ECONOMIC OUTLOOK
2025 MID-YEAR

Building Resilience and Capacity in a Disrupted World

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Except where otherwise noted, the analysis in this Economic Outlook is based on published data available as of May 31, 2025.

Foreword from Our Executive Chair and Chair of the Board

There is much happening in North America and internationally that is disrupting the traditional patterns of trade and investment. Yet, conversations around the world and in Canada remind us of some basic truths.

There is ample capital in Canada and globally to be deployed for productive use. Corporate leaders, institutional investors, sovereign wealth funds, private equity and private debt funds are all searching for assets, projects and enterprises that will deliver the best risk-adjusted returns.

Meanwhile, there are immense needs and opportunities across our country to expand the infrastructure to move our goods to new markets, to transform and to grow our energy system, to strengthen our defence capabilities, to build homes and to capitalize on technology and artificial intelligence (AI) in all sectors of the economy.

The task for business and policy leaders is both simple and complex: to connect the capital with the right needs and opportunities and to generate the investment returns that will deliver shared benefits. This means that all governments must work together with businesses to put the winning conditions in place.

At Bennett Jones LLP, as we serve our clients and help them achieve their business goals, we take pride in contributing to the vital relationship between the public and private sectors in building a stronger and more resilient Canadian economy.

The *Economic Outlook* produced by our Public Policy group aims to inform an ongoing dialogue with our clients and business and policy leaders on how we can best realize greater value together.

I take this opportunity to recognize David A. Dodge, who led our *Economic Outlook* for 15 years and who has now retired from the firm. David is an exceptional Canadian who made an immense and lasting contribution to the country through his career in academia, public service and the private sector. We wish him the best in his retirement.

John M. Mercury

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Executive Summary

A WORLD DISRUPTED BY U.S. POLICY SHIFTS AND UNCERTAINTY

In a period of only months, actions by the U.S. administration of President Donald Trump have disrupted U.S. trade, foreign and economic policies, and created exceptional uncertainty for the U.S. and global economies and financial markets.

Questions about the strategy and end game of the President for the rules that govern international trade and investment are forcing governments, businesses and investors worldwide to reassess their own strategies and relationships.

A "tough on China" policy was largely expected, but statements and actions by the President drawing into question the foundational terms of relationships with even the strongest U.S. allies have caused intense global unease.

Much of the attention has focused on the sequence of decisions of the President on U.S. import tariffs. Despite many pauses or rollbacks of tariffs shortly after their announcement, the effective U.S. import tariff rate, at over 15%, is higher than at any time since 1934.

The threat of new and higher tariffs is ever-present, and the goals of the President in negotiations with global trading partners are not apparent.

A recent court decision declaring invalid tariffs imposed under the *International Emergency Economic Powers Act* (IEEPA) (including the tariffs on Canada, Mexico and China, as well as the "reciprocal" tariffs on other partners) has been stayed pending appeal by the administration.

Thus, tariff and trade uncertainty prevails.

Yet, the uncertain prospects for the U.S. economy and the risks to financial stability posed by large U.S. fiscal deficits and debt, such as permitted by the "big, beautiful" bill in Congress, are at least just as worrisome.

At their meeting of May 22 in Kananaskis, G7 finance ministers and central bank governors recognized that "elevated uncertainty can have implications for the economy and for financial stability."[1]

HIGH STAKES FOR CANADA IN SEEKING A NEW RELATIONSHIP WITH THE UNITED STATES

Given the scope and depth of Canada's relationship with the United States and our status as a middle power, the policy disruptions in the United States and the fallout for the global economy pose an existential threat.

Prime Minister Mark Carney has stated that the old relationship between Canada and the United States based on steadily increasing integration is over. However, there is no economic and national security for Canada without a constructive partnership with the United States.

Adjustment to U.S. tariffs on imports from Canada and Mexico since their original announcement have mitigated impacts for our economy, but tariffs on steel and aluminum products and automotive vehicles and parts are inflicting damage on key industries and regions.

Moreover, the heightened uncertainty is a strong deterrent to investment and spending and thus acts as a drag on the economy.

Prime Minister Carney and President Trump have begun a dialogue. For Canada, the priority is predictability if not certainty on tariffs and the future of the Canada–United States–Mexico Agreement (CUSMA) within the frame of a new relationship to advance the shared interests of both countries.

While the President suggests that the United States does not need Canada, in fact there is much that we bring to the relationship, and all of our assets can be leveraged to secure agreement. Our position in the negotiations is reinforced by a Team Canada approach uniting governments and businesses.

UNTIL SOME POLICY RESOLUTION: A WIDE RANGE OF SCENARIOS FOR THE U.S. AND CANADIAN ECONOMIES

Given this backdrop, there is a wide range of plausible scenarios for growth, inflation and interest rates in the U.S. and Canadian economies in the second half of 2025 and in 2026 and 2027.

We have constructed a baseline scenario by assuming that by the end of 2025 the United States will conclude trade agreements with its major economic partners, including Canada. The agreements will reduce uncertainty and lessen, but not eliminate all, U.S. import tariffs.

Under our baseline scenario, the U.S. economy slows down in the second half of 2025, but it does not undergo a recession. The economy picks up momentum in 2026 and 2027.

- On a fourth-quarter-to-fourth-quarter (Q4/Q4) basis, real gross domestic product (GDP) growth falls from 2.5% during 2024 to 1.1% during 2025, before rising to 1.7% during 2026 and 2.2% during 2027.
- U.S. core personal consumption expenditure (PCE) inflation peaks at about 3.5% before the end of 2025, and then declines progressively to around 2% by the end of 2027.
- With the slowing of the economy and with greater clarity on inflation trends, the Federal Reserve cuts its policy rate by 25 basis points once by the end of 2025, and three more times by July 2026, bringing the Fed funds rate (upper limit) to 3.5%.
- Despite the reduction in inflation and the cuts in the policy rate, the 10-year U.S. treasury yield stays at roughly the current level of 4.5% over the planning horizon as markets remain sensitive to the size and growth of the U.S. public debt.

The growth profile is roughly similar for Canada under our baseline scenario, but we expect a technical recession in the middle quarters of 2025.

- On a Q4-to-Q4 basis, growth would fall sharply from 2.3% in 2024 to 0.3% in 2025, before rising to 1.8% in 2026 and 2% in 2027.
- Headline Consumer Price Index (CPI) inflation remains at or very close to the Bank of Canada's (BoC) 2% target.
- The BoC lowers its policy rate from 2.75% in June 2025 to 2.25% by December 2025. Given assumptions in our baseline scenario, we project the policy rate to hold at 2.25% in 2026 and 2027.
- 10-year Government of Canada (GoC) bond yields, at about 3.2%, maintain a differential of some 130 basis points relative to the yield on U.S. treasuries.

The risks are mostly to the downside. Growth in Canada will be lower, and a recession more severe, if the United States maintains or ratchets up its tariffs, if no trade agreement is concluded and uncertainty prevails, or if there is an escalation of a trade war between the United States and China.

A quick resolution of trade tensions that would bolster global trade and activity is an upside risk, but one to which we ascribe a low probability.

BUILDING RESILIENCE: THE DIVERSIFICATION OF OUR MARKETS

Beyond tariffs and short-term uncertainty, Canada today confronts long-standing economic policy gaps and structural weaknesses. In front of what he describes as the biggest crisis in our lifetime, the Prime Minister has proposed an ambitious transformation of the economy.

To enhance our sovereignty and economic resilience, there is a widely recognized need to reduce our dependence on the United States over time by realizing a more integrated domestic economy and by expanding our linkages with the countries of the Asia Pacific Region and Europe in particular.

There is wide agreement that a place to start is free trade in Canada. Pronouncements and steps by premiers in the last weeks and months in favour of the mutual recognition of standards and labour mobility represent meaningful progress. Strong leadership and diligent follow-through will be required to maintain the momentum and to overcome the multiple obstacles that still stand in the way.

New markets for our exports and more diversified supply chains will never be a substitute for what will continue to be our paramount economic relationship with the United State. Our goal should be less to divert trade from the United States than to grow our other markets *faster*. This rests not so much on the government signing new trade deals as it does on businesses enhancing their market development.

BUILDING CAPACITY: THE EXPANSION OF INVESTMENT

In successive *Economic Outlooks*, we have insisted that prosperity and national security for Canada depends on bolstering investment in productive capacity and innovation.

Currently, there is an opportunity and a need to unlock investment in at least five domains: trade corridors, energy and critical minerals, defence and security, housing, and innovation and productivity-enhancing technology. In each case, the ambition is high. The challenge is execution.

Trade corridors. First ministers are developing a list of projects in the national interest in consultation with Indigenous Peoples. The immediate task is to move from concepts of trade corridors to actual projects led by committed proponents.

In turn, a condition to attract and mobilize the capital for investment is collaboration among governments to streamline project review and permitting. The GoC plans to table *One Canadian Economy* legislation for this purpose. The first ministers are pledging to address project approval, permitting efficiency and timelines for all projects.

The early participation of Indigenous Peoples is now widely recognized as an opportunity to move projects forward while advancing reconciliation and sharing economic benefits. There are many successful examples. An outstanding challenge is proceeding with both legal clarity and speed.

Energy and critical minerals. Canada is well positioned to leverage a rich energy and resource base as a competitive asset for the domestic economy and to play a growing role with allies in responsible and reliable supply chains.

For oil and gas (including liquefied natural gas [LNG]), the critical issue for governments and industry is finding a path to realize the value of our resources while driving down the intensity and ultimately the absolute amount of greenhouse gas (GHG) emissions in the production process.

Public and private investment to power a clean economy also requires clarity of environmental and economic regulation such that each jurisdiction may advance a supply mix, including baseload and intermittent energy, that makes the best use of its resources and capabilities.

Defence and security. To meet our commitments to our allies and to safeguard our national security, Canada must grow defence spending from 1.4% of GDP in 2024 to at least 2% of GDP by 2030 or earlier; in fact, discussion in NATO will push our spending target higher.

A critical responsibility is ensuring that to the greatest extent possible this expenditure draws upon, and reinforces, the country's economic capabilities, assets and technologies.

A stronger domestic defence industrial base and strategic linkages with partners in Europe and the Asia Pacific Region can contribute to enhanced security, the diversification of our trade and stronger growth.

The protection of our territorial sovereignty can also be advanced by investment in dual-use infrastructure in Canada's North, also supporting resource development, opening new trade routes and creating opportunity for Indigenous communities.

Housing. Real house prices have nearly doubled in the country since 2007. There is a shortage of supply, including a lack of rental and affordable housing.

The GoC has set a goal to double the rate of annual home construction to 500,000. It has proposed the creation of a new housing industry that draws on modular and prefabricated housing technology, Canadian workers and Canadian lumber.

While the direction is the right one, the ambition may be tempered by the fact that Canada already allocates greater resources to residential investment than any other advanced economy. Supply constraints, including those on the availability of workers, will be manifest if there is also an acceleration of large projects.

Leadership by provincial and municipal officials is essential to speed up permitting and infrastructure development and to achieve steady, measurable progress in the building of homes.

Technology and AI. A national effort to build physical infrastructure and assets cannot obscure the need to innovate and to lift productivity growth across the economy, notably through technology, digitalization and AI.

Similarly, our preoccupation with trade in goods in response to U.S. tariff action ought not overshadow the services sectors (including the public sector) and the value of investment in intangible assets, including intellectual property and data, for our economic and national security.

In fact, the continued expansion of U.S. big tech and the rapid emergence of China as an innovation powerhouse across a range of strategic technologies pose at least as existential, if not as immediate, a challenge to our sovereignty and prosperity as the Trump tariffs.

THE LYNCHPIN: THE ATTRACTION AND MOBILIZATION OF PRIVATE CAPITAL

Canada is not alone in the pursuit of enhanced economic and national security, and it is competing with other jurisdictions to attract and execute investment that will be led and financed in large majority by the private sector.

The Prime Minister has stated unequivocally that Canada is not for sale. However, Canada is open for business, and this must be conveyed not only by the federal government but by provinces, territories and Indigenous and business leaders.

Structural policy—in large measure, sound and efficient regulation—must be the principal instrument to support private investment and risk-taking.

Given fiscal constraints, governments have to make judicious use of their resources and balance sheets. A political determination to build and to unlock investment can attract many proposals that have an uncertain business case and that seek large public subsidies. Governments have to be principled, consistent, disciplined and coordinated in responding to such proposals.

A CORE RESPONSIBILITY EVEN MORE ACUTE IN AN UNCERTAIN WORLD: SUSTAINABLE PUBLIC FINANCES

Governments worldwide are confronting a range of fiscal pressures in a period of global disruption, low economic growth and political tensions. In 2024, general government gross debt exceeded US$100 trillion, or 92% of global GDP. It was 64% before the Global Financial Crisis (GFC) in 2007–2009.

Meanwhile, the cost of public debt has risen. After a 30-year period of declining bond yields to nearly zero just before COVID in 2020, governments are now paying a higher price when refinancing maturing debt or issuing new bonds.

Given a rising debt as a proportion of GDP, and higher interest costs, governments, including governments in Canada, are allocating a greater share of their revenue to debt service.

Recent increases in U.S. treasury yields and a downgrade of the United States as sovereign borrower by Moody's have served as reminders of the exposure of governments to the market's judgment of risk.

Canada fares well in some international fiscal comparisons. Its *net* general government debt—that is, public debt minus financial and non-financial assets—as a proportion of GDP is among the lowest in advanced economies.

However, on a *gross* basis, Canada's public debt ratio is at par with the average of advanced economies. Thus, Canada's exposure to the debt markets—our annual borrowings to refinance our public debt and fund our deficits—is proportionately comparable to that of our peers.

In a highly uncertain world, governments must consider carefully the sustainability of public finances. If there is not strict fiscal discipline, debt dynamics can quickly become unfavourable. Debt can then rise faster than GDP, interest costs can absorb a rising proportion of revenue, and access to new borrowing can become more difficult and more expensive.

The GoC has decided not to table a fiscal update or budget this spring.

The federal minister of finance will face a long list of fiscal pressures over the next months and years. Foremost among them will be raising defence spending to well over 1.76% of GDP by 2030, the level of spending built into the last budget.

The Speech from the Throne pledged that the government will spend less so that Canadians can invest more. To exert fiscal discipline, the government plans to reduce the growth of operating expenditures to below 2% per year by capping the size of the public service, ending duplication and deploying technology, including AI, to improve public sector productivity.

Such steps will be helpful. However, they will not be sufficient to achieve what is widely regarded as an indicator of fiscal sustainability over the medium term, namely, a declining federal debt-to-GDP ratio.

The government has excluded cuts in major transfers to provinces, territories or individuals. To bring the debt ratio down over time, we judge that there will need to be material cuts to federal program spending.

Under prudent assumptions, we estimate that bringing the federal debt-to-GDP ratio down steadily will require permanent savings of some 15% to 20% in non-defence program spending over the fiscal planning horizon, or C$30 billion to C$45 billion per year on an ongoing basis.

This is a significant undertaking, yet one much less drastic than the fiscal adjustment of the mid-1990s.

A review of federal programs to eliminate those that are not mission critical or effective would allow ministers and a streamlined public service to focus on core federal responsibilities and on the efficient delivery of a limited set of priorities.

Importantly, a sustainable fiscal plan can include larger borrowing to fund government investments in financial or non-financial assets *if* they deliver concrete benefits and future revenue streams. This can be helpful in some cases to lever or "crowd in" large amounts of private capital.

To make the best use of the public balance sheet and to promote the efficient management of large infrastructure assets, the federal as well as provincial governments should give greater consideration to pricing roads and bridges, among other projects. This could shift more costs from taxpayers to users and create an opportunity for the expanded use of public–private partnerships.

To free up capital for public investment in new assets, governments should also consider the sale or long-term lease of existing assets, such as major airport terminals, that generate a steady stream of income and that can represent sound, long-term business propositions for institutional investors.

CHAPTER 1

Tariffs and Uncertainty—A Difficult Backdrop for Policy and Business Planning

In a period of only months, actions by the U.S. administration of President Donald Trump have disrupted U.S. trade, foreign and economic policies and created exceptional uncertainty for the and global economy and financial markets.

Questions about the strategy and end game of the President for the rules that govern international trade and investment are forcing governments, businesses and investors worldwide to reassess their own strategies and relationships.

Much of the attention is focused on tariffs. Yet, shifts in the role of the United States in the world order, uncertain prospects for the U.S. economy in the short to medium term, U.S. fiscal pressures and the resulting risks to financial stability may be even more consequential.

A world divided into zones of strategic and economic influence and driven by "deals" is succeeding one shaped over decades by rising trade and investment under stable and transparent rules and institutions.

Given the scope and depth of Canada's economic and security relationship with the United States and our status as a middle power, the uncertainty and risks amount to an existential threat to our sovereignty and prosperity.

Prime Minister Mark Carney has stated that the old relationship between Canada and the United States based on steadily increasing integration is over. However, there is no economic and national security for Canada without a constructive partnership with the United States.

