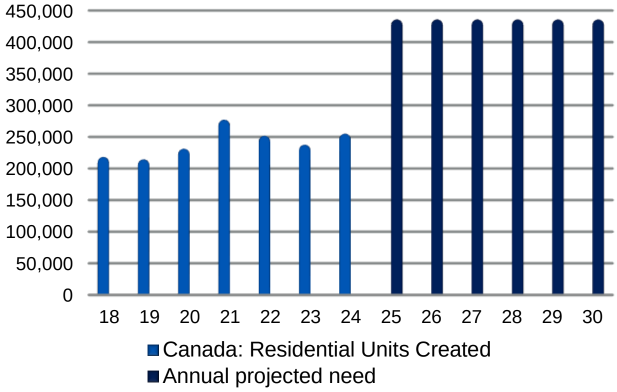
While this policy could theoretically induce growth in the long run, Carney may find himself a victim of circumstance. With the economic impact of tariffs likely to be felt in the short term, the typically long-term investment horizon for the projects Carney has proposed may mean further measures are required in the short term. As such, Carney's ambitions to balance the operational budget risk being pushed out in favour of more deficit spending to support the economy if high, broad, tariffs are imposed.

Housebuilding is a major political priority that will be difficult to solve

Away from tariffs, bringing down housing costs has been a central issue across the political spectrum. Carney plans to boost newly completed homes by expanding schemes like the C$4.4bn Housing Accelerator Fund (due to end in 2027/2028), which aims to remove construction red tape and lower housing costs. However, current measures are likely to underdeliver given the practical hurdles and scale of the current housebuilding deficit. The Parliamentary Budget Officer (PBO)'s April 2024 report estimates 3.1 million new homes are needed by 2030, requiring 436,000 new units annually – a 71% rise from 2024 (see Figure 6).

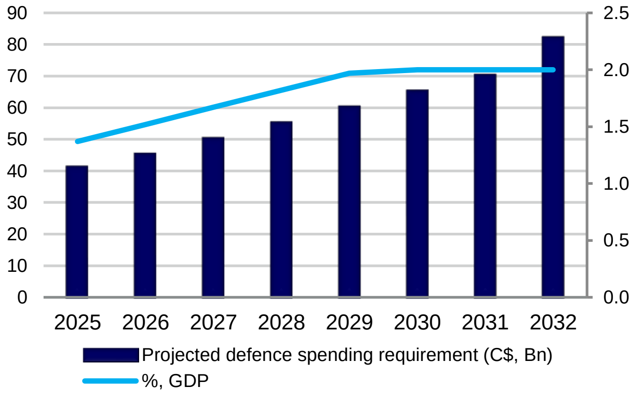
Such a rapid increase is improbable given the curtailment of labour supply through slowing immigration and inflationary concerns related to retaliatory tariffs.

Figure 6: Canadian homebuilding supply still significantly trails demand



Source: Aberdeen, Haver, April 2025

Figure 7: Defence spending projections indicate 2% goal is optimistic



Source: Aberdeen, PBO, April 2025

Increased defence spending more rhetoric than reality

Despite being a NATO member, Canada's defence spending is among the lowest in the G7, at 1.4% of GDP. Heightened geopolitical tensions, and uncertainties over the long-term US strategy towards NATO have resulted in renewed calls to increase defence spending, but significant rises seem unlikely. Carney has set a target of reaching 2% of GDP by 2032. However, projections by the PBO indicate defence spending would have to climb to $81.9 billion to reach 2% of GDP by 2032 (see Figure 7).

Given the fiscal demands of domestic policy, material efforts to increase defence spending are likely to be extremely limited.

The path ahead for the BoC pivots towards growth

BoC Governor Tiff Macklem's hawkish comments have underscored the potential ramifications of US tariffs on both growth and inflation. However, while tariff-induced stagflation is likely, soft March CPI data alongside the scrapping of the carbon tax will mitigate immediate inflation concerns. Consequently, short-term concerns about inflation are secondary to the focus on cushioning any hit to the economy.

We expect the BoC to continue lowering interest rates. Following this month's pause against the backdrop of acute uncertainty, we are pencilling in 75bps of cuts, lowering the policy rate to 2% by year-end. This is below the BoC's 2.25%-3.25% estimate of neutral.

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