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Higher Growth is Possible: Impact of Temporary vs. Permanent Tariffs on U.S. and Canada

- **Scotiabank Economics' last published forecast on April 16th assumes newly implemented tariffs are permanent**, in line with our standard practice of avoiding speculation on future policy changes. This results in a weaker outlook for both the U.S. and Canada relative to a potential scenario in which tariffs are temporary.
- **This note presents an alternative scenario where tariffs are removed September 2025**, generating significantly less economic damages and fewer job losses than our April baseline. By 2026, GDP is up to 1 ppts higher in both countries compared to a permanent tariffs scenario, while the unemployment rate is around 1 ppts lower. The implications for monetary policy differ between the two countries, reflecting how each economy absorbs the trade shock.
- **A large increase in U.S. import duties functions as a supply shock**, raising inflation substantially and damaging growth. This limits the Federal Reserve's ability to react, leading to a higher policy rate relative to a no-tariff scenario. Quick removal of tariffs would allow inflation to reverse on its own, creating more room for monetary policy to ease. In this case, the policy rate would be lower than in a permanent tariffs scenario but still above the no-tariff scenario.
- **In Canada, the tariffs shock primarily acts through demand-side channels**, allowing the Bank of Canada more flexibility to respond. Under permanent or temporary tariffs, monetary policy is looser than in a no-tariff scenario, with temporary tariffs requiring less easing than permanent ones.

Our last official forecast, published on April 16th, assumes that tariffs in effect as of that date are permanent. This aligns with our convention to only incorporate implemented trade measures in our forecasts, avoiding speculation on future actions, including the removal of said tariffs, given the level of uncertainty. This assumption does not necessarily represent Scotiabank Economics' best guess of what is likely to happen. We are in a unique forecasting environment where the level of uncertainty has surpassed the thresholds for making any guesses at all regarding economic and trade policies. This is evident in the Bank of Canada's decision not to publish a forecast in its April Monetary Policy Report, opting instead to provide different scenarios to capture the wide range of possibilities.

This note presents a sensitivity analysis to our April forecast and provides an alternative scenario in which the recently introduced tariffs are temporary and are removed by the end of the third quarter of this year. At a high level, one can expect the negative effects of tariffs to be significantly less pronounced in a scenario where they are temporary. Temporary tariffs cause fewer disruptions in supply chains and trade than permanent tariffs, which substantially reduces the loss in GDP and rise in the unemployment rate. This principle applies to both the U.S. and Canada, though further specific impacts will differ due to their unique economic structures and tariff burdens.

Recall, our April forecast includes tariffs implemented by the Trump Administration as of April 16th, which represent an increase in the effective tariff burden on the U.S. economy of well over 20%. Besides the negative effects of associated uncertainty on household and business sentiments and spending, these tariffs lead to higher production input costs, disruptions in supply chains and international trade, and a misallocation of resources—akin to a supply shock, damaging economic activity and putting upward pressure on inflation. Being permanent, they lead to persistently higher inflation, reducing the Federal Reserve's scope to react to weaker growth given inflation risk. Our model suggests that such a scenario would lead to a higher Federal Funds target rate relative to earlier forecasts with lower or no tariffs. As a result, this scenario sees the U.S. central bank maintaining its policy rate at 4.50% through this year.

Under an alternative scenario where tariffs are quickly removed, inflation reverses on its own, and the tariffs do not cause a significant increase in inflation expectations—which would have propagated into future inflation. As a result, the Federal Reserve can focus on the economic activity part of its mandate and lower interest rates in response to economic weakness. This further mitigates the drop in GDP and the rise in unemployment relative to a permanent tariffs scenario.

Table 1 compares forecasted outcomes for the U.S. economy under the two scenarios. Whereas our April forecast projected a significant slowdown, our temporary tariffs scenario sees the U.S. economy faring better, suffering milder economic and job losses alongside weaker inflation and looser monetary policy. Under temporary tariffs, the U.S. economy is projected to grow by 1.1% in 2025 and 1.6% in 2026, compared to just 0.9% and 0.6% under permanent tariffs. The unemployment rate peaks at 4.6% in 2025 before falling to 4.5% in 2026, while under the permanent scenario it rises to 5.5% in 2026. While this note considers the direct impact of the duration of tariffs, it is possible that a faster normalization of uncertainty measures following the removal of tariffs would further improve GDP and unemployment outcomes relative to what is reported here.