The Prime Minister and the U.S. President have begun a dialogue. For Canada, a priority is predictability if not certainty on trade tariffs and the future of the CUSMA within the frame of a new relationship to advance the shared interests of both countries.

At their meeting of May 22 in Kananaskis, G7 finance ministers and central bank governors recognized that "elevated uncertainty can have implications for the economy and for financial stability."[1]

In the short term, slower growth and a risk of recession because of tariffs and uncertainty require a well-calibrated policy response. Some Canadian industries and workers will need assistance to absorb the impact of tariffs and to adjust to new market conditions.

The mitigation of short-term costs and risks will be important as policy and business leaders step up efforts to identify and execute the investments necessary to build greater economic resilience and capacity for the medium to long term.

U.S. TARIFFS: A LONG AND WINDING ROAD

Political transitions in major economies generally introduce change to foreign, trade and economic policies, which send new signals to global partners and to investors, who in turn recalibrate their policy and business strategies accordingly.

In the United States, the coming-into-office of the Trump administration together with a Republican-led Congress has been no exception.

Some early actions of the President, setting in motion a bold agenda of deregulation and low taxes, were expected and generally well received by businesses as favourable to at least some forms of investment. In his first day in office, the President signed executive orders to muster all of the emergency and normal powers of the executive agencies of the U.S. government to accelerate the development of energy resources. Instruction by the President for the United States to once again withdraw from the 2015 Paris Agreement signaled that his administration would not be constrained by international commitments in realizing the value of the United States' vast hydrocarbon resources. Congressional leaders for their part quickly focused on legislation to extend the personal and corporate tax cuts enacted under the Tax Cuts and Jobs Act of 2017 and otherwise expiring at the end of 2025. The President signaled at an early stage that he expected rapid progress on a "big, beautiful" bill packaging this priority initiative with other tax cuts, increased spending on the border, and cuts in federal expenditure. There was also support in principle in the business community for early efforts to drive savings and efficiency in the U.S. government under the Department of Government Efficiency led by Elon Musk.

However, shifts by the President in the conduct of international relationships and a rapid succession of decisions on import tariffs disrupted trade and created exceptional business and legal uncertainty for global partners.

A "tough on China" policy was largely expected, but statements and actions by the President, drawing into question the foundational terms of relationships with even the strongest U.S. allies, caused intense global unease.

On the trade front, the President developed a pattern of announcing arbitrary import tariffs with virtually immediate application and then pausing or rolling them back as pressure built in the domestic industry and in capital markets.

- **The opening salvo was the February 4, 2025, executive orders imposing a 25% tariff on imports of goods from Canada and Mexico and a 10% tariff on imports of energy products from Canada under the IEEPA; these tariffs were paused and then restarted but with a narrower application.** The original decision, purportedly to secure action to stop the flow of illicit drugs into the United States, caused dismay because it violated the CUSMA and created havoc in a largely integrated North American economy. Originally proposed to be effective February 4, the tariffs were postponed by one month to March 4. Canada retaliated on March 4 by imposing 25% tariffs on imports from the United States valued at about C$30 billion annually. As of March 7, the United States modified substantially the scope of application of the tariffs such as to exempt imports of CUSMA-compliant Canadian and Mexican goods.

- **U.S. import tariffs of 25% on autos and auto parts taking effect April 3 were later modified to provide some accommodation for the integrated North American auto industry.** These tariffs were imposed under Section 232 of the *Trade Expansion Act*, which allows the President to take action when imports of certain goods are found to threaten national security. Canada responded by applying a tariff of 25% on vehicles imported from the United States that are non-compliant with CUSMA and on non-Canadian and non-Mexican content of CUSMA-compliant vehicles. On May 1, the United States announced an exemption for the U.S. content of CUSMA-compliant automobiles and for CUSMA-compliant parts.

- **The most disruptive decision was the introduction of "reciprocal tariffs" under the IEEPA on what the President called "Liberation Day" on April 2; these tariffs were amended one week later.** The reciprocal tariffs shocked the world because of their level (10% to 50%), scope of application (90 countries) and arbitrary calculation. For example, the President proposed tariffs of 20%, 24% and 25% on imports from the European Union (EU), Japan and South Korea, respectively. Markets feared an all-out global trade war. U.S. and global equity markets fell, U.S. treasury bond yields rose, and the U.S. dollar depreciated, representing a sharp and unusual hit to confidence in the U.S. economy. On April 9, the President backed down on the reciprocal tariffs for 90 days but kept a 10% baseline tariff on all imports while raising the tariff on imports from China to 125% (and later to 145%). Tariffs on imports from Canada and Mexico were not affected by these decisions.

- **The tariffs on trade between China and the United States amounted to a virtual trade embargo and were rolled back after an early round of bilateral negotiations.** The truce negotiated by U.S. Treasury Secretary Scott Bessent and China's Vice Premier He Lifeng on May 12 brought tariffs down for an initial period of 90 days, allowing more detailed negotiations. The deal left in place the U.S. baseline import tariff of 10%, the 20% tariff to drive action on fentanyl (both imposed under the IEEPA), as well as goods-specific tariffs, including a tariff of 100% on Chinese electric vehicles (EVs). China dropped its tariff on imports from the United States to 10% and agreed to remove some non-tariff barriers to trade.

- **Later in May, a threat by the President to impose a 50% reciprocal tariff on imports from the EU, effective June 1, because of the slow progress of bilateral negotiations was quickly taken back.** After "a very nice call" with the President of the European Commission (EC), Ursula von der Leyen, the President reestablished the date of July 9 for a decision on reciprocal tariffs, giving more time for negotiations. Equity markets again reacted negatively to tariff threats and positively to prospects for a reasonable resolution.

- **A decision yet to be reversed at the time of writing is the one announced by the President on May 30 to double the import tariff on aluminum and steel products, from 25% to 50%, effective June 4.** The 25% tariffs on U.S. imports of steel and aluminum products were introduced during the first Trump presidency under the authority of Section 232 of the *Trade Expansion Act*, but with exemptions then negotiated with key U.S. allies and trading partners, including Canada. The exemptions were removed for all countries, effective March 12. Canada retaliated with tariffs of 25% on imports of U.S. steel, aluminum and other selected products, valued at about C$30 billion per year. A doubling of the tariff will create mayhem across the aluminum and steel industries and supply chains worldwide and likely provoke retaliation by Canada and other trading partners.

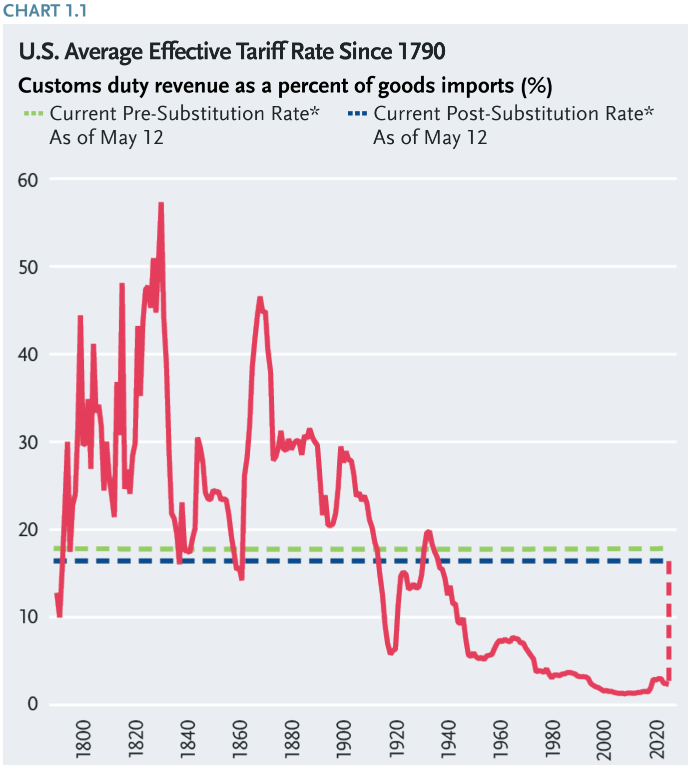
Uncertainty caused by the rapid succession of tariff decisions by the President was further elevated on May 28 by the determination by the U.S. Court of International Trade that President Trump had exceeded his authority in imposing tariffs under the IEEPA. On May 29, a federal appeals court paused this decision to hear the government's appeal. The tariffs are thus staying in place until further decisions by the President or by the courts. Senior Counselor for Trade and Manufacturing Peter Navarro stated that even if courts ultimately ruled IEEPA tariffs to be invalid, the administration would look to other authorities to impose them, suggesting that the courts would not have the final word.

Despite the tariff pauses, rollbacks or modifications, the average effective U.S. import tariff rate (as of May 12) is estimated at 17.8%, the highest since 1934 (Chart 1.1).[2] The threat of increased tariffs on imports of some goods, or from some countries, remains ever-present.

Indeed, the Trump administration has launched Section 232 investigations on a wide range of items. The goods currently under investigation include copper, wood products, semiconductors, pharmaceuticals, critical minerals, trucks and civil aircraft and engines. The President also asked the Department of Commerce to begin the process of imposing a 100% tariff on movies made outside the United States.

Box 1.1 at the end of this chapter summarizes the state of play of extraordinary U.S. tariff measures effective as of June 4, 2025.

CHART 1.1



* Assumes revised April 9 tariffs stay in place.

Source: Historical Statistics of the United States Ea424-434, Monthly Treasury Statement, Bureau of Economic Analysis, The Budget Lab analysis.

Meanwhile, the end game pursued by the administration in bilateral trade negotiations is entirely opaque, and "deals" concluded with the United Kingdom (UK) or China give few if any clues.

- The bilateral "Economic Prosperity Deal" announced on May 8 by President Trump and by Prime Minister Keir Starmer of the UK, heralded by the White House as historic, is a limited, ad hoc arrangement that is unlikely to serve as a model for U.S. partners seeking a lasting, comprehensive framework for an economic relationship.[3]
- Similarly, beyond the rollback of tariffs and non-tariff barriers, the joint statement of the United States and China of May 12 merely commits the two parties to establish a mechanism to continue discussions about economic and trade relations.[4]

CONTRASTING PERSPECTIVES ON TARIFFS AND U.S. ECONOMIC POLICY

The President contends that his tariff actions are justified by the U.S. national interest and that they will ultimately be beneficial for the economy. He believes that tariffs can generate significant fiscal revenue, cause a reshoring of manufacturing activity and jobs, bring trading partners to the table for negotiation of better deals for the United States, and correct chronic U.S. trade deficits. He credits his policies for securing early commitments of over US$5 trillion in new U.S.-based investments in advanced manufacturing and AI infrastructure.[5]

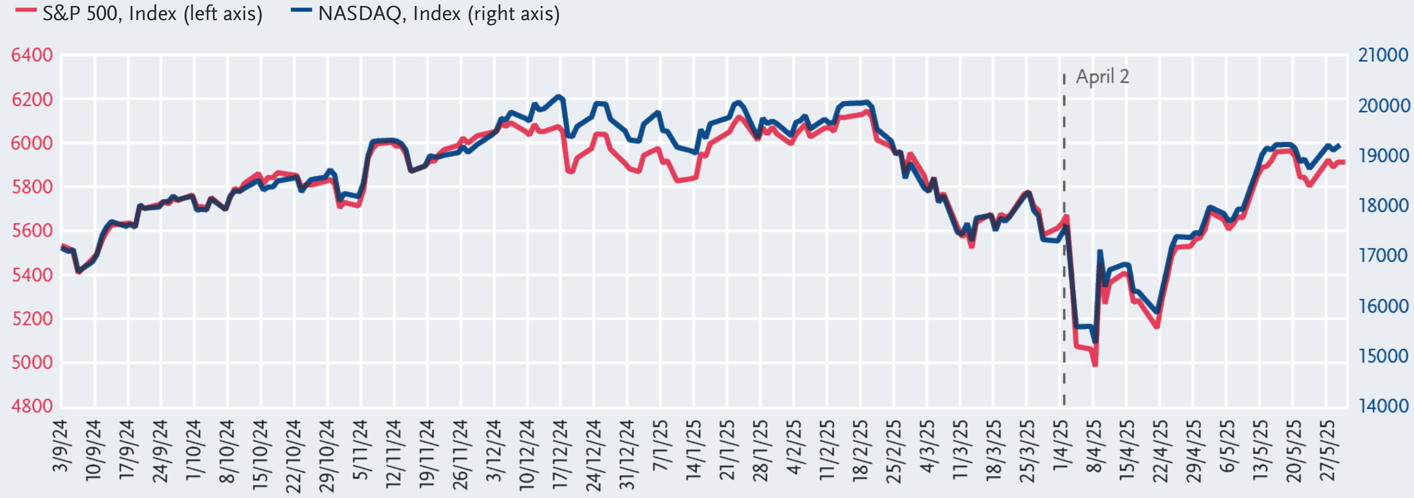
Economists almost universally disagree. They explain that tariffs will raise prices, reduce real incomes, lower economic growth and ultimately diminish the global competitiveness of the U.S. economy. For example, the Budget Lab at Yale estimates that the tariffs effective on May 12 (after the deal with China) represent a cost per household consumer of US$2,800; the tariffs would lower real GDP growth by 0.7 percentage points (pp) in 2024 and in the long-run lower the level of real GDP by 0.4%.[6] Former U.S. Treasury Secretary Larry Summers has pointed out that "the aluminum and steel tariffs that President Trump has implemented on a forward basis will penalize export industries that employ 60 times as many people as the industries that are being protected."[7]

Markets remain on alert. After dropping sharply in the days following the April 2 tariff announcement, U.S. equity markets recovered lost ground after April 9 (Chart 1.2), encouraged by the rollback of tariffs, the May 12 agreement with China and other signs that the President might be easing his tariffs policy and pursuing constructive arrangements with trading partners. Similarly, yields on U.S. treasury bonds that spiked after the April 2 announcement eased after the President retreated on April 9 (Chart 1.3). The value of the U.S. dollar reflected similar sentiment in financial markets around the President's April 2 and April 9 announcements (Chart 1.4).

CHART 1.2

U.S. Equity Market Indices

September 3, 2024 to May 30, 2025

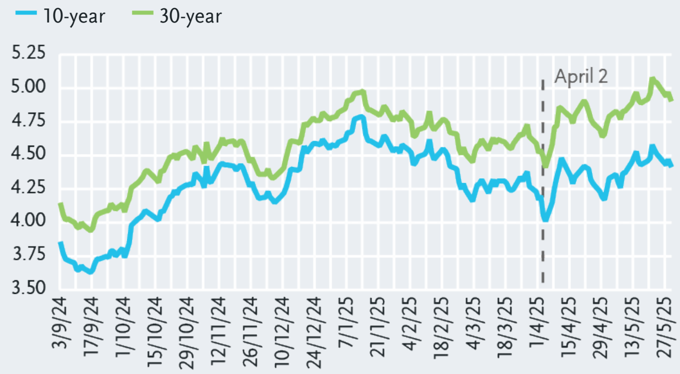


Sources: NASDAQ OMX Group and S&P Dow Jones Indices LLC via Federal Reserve Bank of St. Louis.

CHART 1.3

U.S. Treasury Bond Yields (%)

September 3, 2024 to May 29, 2025



Source: Board of Governors of the Federal Reserve System (U.S.) via Federal Reserve Bank of St. Louis.

CHART 1.4

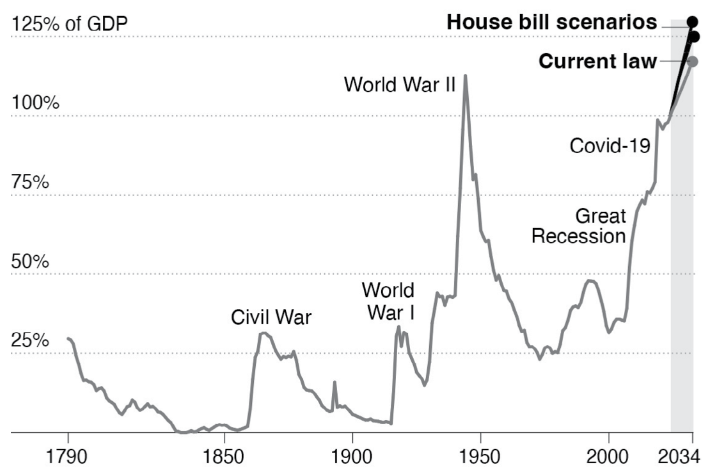
Nominal Advanced Foreign Economies U.S. Dollar Index

September 3, 2024 to May 30, 2025

Source: Board of Governors of the Federal Reserve System (U.S.) via Federal Reserve Bank of St. Louis.

