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GLOBAL ECONOMICS

SCOTIA FLASH

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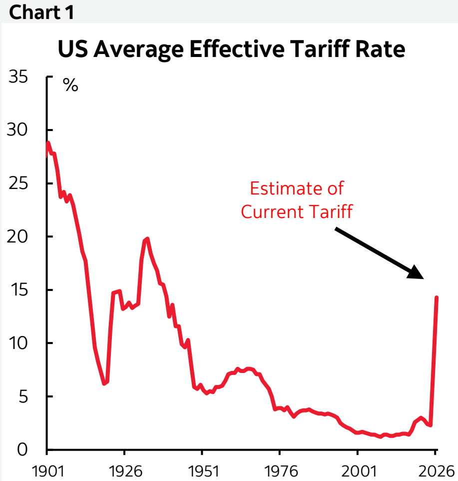
Contributors

Derek Holt
VP & Head of Capital Markets Economics
Scotiabank Economics
416.863.7707
derek.holt@scotiabank.com

Jaykumar Parmar
Senior Economic Analyst
Scotiabank Economics
416.866.4212
jay.parmar@scotiabank.com

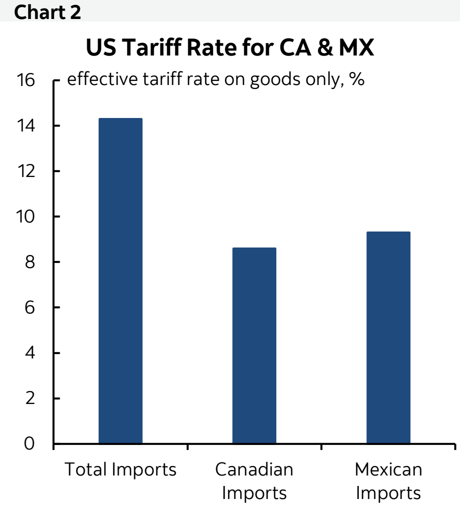
The authors also wish to thank John Fanjoy for support with tariff calculations.

Chart 1



Sources: Scotiabank Economics, United States International Trade Commission (USITC)

Chart 2



Source: Scotiabank Economics.

Tariffs Will Expedite Canada's Diversification on Trade and Investment Away from the US

- **The latest US tariffs on Canada are a micro shock**
- **Cautious optimism remains toward the path to an agreement**
- **It would be imprudent to alter core macro and BoC forecasts**
- **The US preaches do-as-I-say-not-as-I-do on non-market barriers**
- **The BoC could yet face a scenario of high commodities with a trade deal**
- **With or without agreement, Canada is rapidly diversifying away from the US**

The purpose of this note is to assess the implications of the recent tariff actions by the US against Canada. It draws upon content immediately shared with clients and staff on Monday and Tuesday including in chat rooms.

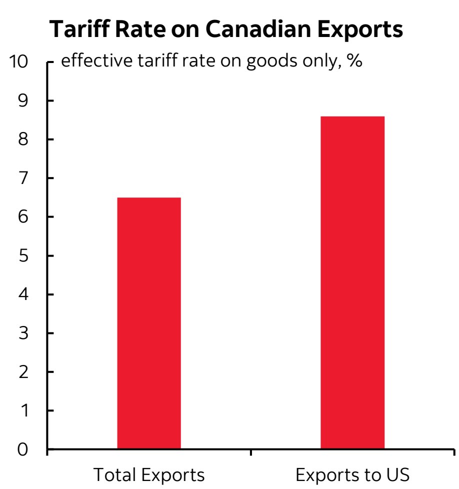
WHAT IS THREATENED

On Monday, the Trump administration issued **this** 'fact sheet' and supporting Executive Orders (**here**, **here**, & **here**). Here is a brief summary of what they contain.

- Under Section 338 of the Tariff Act of 1930, the US is to impose additional 50% tariffs on certain goods from Canada allegedly in response to Canada's discriminatory treatment of American products.
- Each Section 338 proclamation imposes a 50% tariff on a different set of Canadian imports, covering products ranging from wine to hockey sticks to cement.
- These Section 338 tariffs apply to all covered goods regardless of whether a good originates under the U.S.-Mexico-Canada Agreement (USMCA).
- These Section 338 tariffs will not apply to energy, potash, products subject to tariffs under Section 232, and certain other goods, such as fish or critical minerals.
- The tariffs will take effect 30 days after signing and are designed to offset the burden and disadvantage on U.S. commerce from Canada's discrimination.