Table 1: US - Forecasts Under Alternative Scenario (%)

	April Forecast			Alternative Scenario		
	2025	2026	2027	2025	2026	2027
Real GDP	0.9	0.6	2.3	1.1	1.6	2.2
Unemployment Rate	4.7	5.5	5.0	4.6	4.5	4.4
Total CPI	3.0	2.0	2.5	2.2	1.9	2.6
Policy Rate (end of period)	4.50	3.50	3.00	3.75	3.25	3.25

Source: Scotiabank Economics.

In Canada, tariffs imposed by the U.S. and China, as incorporated in our April forecast, have led to an effective tariff burden on Canadian exports of approximately 4%. In response, Canada's retaliatory measures have raised the effective tariff burden on Canadian imports by around 2%. This is significantly smaller compared to the U.S., where the self-imposed imports shock is over 10 times greater. Consequently, in Canada, the demand side of the tariff shock is more pronounced. The main drivers of a weakened Canadian outlook in our April forecast are uncertainty, a weaker U.S., and the impact of U.S. trade actions against China on commodity prices—traditional demand-type channels. This means the Bank of Canada has more room to respond to the loss of output than its American counterpart, and in our April forecast we have them easing in 2026, ending the year at 2.00%.

An assumed fiscal policy response acts as an important guardrail against a weaker outlook in our April forecast. Specifically, we expect the Canadian government to bolster demand in the short run through transfers and tax rebates, providing immediate support to the economy and mitigating worse outcomes. In the medium term, we anticipate a rollout of government investment and expenditure to counteract the permanent damage caused by permanent tariffs and facilitate necessary restructuring. This increase in government investment could offset some of the losses to potential output, thereby creating additional room for monetary policy to respond to economic weakness.

Under a scenario where tariffs are temporary, the Canadian economy would experience a less pronounced slowdown, with GDP growing by 1.7% in 2025 and 1.6% in 2026—above April's forecast of 1.6% and 0.7% (table 2). The unemployment rate would also improve from 6.9% in 2025 to 6.1% in 2026, rather than rising to 7.2% as projected under permanent tariffs. With U.S. and global growth outcomes faring better, Canadian exports would face fewer headwinds, and the drag from lower commodity prices would ease. We continue to assume some short-term fiscal support through transfers and tax rebates to cushion the near-term impact, but no additional government investment as the economy avoids the lasting disruptions associated with permanent tariffs. While monetary policy still responds to the demand-driven weakness, there is less need to ease, and the policy rate path ends up higher than in the permanent tariffs scenario—though still below what it would be in a no-tariff environment. This contrasts with the U.S., where the elevated tariff burden on imports operates more like a supply shock: it raises inflation and constrains monetary policy when permanent, but allows for greater easing when temporary. In both scenarios, the U.S. policy rate ends up above the no-tariff baseline.

Table 2: Canada - Forecasts Under Alternative Scenario (%)

	April Forecast			Alternative Scenario		
	2025	2026	2027	2025	2026	2027
Real GDP	1.6	0.7	1.7	1.7	1.6	2.2
Unemployment Rate	7.2	7.2	6.4	6.9	6.1	5.8
Total CPI	2.3	2.1	2.1	2.1	1.9	2.1
Policy Rate (end of period)	2.75	2.00	2.00	2.75	2.25	2.50

Source: Scotiabank Economics.

The outcome could be even more positive than assumed here if the end of tariffs comes with a burst of relief spending. Pent-up demand is accumulating as households and businesses restrain spending given the tariffs and associated uncertainty. An early reversal of the tariffs could trigger a more rapid rebound in if uncertainty falls more rapidly than assumed in this analysis.