CHART 1.5

U.S. Federal Debt as a Share of the Economy Since 1790



Sources: Congressional Budget Office (historical federal debt held by the public); Committee for a Responsible Federal Budget (projections under the House bill if temporary provisions are made permanent, and under the bill as written) THE NEW YORK TIMES

Market sensitivity more recently has been exacerbated by the net fiscal cost of the "big, beautiful" bill. On May 14, the non-partisan Committee for a Responsible Budget estimated that the bill would add US$3.3 trillion to the federal debt (or US$5.2 trillion if temporary provisions in the bill were made permanent) over and above a fiscal track that had already been pushing the debt past its peak at the end of World War II (Chart 1.5).[8] On May 16, Moody's announced a one-notch downgrade of the U.S. government as long-term issuer to Aa1 from AAA, with the outlook changed to "stable" from "negative."[9] Moody's cited "the increase over more than a decade in government debt and interest payment ratios to levels that are significantly higher than similarly rated sovereigns." Moody's was the last of the three large rating agencies to bring down the U.S. debt rating.[10]

The net fiscal costs of the tax, spending and tariff decisions of the U.S. government remain uncertain, but there is no apparent political will to address seriously the fiscal deficit. On June 5, the Congressional Budget Office (CBO) issued its own estimate of the net fiscal costs of the tax and spending bill in Congress. It estimates a loss of revenue of US$3.7 trillion over 10 years, and a reduction of outlays of US$1.3 trillion, for a net increase of US$2.4 trillion in the cumulative primary deficit. Taking into account added interest costs, the bill's cumulative effect on the budgetary deficit would be US$3 trillion.[11] The CBO also released on June 4 its estimate of the budgetary and economic effects of tariffs implemented between January 6 and May 13, 2025. It estimates a cumulative impact on the primary deficit of US$2.5 trillion over 10 years. With interest cost savings, the tariffs would reduce the cumulative deficit by US$3 trillion. Because the tariffs would reduce the size of the U.S. economy, the CBO judges that the net impact would be a reduction of US$2.8 trillion over 10 years.[12] While the two CBO analyses may suggest that the higher tariffs could compensate for the effects of tax and spending measures in the Congressional bill, one might ascribe lesser weight to projected revenue from highly uncertain tariffs than to projected revenues and costs associated with legislation that will ultimately be passed by Congress.

The past trends and recent developments are pushing up yields on 10-year and 30-year treasury bonds. If yields stay high, this will add to debt service charges that already exceed the costs of national defence or Medicare in the U.S. federal budget. While debt accumulation in the United States is facilitated by what is called the "exorbitant privilege" of issuing the global reserve currency, the privilege is not infinite and U.S. dollar financial assets can lose favour with investors.

TARIFFS AND UNCERTAINTY: THE IMPACTS FOR CANADA

At present, given the scope of application of the U.S. tariffs, excluding CUSMA-compliant goods but including steel and aluminum products and a portion of automobiles, RBC Economics estimates that about 86% of Canadian exports to the United States enter the U.S. market tariff-free.[13] For exports subject to a tariff, it is complex to estimate the impact for producers. The U.S. tariff is paid by the importer, but how contractual relations may apply and how business relationships may evolve depend on both demand and supply factors that are market specific. In the Canadian auto industry, early impacts of U.S. tariffs are brutal: three of Ontario's automotive assembly plants are reported to have cut back production and jobs; a fourth plant, idle because of retooling, may be offline longer than originally planned.[14]

The effect of tariffs is felt most acutely in directly exposed sectors and regions that export a large share of their output to the United States (Table 1.1). The manufacturing sector in Ontario is among the most directly hit. The Ontario Financial Accountability Office (FAO) estimates that U.S. tariffs announced as of April 17 affect some 20% of Ontario's international exports, while Canadian retaliatory tariffs apply to 15% of the province's imports.[15] It notes that the actual impact of tariffs on the economy is uncertain and will depend on the magnitude, breadth and duration of tariff coverage, as well as on how businesses and households respond. Compared with a no-tariff scenario, the FAO estimates that tariffs could cause a loss

TABLE 1.1

Exports to the U.S. as % of Gross Output for Selected Industries: Canada

	Exports to the U.S. as % of industry gross output*
Iron or steel products	43
Unwrought aluminum and aluminum alloys	54
Passenger cars and light trucks	89
Motor vehicle engines and parts	56
Lumber and other sawmill products	54
Pharmaceutical and medicinal products	61

*Average over 2019 and 2021

Source: Statistics Canada tables 12-10-0170-01 and 36-10-0488-01.

of 7% of real exports and 5.4% of real imports by 2029. The reduction in exports relative to the baseline could be up to 50% for steel and aluminum, 20% for automobiles and 30% for automobile parts. The drops in trade would be front-end loaded. The tarrifs would lower **Ontario's real GDP by 1.8% in 2026 and by 2% by 2029**. Cumulative job losses would be 119,200 by 2026 and 137,900 by 2029. Other industries that export a large share of their output to the United States, including softwood lumber and pharmaceuticals, are also highly vulnerable to U.S. import duties or tariffs that could be added over the next months or years.[16]

The impact of tariffs for Canada is amplified by at least three key factors of uncertainty:

- **Uncertainty about the direction of tariffs, the decisions of courts respecting the tariffs and the outcome of trade negotiations.** The tariff decisions of the President are largely unpredictable, and the strategic frame and end game of his negotiations with trading partners are not apparent. If courts strike down tariffs, the administration is clear that it may seek alternative means to impose them. For Canada (and Mexico), there is no clarity on how and when negotiations may determine tariffs and the future of the CUSMA.

- **Uncertainty about prospects for the U.S. and global economies.** Tariffs and other policies of the U.S. administration, together with the potential responses of other large economies, including China, create exceptional uncertainty for the U.S. and global economies. The Chair of the Federal Reserve, Jay Powell, has stated that, as trade, immigration, fiscal and regulatory policies continue to evolve, their effects on the U.S. economy remain highly uncertain.[17] In its statement of May 7, the Federal Open Markets Committee (FOMC) of the Federal Reserve observed that uncertainty about the economic outlook has increased further and that the risks of both higher unemployment and higher inflation have risen.[18] For Canada, with or without tariffs, economic prospects in the U.S. and global economies are key drivers of demand and price for our goods and services.

- **Uncertainty about capital markets and financial stability.** In its latest *Financial Stability Report*, the BoC noted the recent bouts of extreme market volatility, including in the U.S. treasuries market. It observed that "near-term unpredictability of US trade and economic policy could cause further market volatility and a sharp repricing in assets, leading to strains on liquidity. In extreme circumstances, market volatility could turn into market dysfunction."[19] In particular, disruption in the market for U.S. treasuries, considered as the world's safe asset, could have significant repercussions on the cost of capital worldwide and, through many channels, on the real economy.

The exceptional levels of policy uncertainty and market volatility to which the economy is exposed are captured by global and U.S. indicators (Chart 1.6).[20]

THE RESPONSES OF BUSINESSES AND GOVERNMENT IN CANADA

As described further in Chapter 2, uncertainty together with tariffs may be expected to weigh heavily on consumer and business confidence and on short-term economic performance.

A Canadian business can hesitate in undertaking an investment in productive capacity because many factors that will affect returns on its investment are difficult to predict, including:

- if and at what rate the share of its production aimed for the U.S. market may be subject to a **U.S. import tariff**;
- if and at what rate the capital goods or inputs that the business wishes to import may be subject to a **Canadian import tariff**—and, if so, whether the business will be eligible for a tariff exemption or remission;
- how **U.S., global and domestic demand** for the product may evolve in an uncertain way;
- how the ***cost of financing*** of the investment may be affected by capital market developments in the United States and Canada;
- how the **Canada–U.S. exchange rate** may be affected by such developments and in turn modify export revenue and import costs; and
- whether and at what conditions policy may deliver **exceptional financial support** under adverse scenarios.

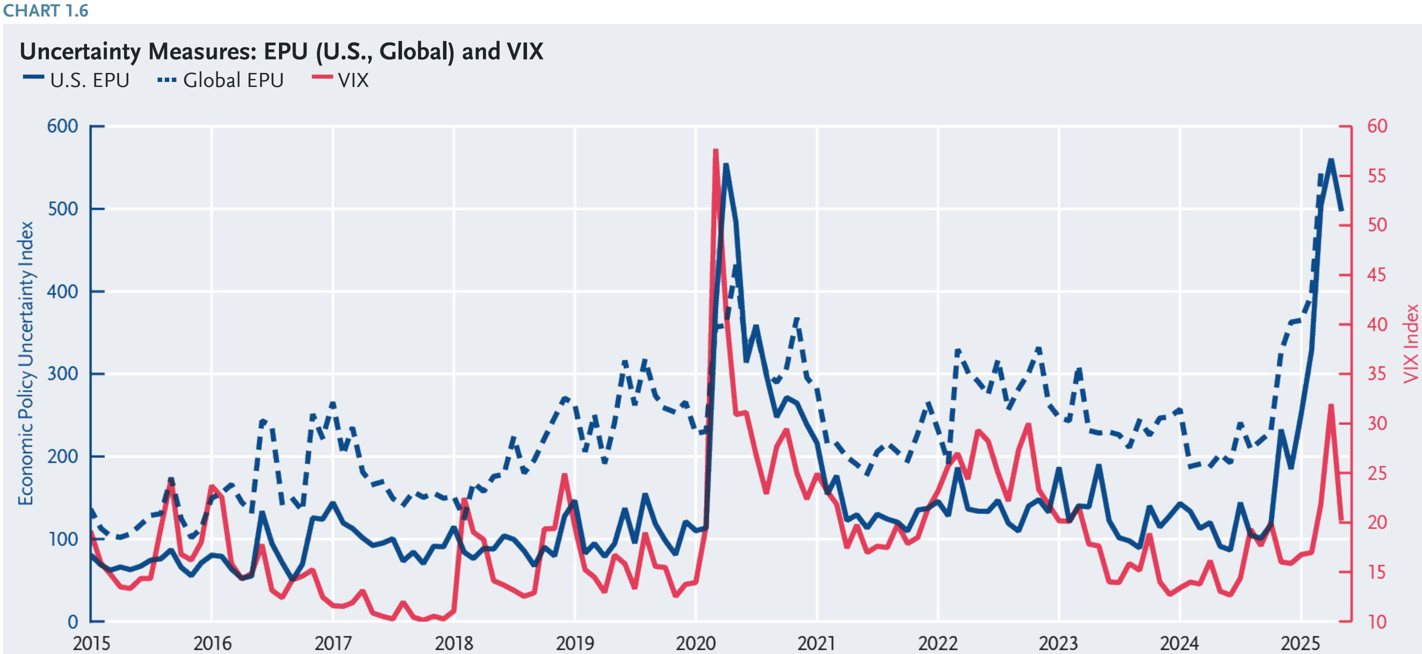
A priority for the Prime Minister and the government is to engage with the U.S. President and his administration to achieve a greater measure of stability and mutual advantage in the bilateral relationship, ideally with Mexico under the CUSMA.

Concurrently, a responsive and well-calibrated policy response is required to address the economic slowdown and risk of recession caused in the short term by the trade disruptions and uncertainty.

GOALS FOR EARLY ENGAGEMENT WITH THE U.S. ADMINISTRATION

It is difficult to predict the outcome of discussions with the President and his administration. The tone of the first meeting between the Prime Minister Carney and President Trump and their respective teams on May 6 was constructive, but no substantive progress was announced.

CHART 1.6



Sources: policyuncertainty.com and Federal Reserve Bank of St. Louis.

The Prime Minister has indicated that he wishes to address immediate trade pressures and to work towards building a new economic and security relationship with the United States. He has also indicated that he will not negotiate in public.

One may expect that an immediate goal is to bring as early as may be feasible a measure of clarity and predictability to the bilateral relationship, by, to the greatest extent possible:

- eliminating or reducing tariffs and the threat of tariffs, except under specific provisions and where justified under the CUSMA and the rules of the WTO;
- providing that integrated industries like automotive vehicles and parts and energy may continue to prosper on both sides of the border and contribute to efficient and secure supply chains and a stronger North American economy;
- establishing a process, principles and goals for the mandated review of the CUSMA by 2026, preferably earlier;
- agreeing on a framework for collaboration on security, including NORAD and the defence of the Arctic, requiring from Canada a concrete plan and timeline to meet the NATO defence spending target of 2% of GDP (or as adjusted higher by NATO at its Summit on June 24 to 25);
- in this regard, handling the delicate issue of the President's invitation to participate in the Golden Dome missile defence system—a project that could represent immense costs with uncertain economic and security dividends for Canada; and
- building co-operation in other economic and strategic domains, including critical minerals and supply chains.

It is not in Canada's interest to abandon, weaken or undermine the comprehensive framework of the CUSMA in favour of quick bespoke deals, such as negotiated by the UK, that will not resolve trade uncertainty. The art of negotiation involves compromise but not in the form of concessions on key principles in return for ephemeral or uncertain gains.

Similarly, it is in the strong interest of Canada to safeguard arrangements that facilitate bilateral investment flows, in particular the Canada–United States Tax Treaty. The "big, beautiful" bill passed by the House of Representatives includes a provision that could override the Treaty and impede investment flows. The bill proposes to levy additional taxes on corporations, individuals and governments of countries that impose "discriminatory or extraterritorial taxes" on U.S. citizens, for example, a digital services tax (DST) such as legislated by Canada in 2024. Clearly, the DST and retaliatory measures such as proposed by the House will be part of the bilateral negotiations.

While the President has suggested that the United States does not need Canada, in fact there is much that we bring to the relationship, and all our assets can be leveraged to secure an agreement. The integration of key industries strengthens the competitiveness of the North American economy in global competition. A secure and reliable supply of energy and critical minerals (including uranium, potash, as well as copper, nickel, zinc and other critical mineral inputs to defence technologies) has economic and strategic value to the United States. A Team Canada approach requires that we leverage assets from across the country in the negotiations to advance our national interest.

The United States may expect alignment on an approach to trade with China; Canada will need to ensure that any arrangement respects our sovereignty and meets our national interest. The economic and national security interests of Canada and the United States can align in the pursuit of secure supply chains in strategic industries, including steel, aluminum, critical minerals and the EV industry. However, as a general proposition, Canada must retain its capacity to decide trade arrangements with other partners, including China.

THE RESPONSE TO A DOWNTURN: MONETARY AND FISCAL POLICY CONSTRAINTS

The monetary and fiscal policy response to a downturn or recession caused by the tariff war, trade policy uncertainty and related disruptions in capital markets will have to be calibrated and structured in ways very different than the response to COVID.

The response to COVID was executed within a frame where policy authorities in the G7 agreed to use all appropriate policy tools to safeguard against downside risks and to sustain the economy during the pandemic.[21]

- At the onset of the pandemic, the BoC cut the policy rate by 50 basis points on three successive dates in March 2020, bringing the rate down from 1.75% to 0.25%. The Federal Reserve similarly cut the target Fed funds rate by 150 basis points to near zero during the same period. Policy interest rates stayed at these low levels until early 2022.
- The Canadian fiscal response comprised exceptional transfers to workers and to businesses that together with automatic stabilizers caused the federal deficit to spike to 14.8% of GDP in 2020–2021, from 1.7% of GDP the previous year. The federal deficit eased in 2021–2022 to 3.6% of GDP. In the United States, the federal deficit tripled in 2020 to over US$3 trillion, or about 15% of GDP.

Amid a tariff war, central banks are likely to have less room to respond to an economic downturn. The BoC will be attentive to both the downward pressures on inflation from a weaker economy and the upward pressures on inflation from higher costs that may result from reciprocal tariffs and disruptions in global supply chains. The Federal Reserve is concerned with risks to both sides of its dual mandate of maximum employment and price stability. If the balance of risks in Canada justifies a greater easing of policy than in the United States, the BoC may also be constrained by the extent of market tolerance for a divergence of policy rates between the two economies. The BoC policy rate, at 2.75% since March 12, 2025, is already low compared with a target range for the Fed funds rate of 4.25% to 4.5% since December 2024.

Similarly, greater fiscal restraint would be expected from the GoC in delivering support to workers and businesses. An imminent downturn or recession is likely to be far less severe and more concentrated in specific sectors and regions than during the pandemic. Thus, the fiscal response can be more targeted and limited. As detailed in Chapter 4, the government will have to be concerned with the sustainability of public finances given a higher debt-to-GDP ratio than in 2020, a higher cost of debt and multiple ongoing fiscal pressures. The government has committed to allocate 100% of tariff revenue to workers and businesses affected by the tariffs. This could represent a sensible ceiling for exceptional assistance as well as a floor.

Importantly, unlike during COVID when fiscal transfers aimed to support workers and businesses until the economy returned to normal, in this case policy should quickly focus on facilitating adjustment to evolving employment and business conditions. In the best of cases, negotiations with the United States may restore the bilateral trade relationship to something resembling the *status quo ante*. But there is no assurance that this will be the case, and businesses and workers in sectors and regions most affected must be equipped to pivot to other market and employment opportunities.

LOOKING AHEAD

It is this extraordinary set of U.S., Canadian and global policy and market circumstances that is the backdrop to our review of U.S. and Canadian economic prospects and risks in Chapter 2.

In a world of disruption and uncertainty, the best assistance for workers and businesses affected by a tariff war will flow from policies and business strategies that build resilience and productive capacity in the medium to long term. This is addressed in Chapter 3.