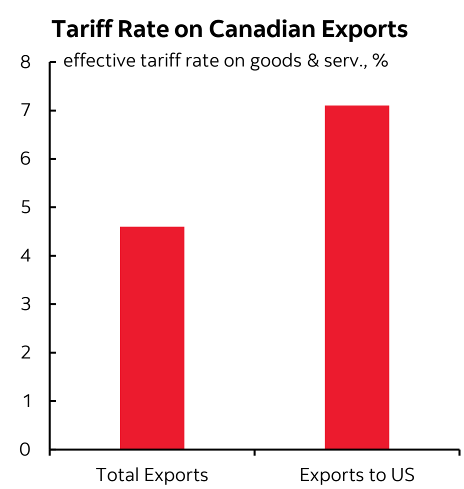
The logic behind the tariffs is deeply flawed not least of which because I'll explain how the US distorts trade. Further, the US started trade wars with many of its trading partners on grounds that most credible economists would reject. Canada retaliated in part—not in kind—so the latest US tariffs to address this retaliation are a net escalation of trade

Chart 3



Source: Scotiabank Economics.

Chart 4



Source: Scotiabank Economics.

tensions by the US with a large trading partner. Recall that the US has the same auto measures, Canada introduced US liquor controls only because Trump started a trade war and the US has the same dairy quota and tariff system that Trump signed himself.

UPDATED AVERAGE EFFECTIVE TARIFF RATE ON US IMPORTS

The following calculations were shared with clients and staff on Monday. These actions affect only about 5% of Canadian imports into the US. We have updated our tariff calculations for Canada and the US.

Chart 1 shows the overall weighted average effective tariff rate that the US has imposed upon itself compared to history across all countries and all products. It remains the highest since the dirty 30s.

While not additive, chart 2 shows the weighted average effective tariff rates on overall US imports, US imports from Canada, and US imports from Mexico. For just goods, the US now imposes a 14.3% tax on its imports from the world. For goods and services, the US is now imposing an ETR of 11.8% on its own imports.

This is a tax paid by a variety of US-based consumers and businesses. About a half dozen studies have shown that the incidence effects of these tariffs land upon Americans. As the Trump administration cuts taxes on profits and upper income earners, it is raising taxes upon other Americans.

As for Canada, chart 3 shows the weighted average effective tariff rate on all goods exports to everywhere, and goods exports just to the US. Chart 4 shows the same thing for exports of both goods and services combined.

For exports of all Canadian goods to everywhere in the world, the ETR goes from 4.2% to now 6.5%. Similarly, for exports of all Canadian goods and services to everywhere in the world, the ETR goes from 3.0% to 4.6%.

The ETR on Canadian exports to US goes up from 5.5% to 8.6% for goods only, The ETR on all Canadian exports of both goods and services to the US goes up to 7.1% from 4.5%.

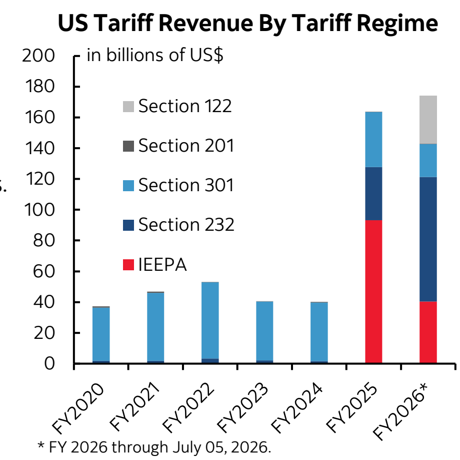
These are much, much lower effective tariff rates than every other major US trading partner now faces. That's important, as the key advice is to ignore the sticker headlines. The implied aim remains to tighten the North American trade block.

OTHER ACTIONS

Also recall that Trump's Section 122 tariffs expire on Friday (the ones that replaced the IEEPA tariffs that SCOTUS shot down). We figure that will reduce the weighted average effective tariff rate by about ¼%. Congress would have to approve an extension of Section 122 tariffs after the initial period; fat chance. As chart 5 demonstrates, the amount of IEEPA refunds at stake is large and has further to run. More replacement measures are possible.