BOX 1.1

Extraordinary U.S. Tariff Measures (as of June 4, 2025) – Summary Table[1]

Note: This table is provided for summary reference purposes only, is not comprehensive and may not be complete as to applicable exemptions, exclusions or scope of the referenced measures. Legal advice should be sought to confirm the scope and applicability of tariffs to particular organizations or products. This table does not include regular customs duties, or trade remedies in force affecting certain goods, such as softwood lumber from Canada.

Category	Goods Affected	Tariff Rate	Legal Mechanism	Status
Canada				
"Northern Border Emergency" Tariffs	All goods originating in Canada for which USMCA (CUSMA) tariff preference is not claimed, but excluding goods subject to S. 232 tariffs or investigations.	• 10% for energy products, critical minerals and potash • 25% for all other goods	IEEPA Executive Order (EO) 14193, *Imposing Duties to Address the Flow of Illicit Drugs Across Our Northern Border*, 90 FR 9113, 9114 (Feb. 1, 2025), as amended.	In force since March 4, 2025. Overturned by Court of International Trade and DC District Court—Decisions under appeal with temporary stays granted pending appeal.
All Countries (including Canada)				
"Reciprocal" Tariffs	All goods, excluding goods subject to S. 232 investigations or tariffs.	• 10% baseline rate • Countries listed in Annex I of EO 14257 will be subject to different tariff rates starting on July 9, 2025 • 20% tariff rate proposed for EU (with threats of up to 50%)	IEEPA EO 14257, *Regulating Imports With a Reciprocal Tariff to Rectify Trade Practices That Contribute to Large and Persistent Annual United States Goods Trade Deficits*, 90 FR 15041, 15045 (Apr. 2, 2025), as amended.	Baseline rate in force since April 2, 2025. Country-specific rates scheduled to enter into effect July 9, 2025.

1. Most of these tariff measures are "non-stacking" meaning that if an article is subject to a particular tariff, it will not be subject to further tariffs, within a specified hierarchy. See e.g. EO 14289, *Addressing Certain Tariffs on Imported Articles* [Internet], 90 FR 18907, April 29, 2025.

Category	Goods Affected	Tariff Rate	Legal Mechanism	Status
All Countries (including Canada) *(continued)*				
Steel and Aluminum Tariffs	Steel and aluminum products and the steel and aluminum content in certain derivative products, as listed in Annex I to Proclamations 10895 and 10986.	• 50%	S. 232 of the *Trade Expansion Act* of 1962. Proclamation 9704, *Adjusting Imports of Aluminum Into the United States*, 83 FR 11619 (Mar. 8, 2018), as amended. Proclamation 9705, *Adjusting Imports of Steel Into the United States*, 83 FR 11625 (Mar. 8, 2018), as amended. Proclamation 10895, *Adjusting Imports of Aluminum Into the United States*, 90 FR 9807 (Feb. 10, 2025), as amended. Proclamation 10896, *Adjusting Imports of Steel Into the United States*, 90 FR 9817 (Feb. 10, 2025), as amended.	In force since 2018, but an exemption for Canada was negotiated in 2019. On March 12, 2025, the previous exceptions for Canada, EU and others were revoked and a tariff on steel came into effect at 25%, tariff rate for aluminum increased from 10% to 25%, and new derivative products were added to the list. On June 4, 2025, the rate was increased to 50% (and 25% for the UK).
Automotive Tariffs	Automobiles and auto parts listed in Annex I to Proclamation 10908, non-U.S. content only and excluding entirely goods for which USMCA (CUSMA) tariff preference is claimed.	• 25%	S. 232 of the *Trade Expansion Act* of 1962. Proclamation 9888, *Adjusting Imports of Automobiles and Automobile Parts Into the United States*, 84 FR 23433 (May 17, 2019). Proclamation 10908, *Adjusting Imports of Automobiles and Automobile Parts Into the United States*, 90 FR 14705 (Mar. 26, 2025), as amended.	March 26, 2025, for the non-U.S. content of auto parts that do not qualify for USMCA. S.232 report was completed in 2019, but tariffs were not imposed at that time.
Copper Tariffs	Copper in all forms, including, but not limited to, raw mined copper; copper concentrates; refined copper; copper alloys; scrap copper; and derivative products.	• TBD	S. 232 of the *Trade Expansion Act* of 1962.	Not yet in force. S. 232 study initiated on March 10, 2025.
Wood Products Tariffs	Timber, lumber, and their derivative products.	• TBD	S. 232 of the *Trade Expansion Act* of 1962.	Not yet in force. S. 232 study initiated on March 10, 2025.
Semiconductor Tariffs	Semiconductors and semiconductor-manufacturing equipment and their derivative products.	• TBD	S. 232 of the *Trade Expansion Act* of 1962.	Not yet in force. S. 232 study initiated on April 1, 2025
Pharmaceutical Tariffs	Pharmaceuticals and pharmaceutical ingredients, including finished drug products, medical countermeasures, critical inputs such as active pharmaceutical ingredients, key starting materials, and derivative products of those items.	• TBD	S. 232 of the *Trade Expansion Act* of 1962.	Not yet in force. S. 232 study initiated on April 1, 2025.
Truck Tariffs	Medium-duty trucks, heavy-duty trucks and medium- and heavy-duty truck parts, and their derivative products.	• TBD	S. 232 of the *Trade Expansion Act* of 1962.	Not yet in force. S. 232 study initiated on April 22, 2025.
Critical Mineral Tariffs	Processed critical minerals (including but not limited to rare earths), uranium and their derivative products. "Critical minerals" includes minerals included in the "Critical Minerals List" published by the United States Geological Survey (USGS) pursuant to section 7002(c) of the *Energy Act* of 2020 (30 U.S.C. 1606) at 87 FR 10381, and uranium.	• Section 232 of the *Trade Expansion Act* of 1962	Not yet in force. S. 232 study initiated.	Not yet in force. S. 232 study initiated on April 22, 2025.
Civil Aircraft and Engines Tariffs	Commercial aircraft and jet engines, and parts for commercial aircraft and jet engines.	• TBD	S. 232 of the *Trade Expansion Act* of 1962.	Not yet in force. S. 232 study initiated on May 1, 2025.
Movies	Films produced outside of the United States.	• 100% (proposed)	TBD	Not yet in force. Announcement via Truth Social on May 4, 2025.

Category	Goods Affected	Tariff Rate	Legal Mechanism	Status
China				
Forced Technology Transfer Tariffs	Various products. Four lists in force.	• 7.5% to 100%	S. 301 of the *Trade Act* of 1974. List 1: Regulations.gov Docket ID: USTR-2018-0005. List 2: Regulations.gov Docket ID: USTR-2018-0018. List 3: Regulations.gov Docket ID: USTR-2018-0026. List 4A: Regulations.gov Docket ID: USTR-2019-0004. (and various amendments to same).	In force since 2018, with various exclusions and additions to the affected product lists over time.
"Fentanyl Trafficking" Tariffs	All goods originating in China.	• 20% • Different rates may apply for *de minimis* or postal shipments	IEEPA EO 14195, *Imposing Duties to Address the Synthetic Opioid Supply Chain in the People's Republic of China*, 90 FR 9121, 9122 (Feb. 1, 2025), as amended.	In force since Feb. 4, 2025. Overturned by Court of International Trade and DC District Court—Decisions under appeal with temporary stays granted pending appeal.
Semiconductor Tariffs	Foundational semiconductors (also known as legacy or mature node semiconductors), including to the extent that they are incorporated as components into downstream products for critical industries like defense, automotive, medical devices, aerospace, telecommunications, and power generation and the electrical grid.	• TBD	S. 301 of the Trade Act of 1974. Initiation of S. 301 Investigation; Hearing; and Request for Public Comments: *China's Acts, Policies, and Practices Related to Targeting of the Semiconductor Industry for Dominance*, 89 FR 106725 (Dec. 30, 2024) (initiated on December 23, 2024).	Not yet in force. S. 301 investigation initiated in December 2024.
Shipbuilding	Services fees on the maritime transport services of Chinese operators and shipowners, operators using Chinese-built vessels, operators of foreign-built vehicle carriers and restrictions on certain maritime transport services for U.S. LNG, and tariffs on certain ship-to-shore cranes and certain other cargo-handling equipment of China.	• Fees of US$500,000 to US$1.5 million each time a ship docks at a U.S. port (proposed)	S. 301 of the *Trade Act* of 1974. Notice of Initiation of Section 301 Investigation: *China's Acts, Policies, and Practices Targeting the Maritime, Logistics, and Shipbuilding Sectors for Dominance*, 89 FR 29424 (Apr. 22, 2024) Docket Nos. USTR–2024–0004, USTR–2024–0005. Notice of Action and Proposed Action in Section 301 Investigation: *China's Targeting the Maritime, Logistics, and Shipbuilding Sectors for Dominance*, Request for Comments, 90 FR 17114 (April 23, 2025).	Not yet in force. S. 301 investigation initiated in April 2024.
Mexico				
"Southern Border Emergency" Tariffs	All goods originating in Mexico for which USMCA (T-MEC) tariff preference is not claimed but excluding goods subject to S. 232 tariffs or investigations.	• 10% on potash • 25% on all other goods	IEEPA EO 14194, *Imposing Duties To Address the Situation at Our Southern Border*, 90 FR 9117 (Feb. 1, 2025), as amended.	In force since March 4, 2025. Overturned by Court of International Trade and DC District Court—Decisions under appeal with temporary stays granted pending appeal.

CHAPTER 2

Prospects for the U.S. and Canadian Economies to the End of 2027

Short-term prospects for the U.S. and Canadian economies are unusually dependent on assumptions about U.S. trade and economic policy as well as on judgment about the impact of uncertainty on household and business spending and investment.

Accordingly, there is a wide range of plausible scenarios for growth, inflation and interest rates in the two economies in the second half of 2025 and in 2026 and 2027.

We have constructed a baseline scenario by assuming that by the end of 2025 the United States will conclude trade agreements with its major economic partners, including Canada. The agreements will reduce uncertainty and lessen, but not eliminate all, U.S. import tariffs. Canada will still be subject to some tariffs.

Under our baseline scenario, the U.S. economy slows down in the second half of 2025, but it does not undergo a recession. The economy picks up momentum in 2026 and 2027.

- On a Q4-to-Q4 basis, real GDP growth falls from 2.5% during 2024 to 1.1% during 2025, before rising to 1.7% during 2026 and 2.2% during 2027.
- U.S. core PCE inflation peaks at, or close to, 3.5% by the end of 2025 and then declines progressively to around 2% by the end of 2027.
- With the slowing of the economy and with greater clarity on inflation trends, the Federal Reserve cuts its policy rate by 25 basis points by the end of 2025 and again three times by July 2026, bringing the Fed funds rate (upper limit) to 3.5%.
- Despite the reduction in inflation and the cuts in the policy rate, the 10-year U.S. treasury yield stays at roughly the current level of 4.5% over the planning horizon as markets remain sensitive to the size and growth of U.S. public debt.

The profile of growth is roughly similar for Canada under our baseline scenario, but we expect a technical recession in the middle quarters of 2025.

- On a Q4-to-Q4 basis, growth would fall sharply from 2.3% in 2024 to 0.3% in 2025 before rising to 1.8% in 2026 and 2% in 2027.
- Headline CPI inflation remains at or very close to the BoC's 2% target over the planning horizon.
- The BoC lowers its policy rate from 2.75% in June 2025 to 2.25% by December 2025. Given assumptions in our baseline scenario, we project the policy rate to hold at 2.25% in 2026 and 2027.
- 10-year GoC bond yields, at about 3.2%, maintain a differential of some 130 basis points relative to the yield on U.S. treasuries.

We consider that the risks to our baseline scenario to be mostly to the downside. Growth in Canada will be worse, and a recession potentially more severe, if the United States maintains or even ratchets up its tariffs, if no trade agreement is concluded and uncertainty prevails, or if there is an escalation of a trade war between the United States and China that provokes a decoupling of the world's two largest economies, with significant losses of efficiency across supply chains.

A quick resolution of trade tensions that would bolster global trade and activity is an upside risk, but one to which we ascribe a low probability.

I. RECENT DEVELOPMENTS

A. Growth in the United States and Canada

After growing at an annualized rate of 2.4% in the fourth quarter (Q4 2024), real GDP in the United States contracted by 0.2% in Q1 2025 as imports surged to get ahead of upcoming U.S. tariffs (Table 2.1). The headline growth number in the first quarter did not reveal a clear direction for an economy that to date has maintained strong underlying momentum. Part of the surge in imports fed into a marked increase in inventory investment. There was a sharp rebound in business non-residential investment, concentrated in equipment, at the same time as a pronounced slowing of household consumption and a slight decline in housing. Altogether, growth in final sales to private domestic purchasers, a measure of "core" GDP, was 2.5% compared with around 3% during 2024. A decline in government spending depressed GDP slightly in the first quarter, and this for the first time since mid-2022.

TABLE 2.1

Real GDP Growth Rate – s.a.a.r.: %

	2024				2025
	Q1	Q2	Q3	Q4	Q1
United States	1.6	3.0	3.1	2.4	-0.2
Canada	2.1	2.5	2.4	2.1	2.2

Sources: Statistics Canada and U.S. Bureau of Economic Analysis

In Canada, real GDP growth in Q1 2025 slightly exceeded 2% for a fifth consecutive quarter, but only because of an accelerated build-up of inventories and, to a lesser extent, a rise in net exports; final domestic demand was flat in the first quarter after growing at an average rate of 3.5% during 2024. Final domestic demand was depressed by a drop in housing, concentrated in resales, and by declines in durables consumption, non-residential structures and government investment. At the same time, there was robust growth in consumption of goods, excluding durables, and in investment in machinery and equipment. Exports and imports of goods grew equally rapidly against the threat of tariffs, while imports of services fell much faster than exports, in part because of a drop in Canadian travel to the United States.

B. The Labour Market

The U.S. economy is basically at full employment. Employment has continued to grow significantly, and the unemployment rate has been stable at just over 4% over the past year (Table 2.2). Job vacancies continue to slightly exceed unemployment, consistent with full employment. Gains in average hourly earnings in the first months of 2025, at just under 4% year-over-year, are slightly below the gains in Q4 2024, but they are still reasonably robust.

In Canada, after a period of stability there has been increasing slack in the labour market since March. Employment has retreated and the unemployment rate has steadily increased. The ratio of job vacancies to unemployed workers has been languishing at a little over one-third from August 2024 to last March, its lowest level since the end of 2020. Yearly gains in average hourly earnings, as revealed by the Labour Force Survey, have been trending down since June 2024, responding slowly, and with appreciable lags, to declining headline CPI inflation.

TABLE 2.2

Labour Market Tightness and Wage Inflation in the United States and Canada

	Jan. 25	Feb. 25	Mar. 25	Apr. 25
United States				
Employment – m/m% s.a.a.r	0.8	0.8	1.4	1.3
Unemployment rate – s.a.	4.0	4.1	4.2	4.2
Job vacancies per unemployed	1.1	1.1	1.0	
Average hourly earnings – y/y% s.a.	3.9	3.9	3.8	3.8
Canada				
Employment – m/m% s.a.a.r	4.4	0.1	-1.8	0.4
Unemployment rate – s.a.	6.6	6.6	6.7	6.9
Job vacancies per unemployed	0.35	0.36	0.35	
LFS average hourly earnings – y/y% not s.a.	3.5	3.8	3.6	3.4

Sources: U.S. Bureau of Labor Statistics and Statistics Canada tables 14-10-0406-01, 14-10-0287 and 14-10-0426-01.

C. Inflation

In the United States, both headline and core inflation diminished in the first months of 2025; however, they remain above the 2% target, and tariffs are now exerting upward pressure (Table 2.3). The headline U.S. CPI diminished steadily year-over-year partly due to reduced gasoline prices, but it was pushed up in April relative to March because of the early effect of new tariffs on the prices of imported goods. Core inflation, based on the index for Personal Consumption Expenditures Excluding Food and Energy (PCEXFE), which is closely watched by the Federal Reserve, has declined on a year-over-year basis from 2.9% in February to 2.5% in April, the lowest level since March 2021. On a three-month annualized basis, PCEXFE inflation jumped to 4.1% in February, before retreating to 2.7% by April. As tariffs are still working their way through the economy and are yet to be fully reflected in prices, there are worrying signals that core inflation remains in excess of the 2% target.

In Canada, headline CPI inflation has fluctuated around 2.3% during the first quarter before dropping to 1.7% in April, but core inflation has risen steadily since last December to reach 3.2% in April. The sharp fall in headline inflation in April was mostly attributable to a drop in the prices of gasoline and other fuels, in turn reflecting the removal of the consumer carbon tax. By contrast, the measure of year-over-year core inflation watched by the BoC, the average of CPI-median and CPI-trim (CPI-M&T), has climbed from 2.6% in December to 3.2% in April. While the same measure on a three-month annualized basis has been stable at around 3.2% since October 2024, on a month-to-month annualized basis it jumped to 4.6% in April, marking a sharp rise in core inflation that surprised both the BoC and the market. In its upcoming decisions, the BoC will have to assess carefully underlying price trends amid heightened volatility.

TABLE 2.3

Consumer Price Inflation in the United States and Canada

	Jan. 25	Feb. 25	Mar. 25	Apr. 25
United States				
CPI—all items, 12-month	3.0	2.8	2.4	2.3
CPI—all items, 1-month s.a.a.r.	5.7	2.6	-0.6	2.7
Core inflation: PCEXFE, 12-month	2.7	2.9	2.7	2.5
Canada				
CPI—all items, 12-month	1.9	2.6	2.3	1.7
CPI—all items, 1-month s.a.a.r.	2.2	7.6	-0.7	-2.9
Core inflation: CPI-M&T, 12-month	2.7	2.9	2.9	3.2
3-Month SAAR %	**Jan. 25**	**Feb. 25**	**Mar. 25**	**Apr. 25**
United States				
Core inflation: PCEXFE	2.6	4.1	3.6	2.7
Canada				
Core inflation: CPI-M&T	3.2	3.4	2.9	3.4

PCEXFE : Chain-type price index for personal consumption expenditures excluding food and energy.
CPI-M&T: average of the CPI-median and CPI-trim measures designed by the Bank of Canada.

Sources: Statistics Canada, tables 18-10-0004-01 and 18-10-0256-01, U.S. Bureau of Labor Statistics and U.S. Bureau of Economic Analysis.

D. Interest Rates and Exchange Rates

The U.S. policy interest rate has remained unchanged at 4.5% (upper limit) since mid-December 2024, but long-term bond yields, after retreating from January peaks, rose again with heightened worries about tariffs and more recently about fiscal deficits and debt (Table 2.4). In the face of increased risks of both slower economic growth and higher inflation stemming from new tariffs, the Federal Reserve went on pause after its mid-December decision. Its purpose has been to gain more clarity about the effect of tariffs in a context in which: core inflation has remained above the 2% target; growth in final private domestic demand (core GDP) has been robust; and the labour market has remained strong. As market expectations of weaker growth, if not recession, gained ascendancy, long-term bond yields declined from their January peaks. After fluctuating sharply in April around the on-again, off-again tariff decisions of President Trump, they rose in May as the "big, beautiful" tax and spending bill passed the House of Representatives, elevating concerns about the growth of the public debt and diminishing confidence in the management of the U.S. economy.

TABLE 2.4

Key Financial Rate for the United States and Canada in 2025

	Jan.	Feb.	Mar.	Apr.	May
Fed funds rate (upper limit)	4.50	4.50	4.50	4.50	4.50
BoC policy rate - %	3.0	3.0	2.75	2.75	2.75
U.S. 10-year treasury yield - %	4.6	4.5	4.3	4.3	4.4
10-year Canada bond yield (%)	3.0	3.1	3.0	3.1	3.2
U.S. dollar per Canadian dollar	0.69	0.70	0.70	0.71	0.72
Nominal advanced economies U.S. dollar index	1.3	-1.0	-2.1	-3.2	-0.5

Sources: Statistics Canada, Bank of Canada and Federal Reserve

In Canada, the policy interest rate was cut twice in the first quarter of 2025 to 2.75% and was unchanged in April through June. As of early June, the Canada–U.S. policy rate differential was -175 basis points (upper limit), an exceptionally wide negative gap. Meanwhile, the 10-year Canada bond yield edged up in April and May, maintaining a negative differential of about 120 basis points relative to the yield on U.S. treasuries over this period.

The Canadian dollar bottomed out at US$0.69 in February and slowly recovered to US$0.72 by May. The recent gains partly reflect a multilateral depreciation of the U.S. dollar, which can itself be explained by the reaction of global markets to tariffs, policy uncertainty, diminishing U.S. growth prospects and rising U.S. government debt, all affecting confidence in U.S. dollar assets.

II. SCENARIOS

As outlined in Chapter 1, tariffs and uncertainty will both be shaping economic developments in the United States, globally and in Canada over the following months and years. U.S. import tariffs, if sustained and/or lifted further, will exert upward pressure on U.S. prices, reduce real incomes and depress domestic demand. While some U.S. businesses may benefit from import substitution, most U.S. producers will suffer from increased costs, weaker domestic and global demand as well as from the retaliatory measures of the United States' trading partners. For Canada, impacts will arise from the loss of exports due to tariffs and weaker U.S. demand. Employment losses will be concentrated in directly affected industries. While retaliatory measures may be required to pressure the administration towards an early and satisfactory resolution of the trade tensions, those measures, if sustained, will also have net negative effects on our economy. Critically, until there is some resolution to the current trade tensions, persistent uncertainty will discourage business investment and household spending.

Given extraordinary uncertainty, there is a wide range of plausible scenarios for the U.S. and Canadian economies over the next quarters, with very different sizes and profiles of changes in output, prices and interest rates. Plausible scenarios include a mild or deeper recession in the United States as well as scenarios where the U.S. economy continues to draw for growth on its remarkable innovation and adaptation capacity. For Canada, a marked slowdown in 2025 is virtually certain, but how deep and how long it may be is far less certain.

The core assumption that underpins our baseline scenario is that trade agreements will be concluded, including between the United States and Canada, by the end of 2025 to reduce uncertainty and to lessen, but not eliminate, all tariffs on goods. Some resolution on the tariff and trade front would revive confidence and, together with an easing of financial conditions, support domestic demand in the two economies. In Canada's case, it is impossible to predict the outcome of bilateral (and trilateral, with Mexico) negotiations, including when or how such negotiations may alter the text and the functioning of the CUSMA, which must be reviewed by the parties by 2026. While the strong Canadian preference is an elimination of tariffs and the continuation of the CUSMA, possibly with some amendments, a prudent assumption for planning purposes is that negotiations fall short of this result and that some U.S. tariffs remain. In turn, outstanding trade barriers would force structural adjustment in some sectors and regions, imposing costs, including higher unemployment.

A. The Global Context

In its April 2025 *World Economic Outlook*, developed shortly after "Liberation Day," the International Monetary Fund (IMF) acknowledged the difficulty of constructing a central outlook for the world economy.

Taking tariffs and uncertainty into account, the IMF projected real global GDP growth of 2.8% in 2025 and 3% in 2026, down 0.5 pp and 0.3 pp, respectively, from its outlook of only three months earlier. For 2025, this would represent a sharp drop from 3.3% in 2024 and the lowest rate of growth since 2009 if one excludes 2020 when COVID hit. In advanced economies, the drop in growth would be especially salient for the United States, which had been outpacing its peers in prior years. In the Euro area, growth would remain weak, at around 1% in both years. Japan would also grow at an anemic rate of 0.6% in both years, although this would be up from 0.1% in 2024. In emerging and developing economies, growth would slow relative to 2024, and relative to the IMF scenario of January, reflecting the generalized negative impact of tariffs and uncertainty. In China, growth would drop from 5% in 2024 to 4% in 2025 and 2026. India would fare better; it would continue to grow at a rate of over 6%. Of course, with this scenario, the IMF also adjusted downwards its projection for growth in the volume of global trade in goods and services to 1.7% and 2.5% in 2025 and 2026, respectively. It projected drops in both years in the price of oil. We observe that as at the end of May, West Texas Intermediate (WTI) oil futures hovered at around US$60, slightly below the spot price. Clearly, other commodity prices will be sensitive to global growth and in some cases, such as for forestry products or critical minerals, they may also be affected by tariffs or trade restrictions and by corresponding effects on the volumes of trade.

B. United States

1. Outlook for Growth

The outlook for growth in the United States is unusually driven by U.S. policy. This includes tariffs, of course, but also:

- **Fiscal policy,** as it may affect domestic demand directly through the changes in the fiscal deficit (the fiscal impulse) and indirectly through the response of businesses, consumers and capital markets to the changes of policy and to the fiscal track. The administration insists that tax cuts in the "big, beautiful" bill will incentivize spending and investment, and stimulate growth. However, faster debt accumulation can push U.S. treasury bond yields up and raise borrowing costs for all borrowers, depressing growth.
- **Monetary policy,** as the Federal Reserve addresses the delicate task of fulfilling its dual mandate of maximum employment and stable prices under circumstances where it will confront both a slowing of the economy and inflationary pressures.
- A massive **deportation of undocumented immigrants** (as well as lower immigration), which can affect the supply of labour in some industries and, in some measure, reduce both investment and household consumption.
- A significant **compression of the federal civil service**, which can result in higher unemployment and affect consumer confidence (because of the fear of losing a job) and spending.
- A bold agenda of **regulatory easing**, especially in energy and finance, which may stimulate entrepreneurship, investment (including foreign direct investment) and innovation, albeit with potentially higher systemic risks (e.g., impacts of cryptocurrencies on financial stability).

In our baseline scenario, there is no U.S. recession, but growth slows sharply during 2025 before accelerating in 2026 onto a pace above 2% by 2027 (Table 2.5). On a Q4-to-Q4 basis, real GDP growth falls from 2.5% during 2024 to 1.1% during 2025, before rising to 1.7% during 2026 and

2.2% during 2027. On a year-over-year basis, growth would average 1.6% in 2025, 1.4% in 2026 and 2.1% in 2027. The quarter-by-quarter profile that we envisage has the seasonally adjusted annual rate of growth hit bottom in Q4 2025 at 0.8% and stay positive through 2026; the negative quarter in Q1 2025 would be a one-time anomaly (Table 2.6).

TABLE 2.5

U.S. Real GDP Growth (%)

	2024	2025	2026	2027
Y/Y %	2.8	1.6	1.4	2.1
Q4/Q4 %	2.5	1.1	1.7	2.2

TABLE 2.6

Annualized Quarterly Growth Rate of U.S. Real GDP (%)

2025				2026			
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
-0.2	2.5	1.2	0.8	1.2	1.7	2	2

2. Outlook for Core Inflation and Interest Rates

Core U.S. PCE inflation is expected to rise from 2.5% in April 2025 but peak at or close to 3.5% by the end of 2025 and progressively subside to around 2% by the end of 2027. In this context, and as the impact of policies on inflation and growth becomes clearer, the Federal Reserve would cut its policy rate by 25 basis points once in 2025 and three times again by July 2026 (Table 2.7). Since growth would be strengthening and inflation subsiding in the first half of 2026, the interest rate cuts at that time would aim at normalization rather than insurance—returning the rate closer to the neutral rate given better comfort that the economy will be operating at about potential and that inflation is heading toward the 2% target. The policy rate by mid-2026 would be 3.5%, at the upper limit of the range of estimates for the long-term equilibrium rate. Weighed down by lower expected short-term rates and inflation but at the same time boosted by large government deficits and rising debt, the 10-year treasury yield would remain close to 4.5% over the next two years.

TABLE 2.7

U.S. Core Inflation and Interest Rate: Baseline Scenario (%)

December	2024	2025	2026	2027
Core inflation: PCEXFE 12-month	2.9	3.4	2.5	2.1
Fed funds rate (upper limit)	4.5	4.25	3.5	3.5
U.S. 10-year treasury yield - %	4.4	4.5	4.5	4.5

C. Canada

1. Outlook for Growth

The outlook for growth in Canada is driven by U.S. policy, the U.S. outlook, uncertainty and Canadian policy responses.

The effects of shifts in U.S. policy will be felt through different channels in Canada.

- Even more than in the United States, the initiatives of the Trump administration have led to an escalation of uncertainty and a loss of confidence, depressing household consumption and business investment.
- Higher U.S. tariffs will hurt Canadian export volumes. Some exporters may hold onto volumes for some time by reducing prices and margins, but tariffs of 25% or more, if sustained, will sharply limit such possibilities. There can also be some rerouting of Canadian exports to other foreign markets where accessible logistically and economically, but this will also be limited. The net depreciation of the Canadian dollar relative to the U.S. dollar since the third quarter of 2024 can provide some support to net exports, but again this factor will be dwarfed by large tariffs if they are kept or expanded.
- Lower growth in the United States and the rest of the world due to U.S. trade restrictions and collateral uncertainty will also have a negative effect on growth in Canadian exports and GDP. Conversely, once U.S. growth starts picking up in 2026, Canada will start to feel the positive spillovers.[1]
- The U.S. agenda of low taxes and deregulation could induce the migration of Canadian production and investment to the United States if not followed by competing initiatives or forces in Canada. This effect should be modest in the short term, but it could grow and become significant over the medium term.

Policy responses in Canada will provide support to growth in Canada.

- Automatic stabilizers, including lower revenue intake because of depressed incomes and spending, and higher transfer payments because of higher unemployment, will mitigate some of the impacts for households, businesses and the economy. Federal plans that include a middle-income tax cut effective July 1, as well as increased discretionary spending on such items as border security and national defence, will provide some short-term offsets, as will rising provincial spending and investment. Federal plans to collaborate with provinces towards bolstering private investment in infrastructure, energy and critical minerals, and housing may further support confidence and over time overcome other forces depressing private investment.

- The BoC will cut its policy rate further, reducing the costs of new borrowing for households and firms and easing the servicing costs of variable-interest debt.

Our baseline scenario projects a technical recession in Canada during the middle quarters of 2025; however, with some resolution of trade uncertainty by the end of the year and with a strengthening of the U.S. economy in 2026 and 2027, there should be a gradual firming of growth in 2026 and 2027 (Table 2.8). Real GDP growth on a Q4-to-Q4 basis would fall sharply from 2.3% in 2024 to 0.3% in 2025, before rising to 1.8% in 2026 and 2% in 2027. On an average annual basis, growth would remain slightly above 1% in 2025 and 2026 before rising to 2% in 2027. A profile consistent with this scenario would comprise negative growth in Q2 and Q3 2025 and then a recovery beginning in Q4 2025 and strengthening in 2026 (Table 2.9).

TABLE 2.8

Canadian Real GDP Growth (%)

	2024	2025	2026	2027
Y/Y %	1.6	1.1	1.0	2.0
Q4/Q4 %	2.3	0.3	1.8	2.0

TABLE 2.9

Annualized Quarterly Growth Rate of Canadian Real GDP (%)

2025				2026			
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
2.2	-0.9	-0.9	0.7	1.5	1.8	2.0	2.0

Different components of demand will be reacting differently to trade policy tensions, uncertainty and other factors. Business non-residential investment should fall appreciably over the next quarters, especially investment in machinery and equipment after a surge in Q1. The household sector will be weak. Over the rest of 2025, household consumption is likely to grow at an average annualized rate of less than 1%. Housing may well continue to decline although at a lesser rate than observed in Q1. Government expenditures on consumption and investment should pick up after declining in Q1 but probably at a slower pace on average than in the year to Q1 2025. Both exports and imports should decline in response to both tariffs and slower domestic and foreign demand. During 2026 and 2027, overall growth should firm up and broaden in response to diminishing uncertainty, easier financial conditions and strengthening U.S. growth.

Based on budgets released in 2025, the four largest provinces are planning large net borrowings to fund current operations and net capital investments; this will make a significant contribution to Canadian growth in fiscal year 2025–2026 (Table 2.10). The fiscal plans of the four provinces together represent a positive impulse equivalent to 1.3% of Canadian GDP over 2025–2026. If the provincial budgets were executed to plan (a not entirely plausible assumption because some of the underlying economic projections are already out of date), this fiscal impulse would be largely reversed over the next two fiscal years, as the provinces, especially Ontario and Quebec, plan to rein in their budgetary deficits. In addition, Ontario projects net capital investment to fall by over C$4 billion in 2027–2028. We have observed that, while the rising deficits of the provinces can support growth in the short term, there is cause at the same time to be concerned with the sustainability of public finances, an issue addressed in Chapter 4 with a focus on the federal government.

TABLE 2.10

Net Impulse to Growth from Four Provincial Budgets

	2024-25	2025-26	2026-27	2027-28
Quebec—March 25				
Deficit $B.	8.1	11.4	7.1	3.2
Net capital investment $B.	8.0	8.0	8.6	9.3
Total net borrowing $B.	16.1	19.5	15.7	12.5
Change in net borrowing $B.		3.4	-3.7	-3.3
Change as % of Canadian GDP		0.14	-0.15	-0.13
Ontario—May 15				
Deficit $B.	6.0	14.6	7.8	-0.2
Net capital investment $B.	8.6	14.0	14.4	10.0
Total net borrowing $B.	14.6	28.6	22.2	9.8
Change in net borrowing $B.		14.0	-6.4	-12.4
Change as % of Canadian GDP		0.57	-0.26	-0.49
Alberta—February 27				
Deficit $B.	-5.8	5.2	2.4	2
Net capital investment $B.	1.0	1.3	0.9	1.4
Total net borrowing $B.	-4.8	6.5	3.3	3.4
Change in net borrowing $B.		11.3	-3.2	0.1
Change as % of Canadian GDP		0.46	-0.13	0.00
British Columbia—March 4				
Deficit $B.	9.1	10.9	10.2	9.9
Net capital investment $B.	5.3	6.3	7.6	7.6
Total net borrowing $Bb.	14.4	17.2	17.8	17.5
Change in net borrowing $B.		2.8	0.6	-0.3
Change as % of Canadian GDP		0.11	0.02	-0.01
Total—Four provinces				
Change in deficit $B.		24.7	-14.6	-12.7
Change in net capital investment $B.		6.7	1.8	-3.2
Change in net borrowing $B.		31.4	-12.8	-15.9
Change as % of Canadian GDP		1.3	-0.5	-0.6

2. The Outlook for CPI Inflation in Canada

We project headline CPI inflation to be at or very close to the BoC's 2% target over the projection horizon. We see the following main factors acting on Canadian inflation.