We also caution that Trump is escalating tariff tensions and trade restrictions on numerous fronts. His promise of lower tariffs should aluminum smelters move to the US would introduce wild inefficiencies to recreate industry capacity at higher cost and higher prices paid by Americans; there is low probability of this happening. His threat to raise tariffs on generic drugs to eventually 200% is hard to see as credible but would raise prices paid by Americans, negatively impact insurers, negatively impact the fiscal position of the US by paying more for drugs, and probably result in employers curtailing benefits, reducing or cancelling coverage, or raising co-insurance premiums or some combination thereof. These are all insensible measures lacking credibility that punish Americans, damage the global economy with feedback effects upon the US, and benefit vested interests seeking the administration's protections much like Adam Smith warned.

Chart 5



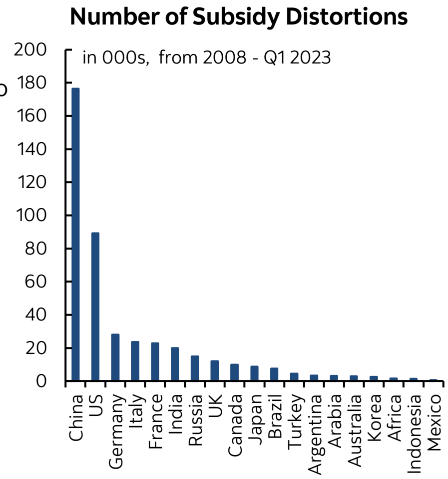
* FY 2026 through July 05, 2026.
Sources: Scotiabank Economics, CATO Institute, US Customs and Border Protection.

DO AS I SAY, NOT AS I DO

Still, what the US is practicing is the same do-as-I-say-not-as-I-do approach to trade. The US economy has many attractive features including deep capital markets, high innovation, many excellent universities, and flexible labour markets. It is also building a protectionist wall around high subsidies.

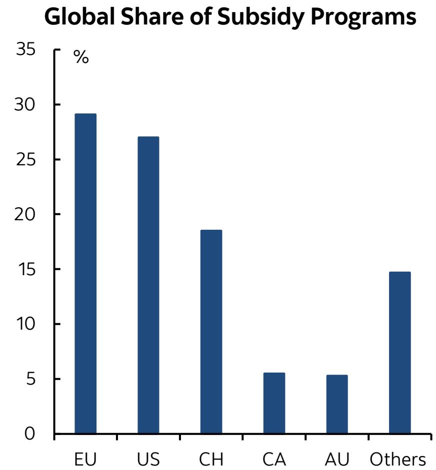
As charts 6–9 indicate, nobody subsidizes agriculture like the US government and the US ranks second on the list of countries with the most subsidy distortions behind only China. Canada watched its auto industry diminish as midwestern and southern US states siphoned off investment with heavy subsidies. US tech firms are massive recipients of subsidies alongside aerospace firms ([here](#)). And the US ranks higher than virtually anyone else for the prevalence of non-tariff barriers to commerce.

Chart 6



Sources: Scotiabank Economics, The Hinrich Foundation.

Chart 7



Sources: Scotiabank Economics, World Bank.

CAUTIOUS OPTIMISM

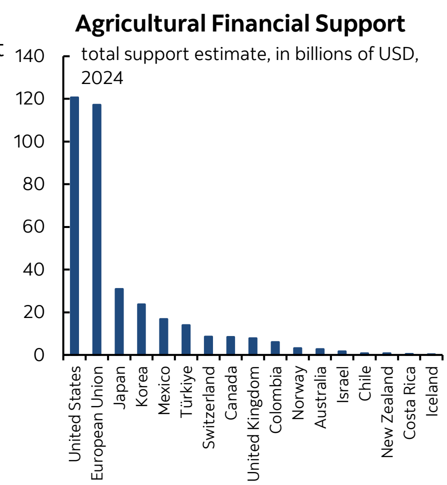
I still maintain my cautious optimism toward trade negotiations with the US with several supporting points.