- Slack in the economy increases during 2025, and it is absorbed only gradually during 2026 and 2027, exerting downward pressure on inflation but with diminishing intensity after 2025. Weak growth in potential output limits the amount of slack and hence the strength of downward pressure on inflation over the projection period.
- Retaliatory tariffs on imports from the United States feed into higher consumer prices over several quarters, which tend to push headline inflation up slightly but only temporarily.
- Longer-term inflation expectations remain firmly anchored at 2%.
- The Canadian dollar will stabilize relative to the U.S. dollar (Chart 2.1).
- International oil prices are expected to remain depressed over 2025 and part of 2026 before firming up.
- Mortgage interest costs continue to make a diminishing contribution to service inflation with further declines in the policy interest rate.

3. The Outlook for Interest Rates in Canada

We anticipate that the BoC will lower its policy rate from 2.75% in June 2025 to 2.25% by December 2025. It would act after having taken a pause last March, when it aimed to evaluate whether the policy stance properly balanced the upside risks to inflation as outstanding tariffs feed through to domestic prices and the downside risks associated with insufficient demand (Table 2.11). Because of higher debt ratios for the federal government down the road, we see the 10-year Canada bond yield remaining slightly higher than 3%, notwithstanding lower short-term interest rates. This would represent a negative differential of some 130 basis points relative to the U.S. 10-year treasury yield. In this scenario, the Canadian dollar would stabilize relative to the U.S. dollar. The Canadian dollar would be supported by the narrowing of the short-term Canada-U.S. interest rate differential and by a possible further multilateral depreciation of the U.S. dollar due to international portfolio rebalancing in favour of non-U.S.-dollar assets. However, weaker growth and more slack in Canada than in the United States would likely offset these factors.

CHART 2.1

Year-on-Year Inflation and the Policy Rate in Canada

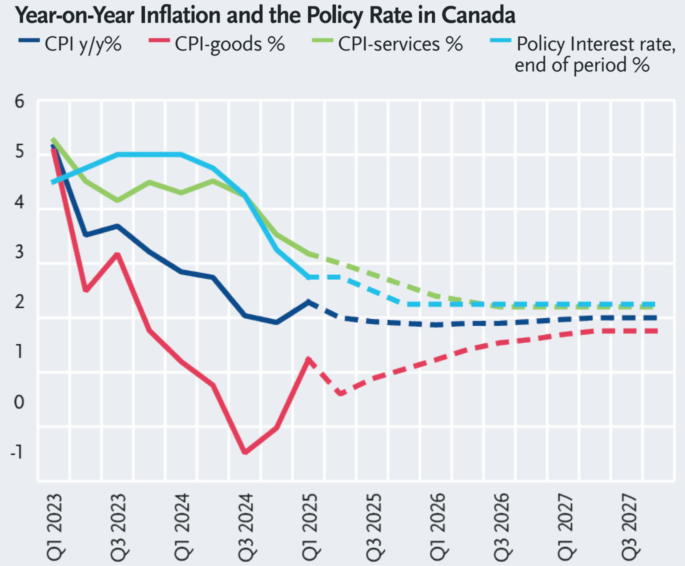


TABLE 2.11

Canadian Interest Rates in the Short Term				
December	2024	2025	2026	2027
BoC policy rate - %	3.25	2.25	2.25	2.25
10-year Canada bond yield - %	3.12	3.2	3.2	3.2
U.S. dollar per Canadian dollar	0.70	0.72	0.72	0.72

III. RISKS TO GROWTH IN CANADA

The policy agenda of the Trump administration creates several risks to economic growth in Canada. Below we elaborate on three main downside risks. These risks are not mutually exclusive. We also discuss a possible upside scenario.

Higher tariffs. Our baseline outlook builds on the view that several of the current tariffs imposed by the United States on imports from Canada are renegotiated to lower levels or zero over time. However, given the unclear objectives of the Trump administration, it is possible that all present tariffs remain at their current levels and that some additional tariffs are imposed. In that case, the possibility of the Canadian economy entering into more than a technical recession over the next year increases greatly, as both demand for goods from the United States and investment decisions in Canada would be affected negatively. Such a recession would be further exacerbated if Canada decided to react to tariffs more strongly than it is currently doing. In particular, expanded retaliatory tariffs would increase inflation in Canada, thereby making it less likely that the BoC would cut interest rates to support employment. Higher and persistent tariffs would also require more structural adjustment in the Canadian economy, causing a greater rise in unemployment because of increased sectoral reallocation.

Heightened uncertainty. Even if no additional tariffs are imposed on the Canadian economy over the next year, in the absence of any clarity on tariff policy, ongoing uncertainty would be an important further drag on the Canadian economy. Investment in Canada would remain depressed because of this uncertainty, and needed structural adjustment would be delayed. Prolonged uncertainty would be further detrimental if it reduced the confidence of Canadian households with respect to employment and long-term growth prospects. Under such a scenario, the BoC would likely decrease interest rates to below 2.25%, but in the end, it would be limited by the downward pressure it could place on the Canadian dollar and the collateral upside risk it could create for inflation.

U.S. recession due to renewed tensions with China. The United States and China have recently agreed to decrease tariffs by 115% while leaving in place the U.S. bilateral tariff of 30% on imports from China and the Chinese 10% tariff on imports from the United States. However, this agreement may represent only a temporary reprieve. A return of tariffs to levels anywhere close to 100%, or even 50%, would effectively create a decoupling between China and the United States. Under such a scenario, inflation pressure in the United States would significantly increase and the growth outlook would deteriorate. Furthermore, the Federal Reserve would be hesitant to quickly cut interest rates due to the inflationary pressures, while long term real interest rates would likely face upward pressure due to a potential loss of confidence in U.S. assets. Such decoupling would greatly increase the probability of a near-term recession in the United States that could be more than only technical. A more pronounced recession in Canada would almost surely arise in parallel. So even if our trade tensions with the United States were to diminish, our growth outlook would be severely and negatively affected by the escalation of a trade war between the United States and China.

Upside risk: rapid trade normalization. Relative to our baseline scenario, we see many downside risks, but we also see a possible upside risk. If the current strategy of the Trump administration is foremost to obtain quick trade concessions from other countries to enhance trade—as opposed to reducing it—then growth in Canada would be higher than in our baseline scenario. Under such a scenario, the United States would agree to decrease many of the new tariffs and refrain from adding more in response to other countries offering increased access to U.S. exports in their markets. While substantial uncertainty around the trustworthiness of such deals would likely remain, a quick resolution of the current trade war would be taken as highly positive by households, governments and firms across the world. In such an environment, Canada would benefit directly from lower tariffs and indirectly from higher growth elsewhere, especially in the United States.

IV. PLANNING PARAMETERS

We consider the parameters in Table 2.12 to be a reasonable basis for business planning, but, even more than usual, businesses should assess the sensitivity of their business prospects to key economic variables and consider alternative scenarios. Members of the Bennet Jones Public Policy group are available to help assess the risks and develop alternative scenarios.

TABLE 2.12

	Canada	United States
GDP growth (Q4/Q4 % change)		
2024	2.3	2.5
2025	0.3	1.1
2026	1.8	1.7
2027	2.0	2.2
Headline CPI (Q4/Q4 % change)		
2024	1.9	
2025	1.9	
2026	1.9	
2027	2.0	
Policy rate (%)		
Dec-24	3.25	4.5
Dec-25	2.25	4.25
Dec-26	2.25	3.5
Dec-27	2.25	3.5
10-year treasury yield (%)		
Q4 2024	3.1	4.4
Q4 2025	3.2	4.5
Q4 2026	3.2	4.5
Q4 2027	3.2	4.5
Canadian dollar (U.S. cents)		
Dec-24	0.70	
Dec-25	0.72	
Dec-26	0.72	
Dec-27	0.72	

CHAPTER 3

Unlocking Investment for Security and Prosperity

Beyond tariffs and short-term uncertainty, Canada today confronts long-standing economic policy gaps and structural weaknesses. In front of what he has described as the biggest crisis of our lifetime, Prime Minister Mark Carney has proposed an ambitious transformation of the economy.

To enhance our sovereignty and economic resilience, we need to lessen our dependence on the United States over time by realizing a more integrated domestic economy and by expanding our linkages with the countries of the Asia-Pacific Region and Europe, in particular.

New markets for our goods and services and more diversified supply chains will never be a substitute for what will continue to be our paramount economic relationship with the United States, but they can deliver long-term value and help us manage our risks.

A secure and prosperous future for Canada depends on unlocking investment in economic infrastructure, energy and critical minerals, defence and security, housing, and innovation and productivity-enhancing technology across the tangible and intangible economies.

In each of these sectors, the ambition rightfully can be set high. Success will depend on leadership, vision and capacity for execution in the public and private sectors.

The GoC, the provinces, the private sector, and Indigenous leaders have to come together on strategies and concrete plans to invest at a scale and at a pace that mark a break from the past.

The larger share of the investment will be driven and financed by the private sector. Structural policy must be the principal instrument to support private investment and risk-taking. Given fiscal constraints, governments have to make judicious use of their resources and balance sheets.

Further, governments, businesses, labour and academia have to collaborate in building a resilient and productive workforce that will support the structural adjustment and growth of the economy.

REDUCING CANADA'S DEPENDENCE ON THE UNITED STATES: THE IMPORTANCE OF LEADERSHIP

The Prime Minister has stated that "[Canada's] old relationship with the United States, a relationship based on steadily increasing integration, is over." Strengthening other relationships will require commitment. The United States is the destination for 77% of our exports of goods and 53% of our exports of services; it is the source of 63% of our imports of goods and 59% of our imports of services.[1] In the last decades, our economy has developed largely north–south with progressively more integrated industries and supply chains across the Canada–U.S. border. The Prime Minister's words signal not a desired weakening of a critical economic relationship between the two economies but rather a pivot for Canada to lessen its dependence on a dominant economic and strategic partner. This requires growing our other markets and business relations at an accelerated pace.

There is wide agreement in principle that a place to start is the internal market; results will depend on the strong and united leadership of our premiers. Some C$532 billion of goods and services were traded across provincial and territorial borders in 2023, representing 18.1% of Canada's GDP.[2] If expanded efficiently, internal trade can make a significant contribution to economic resilience and prosperity. The Prime Minister has committed to the removal of all federal barriers to internal trade by July 1, 2025. However, the greatest impediments to trade within Canada are provincial and territorial rules that create local preferences or that establish different standards for goods, services and workers. The impediments include what are called "party-specific exceptions" to the Canadian Free Trade Agreement (CFTA). Over time, different initiatives, including some from western premiers, aimed to address such barriers yet failed to galvanize the collective effort of all provinces and territories. There are now signs of accelerated progress. The Province of Nova Scotia led the way in March 2025 by passing a *Free Trade and Mobility* *within Canada Act*. Ontario followed suit with a *Protect Ontario Through Free Trade Within Canada Act, 2025* and with memoranda of understanding with Nova Scotia, New Brunswick and Manitoba. The provinces of Ontario and Nova Scotia are agreed that once both of their respective bills are in force there will be no barriers to free trade between the two them.[3] Intervention by regulators in Nova Scotia triggered some amendment to the provincial bill to ensure continued oversight of professions—a reminder that details of implementation matter. At their meeting of June 2, Canada's first ministers together "committed to unlock multilateral, economy-wide mutual recognition and labour mobility, while respecting Québec's specificity."[4] Sustained progress requires strong direction by premiers and diligent follow-through by all competent authorities.

Diversification of international trade is less a matter of the government signing new trade agreements than of businesses broadening their market development and supply chain strategies. The changes in international trade and investment flows that will represent over time the Canadian response to U.S. tariffs and economic coercion will be the sum of the responses of individual businesses. There has long been a strong policy and business case for the diversification of our trade but never an urgency, because the U.S. market was familiar, open and consistently growing. There is now a crisis that even if resolved should serve as a lesson about the risks of dependency. Businesses can take advantage of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), the Canada–European Union Comprehensive Economic and Trade Agreement (CETA) and other trade agreements to access new markets and build resilience in their supply chains. They can be supported in their offshore ventures by federal trade commissioners, Export Development Canada and other federal and provincial business services. The circumstances of each exporter and importer are unique, but there can be a collective ambition to grow our trade with the Asia-Pacific Region, Europe and the rest of the world *faster* than with the United States.

A matter for the government to resolve, not elaborated upon here, is the framework for our trade with China that will also be of significant consequence for our economic and national security.

THE CHALLENGE AND THE OPPORTUNITY: A HISTORIC EXPANSION OF INVESTMENT

In the face of new global threats as well as long-standing domestic gaps, there is a priority national interest in a robust expansion of investment in our economic, security and social infrastructure and assets. The challenge for Canada is less to grow consumption or to redistribute a greater share of income than to lift public and private investment as a share of the economy. The opportunity is to transform the economy for future security and prosperity.

There is a wide political and business consensus to build a stronger asset base in at least five critical domains; in each one, distinct sets of strategies and partnerships are required to achieve ambitious results on an accelerated timeline. Success will depend on moving as soon as possible from objectives or targets to final investment decisions for concrete investments in new capacity.

The five domains of investment are not exclusive, but they deserve priority national attention.

(i) Trade Corridors

There is strong political interest in nation-building infrastructure projects. At their meeting on March 21, 2025, first ministers agreed that "a national trade corridor that connects the country from coast to coast to coast—to transport and export oil, gas, agricultural products, electricity, critical minerals, and other commodities—is a shared priority and is essential to support Canadian sovereignty and economic well-being."[5] On June 2, the first ministers discussed "projects of national interest which fit the following criteria, subject to consultation with Indigenous Peoples whose rights may be affected:

- Strengthen Canada's autonomy, resilience, and security.
- Offer undeniable benefits to Canada and support economic growth.
- Have a high likelihood of successful execution.
- Are a high priority for Indigenous leaders.
- Have clean growth potential, such as the use of clean technologies and sustainable practices."[6]

The immediate task is to turn trade corridor concepts to actual projects led by committed proponents. Where it makes sense, new linear projects such as roads, railways, pipelines or transmission lines should be promoted, evaluated and built as multi-purpose and multi-modal corridors. There is also an opportunity to expand the capacity and versatility of existing corridors.

To attract and mobilize investment capital to realize projects, governments must collaborate to streamline their review and permitting. Much has been said and written about a regulatory process in Canada that is cumbersome, lengthy, costly, unfocused, duplicative and unpredictable. Amendments to the federal *Impact Assessment Act* in 2024 further to a judgment by the Supreme Court that the original Act was unconstitutional did not resolve definitively whether the Act will now properly circumscribe the exercise of federal authority over projects to effects within federal jurisdiction. The federal government is proposing a *One Canadian Economy* legislation that would streamline the review of projects of national interest. On June 2, first ministers also agreed "to work toward efficiently and effectively implementing 'one project, one review' with the goal of a single assessment for all projects,"[7] Again, the sustained leadership of first ministers will be essential. Strong direction and governance to align regulators and to drive change through the regulatory system can foster a diligent, disciplined, predictable, efficient and collaborative regulatory process.[8]

An outstanding challenge for governments and project proponents is proceeding with legal clarity and with speed while meeting obligations to Indigenous Peoples and forging productive partnerships. The Speech from the Throne states that "as Canada moves forward with nation-building projects, the Government will always be firmly guided by the principle of free, prior, and informed consent." This can be a challenge, particularly for linear projects that bring into play the diverse and in some cases competing perspectives or interests of Indigenous rights holders. Governments and proponents both have critical roles in establishing the foundations of success.

The early participation of Indigenous Peoples is now widely recognized as an opportunity to move projects forward while advancing reconciliation and sharing economic benefits. Increasingly, there are successful partnerships to serve as models, and financial instruments, such as federal or provincial loan guarantees for equity investments, to establish a collaborative business structure.

(ii) Energy Infrastructure

The expansion and diversification of our trade, access to reliable and competitively priced energy, and the security of supply chains require a rapid expansion of our infrastructure and assets for energy and critical minerals. The Prime Minister has stated that he wants Canada to be an energy superpower in both clean and conventional energies and that this may include the building of new pipelines where there is support from provinces and Indigenous Peoples.

For oil and gas—including LNG—the critical issue for both government and industry is finding a path to realize the value of our resources while driving down the intensity and ultimately the absolute amount of GHG emissions in the production process. There are two basic facts. First, the oil and gas industry represents about 20% of Canada's exports, and it is a source of prosperity across the country through employment, supply chains, investment returns and direct and indirect revenue for governments.[9] The global market for LNG, which is in part displacing coal, is growing robustly, and the market for oil has not yet plateaued. Second, the oil and gas industry represents 30% of Canada's GHG emissions.[10] Thus, a strategy to reduce emissions intensity and ultimately absolute emissions in the sector is core to making progress on nationwide climate goals. A proposed federal cap on absolute emissions is strongly resisted by the provinces of Alberta and Saskatchewan and by the industry itself. A discussion should move beyond a cap/no-cap dichotomy and analyze trade-offs to assess what may be achieved by way of growing supply *and* accelerating investment in emissions mitigation, including carbon capture and storage (CCUS). The analysis of new pipelines should factor the economic and national security benefits of lessening our dependence on both U.S. demand and U.S. supply. The business case is likely stronger for new capacity for export via the west coast than for new pipelines to the east. Again, the driver should be a private proponent with a concrete project and available capital. Governments can then work with the proponent to establish the conditions for success.

Export opportunities, notably to Asian markets, may include hydrogen and ammonia. Exports of ammonia could leverage our natural gas resources (with CCUS), contribute to the diversification of our trade and help develop the critical mass for a domestic hydrogen economy. If there is a solid business case, governments, industry and Indigenous groups should step up efforts to create the conditions for investment in the supply and transportation infrastructure to meet the market opportunity. Green hydrogen from renewable power is likely a longer-term proposition.

A formidable challenge is roughly doubling the electricity grid over the next 25 years to power a growing, cleaner economy. Interties may contribute to the efficient deployment of generation capacity and to the improved reliability of the grid. However, each jurisdiction will be prioritizing its own supply based on its own resources and technology choices.

The planning and execution of investments, whether by independent suppliers or by publicly or privately owned utilities, require clarity in respect of environmental, climate and economic regulation. The federal *Clean Electricity Regulations* target a net-zero grid that poses significant risks and costs in some jurisdictions that depend on natural gas for baseload capacity. Meanwhile, elements of provincial economic regulation may discourage investments in assets that are not strictly least cost but that may improve the reliability of the grid or introduce technological innovation. Governments and regulators have to ensure that rules provide the clarity and incentives for investment in reliable and competitively priced capacity and energy for a cleaner economy.

Some projects such as CCUS, large nuclear or small modular reactors (SMRs), offshore wind, hydrogen or critical mineral extraction and processing (and enabling infrastructure) will require public financial support to de-risk investments and improve prospective returns. In the prior Parliament, the federal government introduced generous (refundable) investment tax credits for a range of clean energy projects. There will need to be further engagement with project proponents to determine whether the tax credits may achieve the intended results and/or whether other forms of public financial support may be necessary and appropriate to get at least the first projects over the line.

(iii) National Security

To meet our commitments to our allies and to safeguard our national security, Canada must grow defence spending from 1.4% of GDP in 2024 to at least 2% of GDP by 2030 or earlier; in fact, discussion in NATO will push our spending target higher. In advance of the NATO Summit of June 24 to 26 in The Hague, Netherlands, Secretary-General Mark Rutte has proposed a target of 5% of GDP by 2032, including 3.5% of GDP on "hard military spending" plus 1.5% of GDP on related spending, including infrastructure and cybersecurity.[11] Germany has expressed support for such targets. It is unrealistic to expect that Canada could, in the foreseeable future, mobilize and allocate productively resources close to 5% of its GDP for defence purposes. Even 2% or 2.5% of GDP represents a significant fiscal challenge amid other fiscal pressures discussed in Chapter 4. Yet, in an uncertain world Canada has no choice but to embark on a path of significantly higher defence spending.

A critical responsibility is ensuring that to the greatest extent this expenditure draws upon—and reinforces—the country's economic capabilities, assets and technology.

Strategic planning and the procurement and management of our spending envelope must realize advantages that go beyond the Industrial and Regional Benefits and Industrial and Technological Benefits built into current procurement policy. To strengthen our national security and meet our commitments, we will have to make large purchases from foreign-based defence contractors, with negotiated industrial and technology benefits in Canada. However, to develop stronger autonomous capability, it will be important to expand the domestic defence industrial base and to position our firms to participate and win in the global market. As per the Business Council of Canada: "The Government of Canada can safeguard Canadians and honour its international commitments by investing in a strong and sovereign defence industrial base. By doing so strategically, it can also supercharge Canada's broader economic security and prosperity."[12]

A stronger domestic defence industrial base and strategic linkages with partners in Europe and the Asia-Pacific Region can contribute to the diversification of our trade and to enhanced security. Priorities for Canada will continue to include tight collaboration with the United States, including the modernization of the North American Aerospace Defense Command (NORAD). However, formulating a new defence strategy is also an opportunity to participate in security partnerships and supply chains with other partners. An example is the partnership with the Government of Australia through the development of Over-The-Horizon Radar technology for domain awareness in Canada's North.[13] The Prime Minister has also evoked Canadian participation in the ReArm Europe Plan.[14]

The protection of our territorial sovereignty and national security can also be advanced by investment in dual-use infrastructure in Canada's North, supporting resource development, opening up new trade routes and creating opportunity for Indigenous communities.

A larger spending envelope for national security should also comprise proportionately larger contributions to Canadian technology and research and development (R&D), including dual-use technologies. Opportunities include investment in cybersecurity and remote-sensing capability, as well as mission-driven innovation with Canadian researchers and businesses such as pioneered by the U.S. military.

(iv) Housing

There is a broadly recognized need in Canada to grow the supply of housing and to improve the affordability of homes. As observed in the 2025 OECD Economic Survey of Canada, real house prices have nearly doubled in the country since 2007, and rents have also increased faster than in most other OECD countries.[15] The OECD notes not only a shortage of supply, but also a mismatch between available housing and demand, with a lack of rental and affordable housing. Housing starts in Canada, which averaged 254,700 units in 2021–2024, were materially higher than in the last four decades, but about the same level as in the 1970s despite much larger population growth.[16]

The Prime Minister is proposing new models of public–private co-operation to accelerate housing construction, including by making available C$25 billion in low-cost financing to private developers. This includes supporting the development of a modern housing industry that can draw on Canadian modular and prefabricated housing technology, Canadian workers and Canadian lumber. The government has undertaken to improve affordability for first-time homebuyers by removing the GST on new homes of up to C$1 million and to lower the GST on homes between C$1 million and C$1.5 million. The government will also work with provinces and territories to cut municipal development charges in half for multi-unit housing.

The national ambition to raise the rate of construction of new homes may be tempered by the fact that Canada already allocates greater resources to residential investment than any other advanced economy. The Liberal Party's electoral platform had set a target to double the rate of construction of new homes to 500,000 per year; the target may be seen as aspirational. Residential investment in Canada in 2024 accounted for almost 8% of real GDP, nearly double what it is in the United States and higher than in any other OECD economy.[17] Given labour constraints and the need to also ramp up non-residential construction, including trade corridors and energy infrastructure, a doubling of housing construction in the next few years does not appear to be in reach.

Leadership by provincial and municipal governments will be essential to achieve steady, measurable progress. It is not only a matter of mobilizing private capital and resources to build the homes. Provincial and local governments must accelerate the planning and permitting of development and the building of the enabling infrastructure to accommodate new homes and to serve citizens.

(v) Innovation, Technology, Digital Infrastructure and AI

An effort to build physical infrastructure and assets and to address our trade, energy, national security and housing needs cannot obscure the need to innovate and to lift productivity growth across the economy, notably through technology, digitalization and AI. In fact, in all the above domains innovation and the deployment and commercialization of technology will be critical to building at pace and realizing value. Canadian firms are unlikely to compete with big tech for AI platforms and infrastructure, but they can create market advantage by the development, use and commercialization of applications that will improve productivity.

Similarly, our preoccupation with trade in goods in response to U.S. tariff action ought not overshadow the services sectors (including the public sector) and the value of investment in intangible assets, including intellectual property and data, for our economic and national security. In fact, the continued expansion of U.S. big tech and the rapid emergence of China as an innovation powerhouse across a range of strategic technologies pose at least as existential a challenge to our sovereignty and prosperity as the Trump tariffs and threats of economic coercion.

Our innovation and productivity growth gaps are long-standing and require new approaches and improved collaboration among governments, entrepreneurs, investors, start-ups and universities and colleges to foster distinct Canadian assets and advantages. It is unlikely that new or expanded funding programs will move the needle. Efforts may focus on framework policy and regulation. For example, in the financial services industry, after years of delays in the building of a modernized retail payments system and an open banking regime, regulation should be adapted quickly to better stimulate competition, innovation and digitalization while responsibly managing risks.

The development of digitalization and AI are dependent upon physical assets located in data centers that draw on large-scale power facilities. There is commercial interest in leveraging Canadian energy assets to attract investment in data centers. The case for public intervention in support of such investment should be assessed by considering how the deployment of data centers in Canada can serve our innovation ecosystem and advance our economic and national security interests.

CONDITIONS NEEDED TO UNLOCK INVESTMENT

A historic transformation of the economy, as called for by the Prime Minister, requires the mobilization of enormous resources.

Canada is not alone in the pursuit of enhanced economic and national security, and it is competing with other jurisdictions to attract and execute investment that will be led and financed in large majority by the private sector. In the EU, for example, another former central banker, Mario Draghi, recommended raising investment to restore European competitiveness by an amount equivalent to close to 5% of EU GDP.[18] Draghi noted that historically in Europe around four-fifths of productive investment has been undertaken by the private sector. Of course, President Trump's agenda of deregulation, low taxes and import tariffs aims to create the conditions to pull investment away from other jurisdictions, including Canada, and into the United States.

Canadian and foreign corporations, institutional investors, sovereign wealth funds, private equity and private debt funds all search for assets, projects and enterprises that will deliver the best risk-adjusted returns.

At least four factors are critical to mobilizing this capital:

- **Leadership and a focus on execution.** The Prime Minister has stated unequivocally that Canada is not for sale. However, Canada is open for business, and this must be conveyed in words and in action not only by the federal government but by the provinces and territories and by Indigenous and business leaders.

- **Responsive structural policy.** It is largely the market, not governments, that will drive the development of trade corridors, expand and diversify markets, or develop the best AI applications. The first task of governments is to establish a predictable, competitive environment for investment and to remove the regulatory obstacles that serve no demonstrable and compelling policy interest. Currently, our priority is to foster stability and confidence by normalizing our trade relationship with the United States to the greatest extent possible and in a way that is consistent with our national interest. For large energy and infrastructure projects, the competent delivery of a streamlined review and permitting system is a foremost condition. In the domain of AI, there is tension to resolve between regulation to prevent breaches of privacy and public harm and frameworks to foster innovation and productivity growth. A comprehensive, if step-by-step, review of the structure of the business tax system is long overdue.

- **Financial and fiscal discipline.** A political determination to build and to unlock investment can attract many proposals that have an uncertain business case and that seek large public subsidies. Governments must be principled, consistent, disciplined and coordinated in responding to such proposals. There is an undisputed case for public investment in infrastructure or assets that serve a public good and that cannot be monetized, for example, in education, public health, public safety and national security. There is also a well-established case for tax or program assistance for innovation, including R&D and projects or ventures at the frontier of commercialization to help de-risk private investment and to recognize benefits (e.g., positive externalities) not captured by private investors. However, governments must adopt a disciplined approach to proposals seeking their participation. Over the past several years, the multiplication of windows for financial assistance from governments has not only represented a large fiscal cost, it has also caused considerable confusion among project proponents and investors. The intervention of governments has to be rationalized. One approach is to favour, again selectively, low-cost financing that can make use of the government's balance sheet to help lower the cost of capital for public or private partners in ventures that may be less than fully commercial yet advance the national interest. In this case, the government's goal is to crowd in, not crowd out, private capital. The Prime Minister is proposing such an approach for housing with a C$25 billion envelope for private developers. The Canada Infrastructure Bank (CIB) was created to perform this role in the infrastructure space.[19] The Canada Growth Fund (CGF) may serve a similar purpose for some investments. Fiscal discipline requires that, except where explicitly provided for in the fiscal framework, the government target an average return on its investments in these Crown entities that is at least equivalent to its cost of debt.

- **Human resources (HR) strategies and plans.** Employers and project proponents across the economy lament a shortage of workers, from highly qualified personnel to workers in the trades to healthcare and social workers. There has been much experimentation and debate about how our HR needs may be met by migrant workers, including both new permanent residents under economic immigration streams and temporary foreign workers. In 2022 and 2023, a surge in the intake of non-permanent residents, including temporary foreign workers and foreign students, caused Canada's population to grow at an unsustainable rate.[20] The Prime Minister's mandate letter to ministers establishes "attracting the best talent in the world to help build our economy, while returning our overall immigration rates to sustainable levels" as one of the seven priorities of the government.[21] Immigration will not be the answer to all real or perceived shortages of labour. Moreover, there will be limits to our capacity to handpick immigrants to meet specific needs in any one region, sector or occupation. There is, in fact, no substitute for a well-performing education and training system, a mobility of labour across the country not impeded by provincial rules or regulations, and a competitive labour market that sets wages at levels that will favour the efficient allocation of resources. Governments, businesses, labour and academia need to collaborate on strategies and plans.

Canada is at a crossroads. The moment calls for the very best in public and private sector leadership and a relentless, shared focus on execution.

CHAPTER 4

Fiscal Pressures and the Sustainability of Public Finances

Governments in Canada and internationally are confronting a range of fiscal pressures that over time may test seriously the sustainability of public finances. In the short term, the economic slowdown caused by U.S. tariffs, trade disruptions and policy uncertainty will result in fiscal erosion. Over the medium term, geopolitical tensions will require a ramp-up of defence spending while structural change, including the rewiring of the global economy, will create added demand on governments to support public and private investment in productive capacity and innovation. Meanwhile, medium-term growth prospects are modest, and interest rates are likely to stay considerably higher than they were pre-COVID, with debt markets under stress and vulnerable to disruption.

In a highly uncertain world, governments must consider carefully medium to long-term debt dynamics and risks. If macroeconomic and market developments turn out to be adverse, and if there is not strict fiscal discipline, debt dynamics can quickly become unfavourable. Debt can then rise faster than GDP, interest costs can absorb a rising proportion of revenue, and access to new borrowing can become more difficult and more expensive. Such developments are then difficult to correct, requiring deep cuts in programs and services, as seen in Canada in the mid-1990s.

The Prime Minister has set an ambitious goal for Canada to embark on its largest economic transformation since the Second World War. At the same time, to safeguard our national security in a more dangerous world and to meet our commitment to our NATO allies, the government must raise defence spending from 1.4% of GDP in 2024 to at least 2% of GDP by 2030, if not earlier. To improve affordability, the government is moving forward with a middle-class tax cut that will cost C$6 billion annually in foregone revenue. The minister of finance will face a long list of other fiscal pressures in the short and medium term.

The Speech from the Throne delivered on May 27, 2025, pledged that the government will spend less, so that Canadians can invest more. To exert fiscal discipline, the government plans to reduce the growth rate of operating expenditures to below 2% per year. It proposes to cap the size of the public service, end duplication and deploy technology, including AI, to improve public sector productivity.

Such steps will be helpful. However, to ensure that the federal debt-to-GDP ratio is on a firm downward track, it will *not* suffice to target efficiencies in the delivery of programs and services. The government has excluded cuts in major transfers to provinces and territories and to individuals. There will therefore need to be some material cuts in federal *program* spending.

Under reasonable and prudent assumptions about economic growth and interest rates over the medium term, we estimate that bringing the federal debt-to-GDP ratio down steadily (e.g., by one-half point of GDP per year) will require the government to generate a primary budget surplus of some 0.5% to 1% of GDP annually. Over the economic cycle, budgetary revenue on average will therefore need to exceed budgetary expenditure before interest costs. Accordingly, taxes paid by Canadians on average will exceed by some measure the value of the services they receive.

To achieve this result, the government will need to realize permanent savings of some 15% to 20% in non-defence program spending over the fiscal planning horizon. This is a significant undertaking, yet one that is moderate compared with the large fiscal adjustment of the mid-1990s.

A review of federal programs to eliminate those that are not mission-critical or effective will allow ministers and a streamlined public service to focus on core federal responsibilities and on the efficient delivery of a limited set of priorities.

If the government wishes to introduce large new spending, or if its NATO allies expect defence spending to grow to something closer to 3% of GDP or more, then cuts to other spending will have to be deeper; or else, the government will have to contemplate tax increases.

Importantly, a sustainable fiscal plan can include larger borrowing to fund government *investments* in financial or non-financial assets *if* they deliver concrete benefits and future revenue streams. This can be helpful in some cases to lever or "crowd in" larger amounts of private investment.

To maximize the public balance sheet and to promote the efficient management of large infrastructure assets, such as roads and bridges, the federal and provincial governments should give greater consideration to pricing them. This could shift more costs from taxpayers to users and create an opportunity for the expanded use of public–private partnerships.

To free up capital for public investment in new assets, governments should also consider the sale or long-term lease of existing assets, such as major airport terminals, that generate a steady stream of income and that can represent sound long-term business propositions for institutional investors.

A RANGE OF GLOBAL AND DOMESTIC PRESSURES FOR NET NEW BORROWINGS BY GOVERNMENTS

Geopolitical, trade and structural forces of change as well as developments and risks specific to each jurisdiction are creating new borrowing pressures for governments around the world.