- Our immediate reaction was that the tariffs may not be enacted. It may just be a negotiating ploy. We've seen this movie before, by way of threats when the negotiations get more intense. One indication of this is the 30-day delay to give time to negotiate. The other indication is that PM Carney and Trump have agreed to expedite negotiations after the US focused upon Mexico at first only for Mexico to indicate that it insists on a tri-party agreement.

- Trump may wish to have a trade deal before the midterms. He needs some wins—howsoever substantive—given his failings on Iran and affordability.

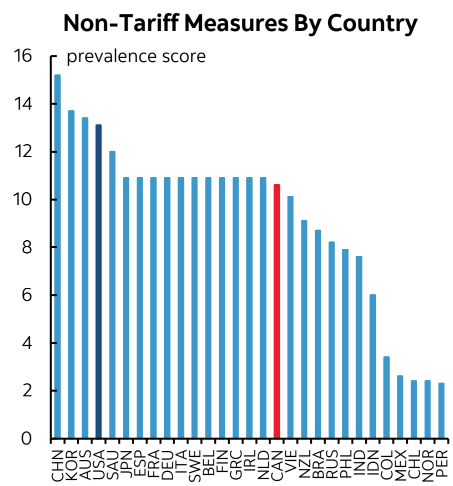
- If not, then he would be wise to compromise before the new Congress convenes in early January. At that point, the odds shift toward the Democrats owning at least one of the Chambers post-November 7th and taking over in January.

Chart 8



Sources: Scotiabank Economics, OECD.

Chart 9



Sources: Scotiabank Economics, UNCTAD.

- If you want a trade deal with the GOP's signature—and most importantly, DJT's—then you get it through Congress before you have to rely on the Democrats to pass it in Congress at which point it gets more complicated and out of Trump's control. More issues would be brought to the table and that's assuming the Dems don't take both chambers in which case Trump is quite possibly on his way out two years ahead of schedule. Canada should continue to play the midterms game.

- Even if imposed, Canada would face the lowest average effective tariff rate of any of America's key trading partners. This invites trade diversion toward N.A. away from Europe, Asia and other countries.

- Furthermore, since the Trump administration is making unprecedented use of the Trade Act of 1930, it is likely that court challenges are bound to ensue should the tariffs become implemented. Unfortunately, however, the horribly inefficient and slow US legal system will take ages to address them.

- There are also important shock absorbers to consider. A big one is that the Canadian dollar can offset the tariff shocks and Trump is fighting a market-driven flexible exchange rate regime and losing. CAD has depreciated by about two dimes relative to the USD since 2021 with long and lagging effects on supply chains and trade competitiveness. CAD once again reacted to the latest tariffs with offsetting depreciation. The weighted average tariff hit is a small offset and focused upon relatively few sectors. Plus the income elasticity effect (or pull effect) of US growth on Canadian exports is helping.

- And of course, one of Canada's hedges remains the gift wrapped with beautiful maple leaf paper with a giant bow on top. Namely high commodities due to the Iran war. Brent (which drives east coast projects that sell into the northeastern US seaboard) is above US$91. WTI US$85. Western Canada Select at Hardisty, Alberta is above $68 and hence generally well above project break evens. CAD depreciation reinforces the effects given local cost structures. Plus other commodity prices have also moved materially higher.

STEADY AS SHE GOES ON FORECASTS—INCLUDING THE BOC

Because of such possibilities, I wouldn't change a thing about our forecasts at this point. It could be very foolish to over react and then swing back afterwards. It could be very one-sided to lean to trade uncertainty or commodity uncertainty at this juncture. Those of us who have seen this movie many times from the 1980s negotiations for the original FTA to the 1992 NAFTA agreement to Trump 1.0 and now Trump 2.0 know to be patient, to play the long game, and without over reacting to the twists and turns.

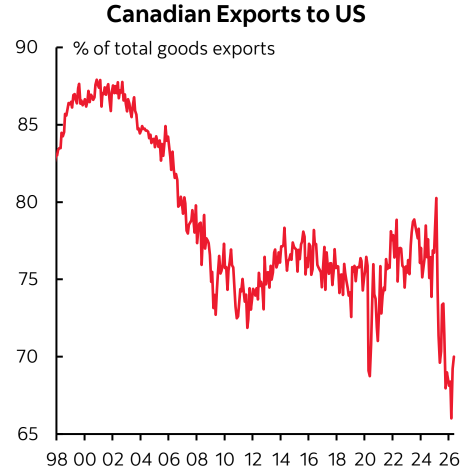
From a BoC standpoint, all of this trades off trade policy risks against commodity risks. The longer and higher commodities go, the greater the pass through as the dam bursts on tolerance to eat it on margins etc. As the BoC noted, there are many possible scenarios on trade negotiations and commodities beyond merely a bad trade outcome or a high commodity prices. In fact, I can easily see a scenario whereby current BoC pricing is too light should a trade agreement be achieved in our base case scenario and commodities remain elevated which is a reasonable base case.

CANADA IS DIVERSIFYING AWAY FROM THE US

Regardless of the prospects for a CUSMA 2.0 deal, Canada is in the long-run process of diversifying away from the US and I believe that the Trump administration's actions are expediting such an outcome that will define a generational shift.

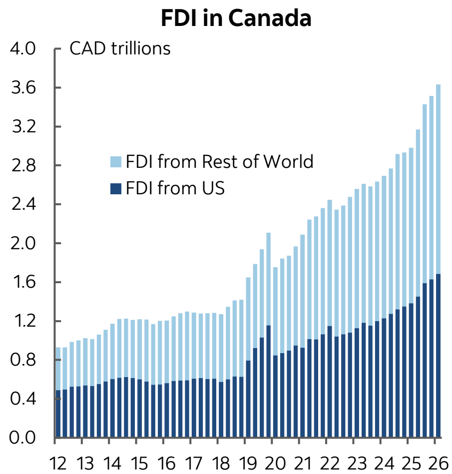
Canada used to send about 87–88% of goods exports to the US. Now it's about two-thirds for a massive reduction in just a quarter-century (chart 10). I wouldn't be surprised to see the share drop to around half in another 10–20 years.

Chart 10



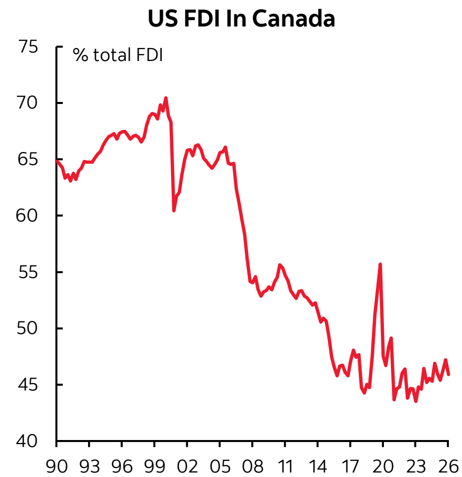
Sources: Scotiabank Economics, Statistics Canada.

Chart 11



Sources: Scotiabank Economics, Statistics Canada.

Chart 12



Sources: Scotiabank Economics, Statistics Canada.

Chart 11 shows rising foreign direct investment into Canada from the US but more rapidly rising FDI into Canada by the rest of the world. Chart 12 shows that the US is a diminishing share of foreign direct investment into Canada as other foreign economies overtake the US. The US used to account for 70% of FDI into Canada but within just a quarter century that share has fallen by about a stunning 25 percentage points. In the world of slow moving balance of payments accounts, such a shift in such a short period of time is astounding. I think the fact that Canada is signing trade and investment agreements all over the world or moving toward them (China, India, Saudi Arabia etc) could accelerate these trends, possibly making the US a nearly trivial source of FDI into Canada as soon as the 2030s.

The points above about less and less US influence in Canada's economy offer mixed interpretations. On the one hand, it's somewhat unfortunate given shared borders, many similarities, continental security etc. Plus I have serious reservations about cozying up to some of the world's more unsavoury regimes.

On the other hand, it's driven by necessity. If the US doesn't want to play fair, punishing Canadians with false accusations of being mules and human traffickers, and threatening assimilation, then Canada will seek involvement in its economy by others. If the US does not honour the long-term contracts that it signs and seeks to renege on them like the Gordie Howe Bridge, then Canada has to diversify investment risk. This has long been one of my arguments in that Trump is lessening continental security with his assault on NAFTA partners especially Canada. On balance, diversification of trade and investment makes eminent sense as the US turns more isolationist and protectionist and less reliable.