In the short term, tariffs and trade disruptions will slow down the U.S. and global economies and damage the fiscal balances of governments through the operation of automatic stabilizers and potential discretionary relief.

In the medium term, a range of factors will exert pressure on fiscal balances and push up public debt.

In the United States, political dynamics are precluding any serious action to rein in deficits and to slow down debt accumulation. The U.S. fiscal deficit in 2024 was US$1.8 trillion or 6.4% of GDP in an economy at roughly full employment.[1] As discussed in Chapter 1, the "big, beautiful" bill advancing through Congress could add some US$3 trillion of debt in the next 10 years (or US$5.2 trillion if temporary measures in the bill are made permanent). This is over and above a fiscal track that would already add some US$20 trillion of debt over this period. Thus, publicly held debt could rise from 100% of GDP in 2025 to 125% or 129% of GDP by 2034.[2] Revenue from tariffs could mitigate some of the growth in the debt, but not fundamentally alter underlying fiscal trends.

In Germany, Chancellor Friedrich Merz secured agreement with coalition partners on a groundbreaking reform of the country's constitutional debt limit that will allow large new borrowing for defence spending and public investment.

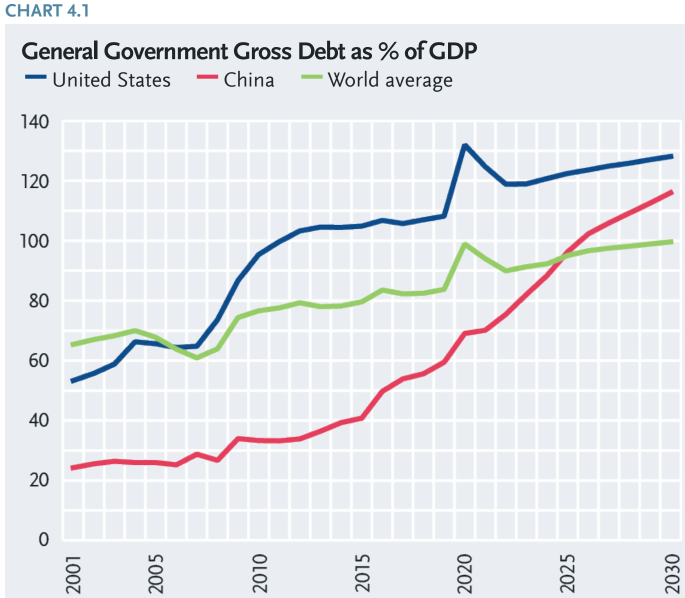
In the EU, the ReArm Europe Plan proposed by the EC aims to facilitate the financing of an increase of up to 1.5% of GDP in annual defence spending. EU spending on defence grew some 30% between 2021 and 2024 to 1.9% of GDP.[3] The proposed increase in this spending to up to 3.4% of GDP will require large public borrowing. The Plan activates an escape clause of the Stability and Growth Pact in order to allow member states to increase significantly their defence expenditures (and borrowing) without triggering the Excessive Deficit Procedure.[4] The Plan also comprises a €150 billion loan facility to help member states invest in key defence areas like missile defence, drones and cybersecurity.

Meanwhile, amid structural change and a rewiring of global supply chains, governments face intense pressure to support public and private investment in economic and energy infrastructure, as well as in the innovation ecosystem, including digital infrastructure and AI. The pursuit of competitiveness and prosperity requires incentivizing, de-risking and complementing private investment through a range of instruments, including tax incentives and low-cost financing.

GOVERNMENTS ALREADY CONFRONTING HIGH LEVELS OF DEBT AND DEBT SERVICE COSTS

Government borrowing globally has risen to historic highs. In 2024, general government gross debt exceeded US$100 trillion, or 92% of global GDP.[5] This is up sharply from 64% of global GDP before the GFC and 84% before the COVID pandemic (Chart 4.1). Strong nominal economic growth in 2021 and 2022 brought the global public debt-to-GDP ratio down temporarily, but since 2022, with slower growth and lower inflation, it has resumed an upward trend. The increase in public debt is led by the largest economies.

CHART 4.1



Source: International Monetary Fund (IMF), Fiscal Monitor Database, April 2025.

As discussed above, the United States is accumulating (and widening) large fiscal deficits despite being at near full employment. China has been raising its level of borrowing sharply at central and local levels, notably to fund public investment and to meet growth targets at a time of difficult adjustment in the overbuilt real property sector.

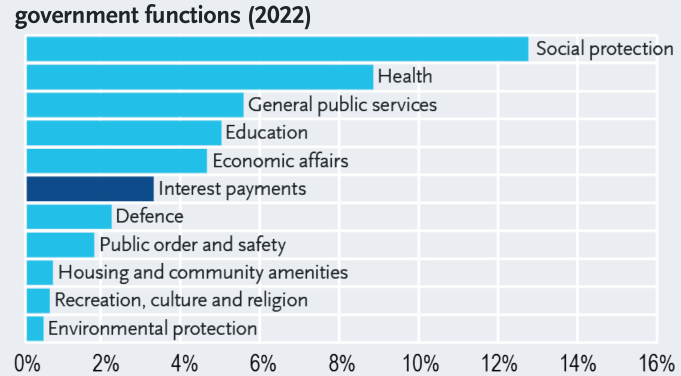
Meanwhile, the cost of public debt has risen. After a 30-year period of decline in sovereign bond yields to near zero just before COVID, governments are now paying a higher price when refinancing maturing debt or raising new funds in the bond market (Chart 4.2). In the short-term market for government debt (e.g., 90-day treasury bills), interest rates in the United States and other advanced economies have come down from their recent peaks in 2023 with the lowering of policy rates by central banks. However, they remain considerably higher than they were through the years following the GFC, and they are unlikely to return soon to near-zero or negative levels (Chart 4.3).

Recent developments in debt markets illustrate sensitivity to fiscal trends and pressures as well as to policy uncertainty. As discussed in Chapter 1, yields on U.S. government 10-year and 30-year bonds have fluctuated sharply around the tariff decisions of President Trump and around reports about the fiscal impacts of the "big, beautiful" bill. A large and rising U.S. public debt in an environment of elevated policy uncertainty can result in an increased risk premium on U.S.-based assets. **Some analysts warn of a "Liz Truss" moment when a loss of confidence in U.S. economic policy could cause a large and sudden sell-off of U.S. treasuries and a sharp spike in yields, with disruption across global capital markets affecting all borrowers.**

Given higher levels of debt and higher interest rates, debt service charges in advanced economies are rising in proportion to GDP and to governments budgets. In 2024, gross sovereign interest payments in the OECD were equivalent to 3.3% of GDP, up from 3% in 2023 and 2.7% in 2015–2019.[6] On average, interest payments now exceed spending on a range of significant items in the budgets of OECD governments, including defence (Chart 4.4).

CHART 4.4

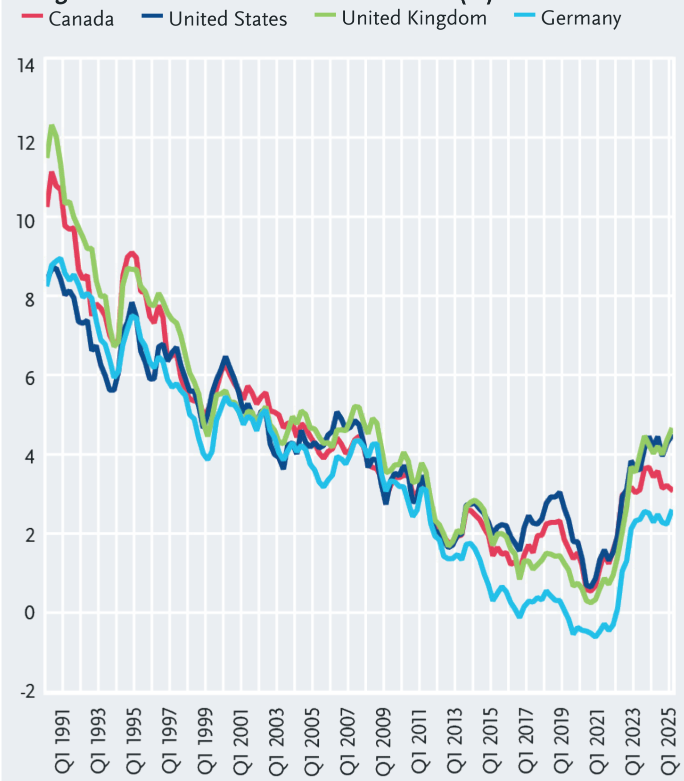
OECD interest payment share of GDP (2024) compared to government functions (2022)



Source: OECD, Global Debt Report 2025.

CHART 4.2

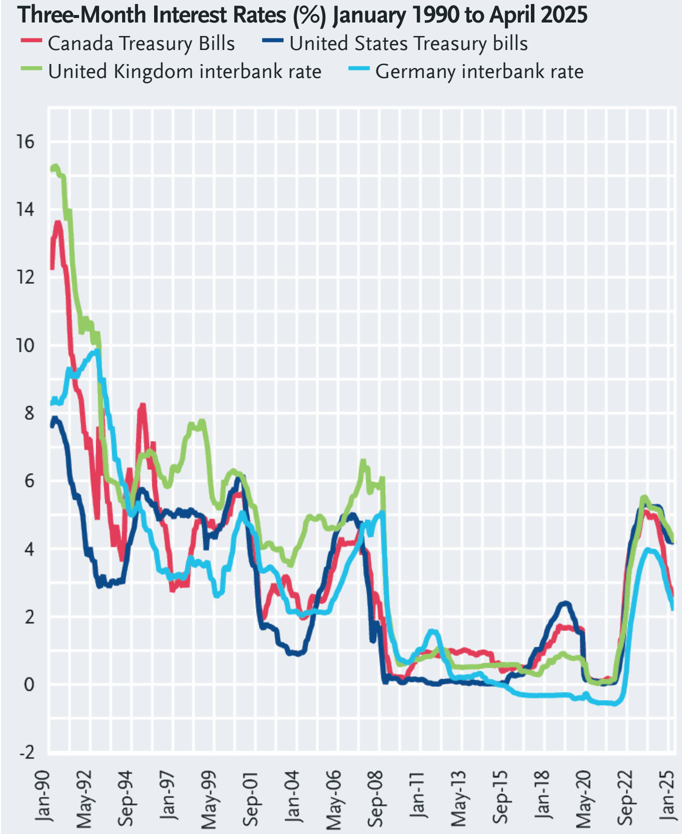
Long-Term Government Bond Yields: 10-Year (%)



Source: Organisation for Economic Co-operation and Development (OECD), Main Economic Indicators via Federal Reserve Bank of St. Louis.

CHART 4.3

Three-Month Interest Rates (%) January 1990 to April 2025



Sources: OECD, Main Economic Indicators via Federal Reserve Bank of St. Louis; and Statistics Canada table 10-10-0122-01.

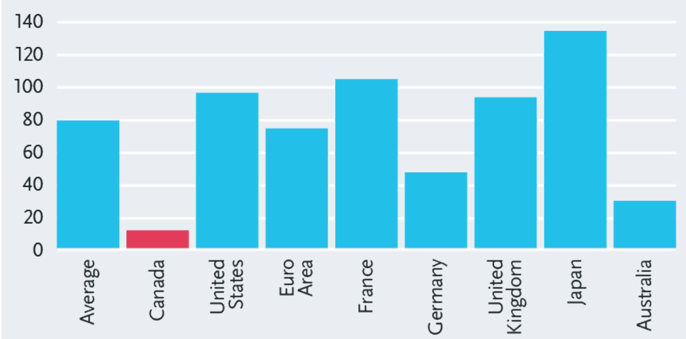
WHERE CANADA STANDS, INTERNATIONALLY AND HISTORICALLY, ON PUBLIC DEBT AND DEFICIT MEASURES

Canada's net public debt for all governments (federal and provincial) is low in proportion to GDP, compared with other advanced economies (Chart 4.5). International comparisons, such as presented by the IMF, are based on national accounts data that exclude the unfunded liabilities of governments for public sector pensions and future benefits. Moreover, for comparability with other countries, the net public debt for Canada in IMF tables is net of the assets in the Canada Pension Plan and the Quebec Pension Plan (CPP/QPP), which were equivalent to close to 25% of GDP in 2023. Clearly, this measure of net public debt understates the liabilities of governments because assets in the CPP/QPP are dedicated to the funding of pensions, and they do not offset government debt.

Annex 1 explains briefly the different measures of public debt for Canada.

Canada also has among the lowest general government deficit-to-GDP ratios among advanced economies (Chart 4.6). This advantage has prevailed since the late 1990s: the U.S. and other G7 economies, except Germany, have consistently recorded higher fiscal deficits than Canada.

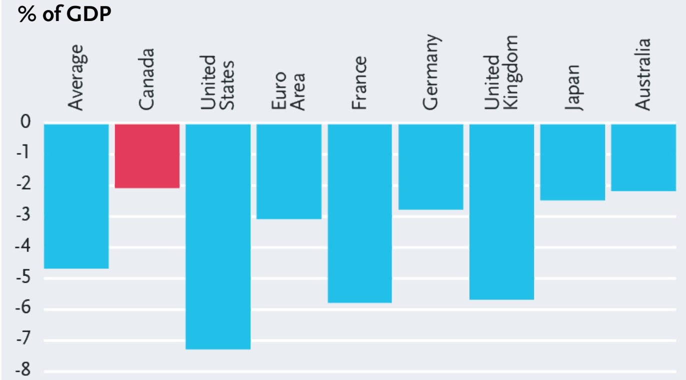
CHART 4.5



Advanced Economies: General Government Net Debt, 2024
% of GDP

Source: IMF, Fiscal Monitor, April 2025.

CHART 4.6



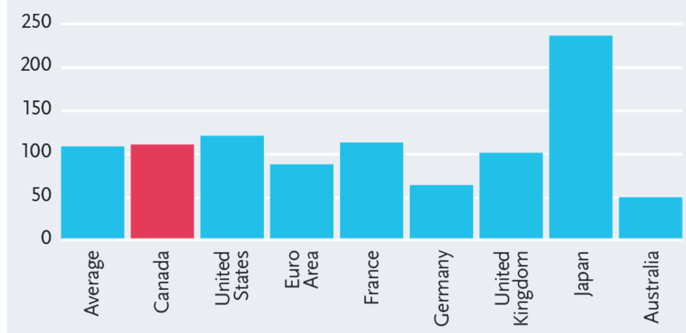
Advanced Economies: General Government Overall Balance, 2024
% of GDP

Source: IMF, Fiscal Monitor, April 2025.

However, on a gross basis Canada's public debt ratio is on par with the average of advanced economies (Chart 4.7). Gross public debt includes debt incurred to fund non-financial and financial assets (for example, investments in Crown corporations) that generate a financial return and that can offset (some of) the interest on the debt on the liability side of the government's balance sheet. Nonetheless, comparisons of gross public debt provide a measure of the relative exposure of governments to debt markets. **It is the gross debt that governments must finance, and refinance, largely by access to capital markets. Governments in Canada collectively have an exposure similar to that of other major advanced economies.**

From a historical perspective, the debt-to-GDP ratios for the GoCremain well below the peaks of the mid-1990s, but they have ratcheted up after both the GFC and the COVID pandemic (Chart 4.8). The movements are the same for all measures of debt, including *gross* debt and *federal* debt, the latter being the sum of accumulated deficits. Federal debt was 42.1% of GDP at the end of the 2023–2024 fiscal year.

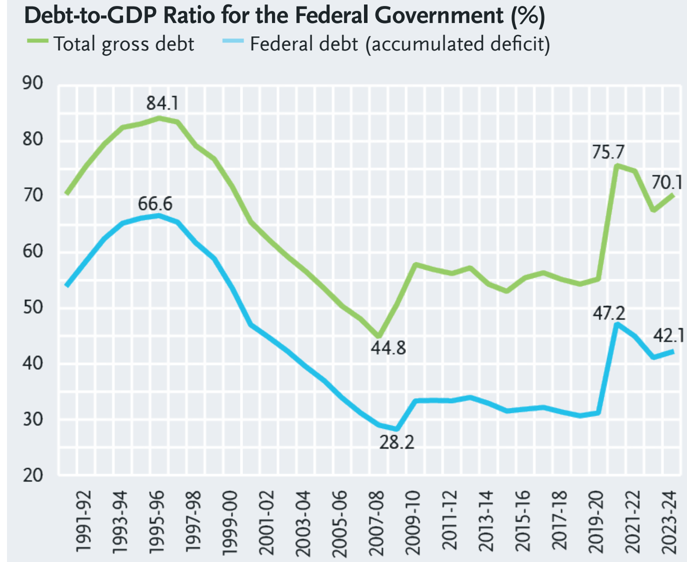
CHART 4.7



Advanced Economies: General Government Gross Debt, 2024
% of GDP

Source: IMF, Fiscal Monitor, April 2025.

CHART 4.8



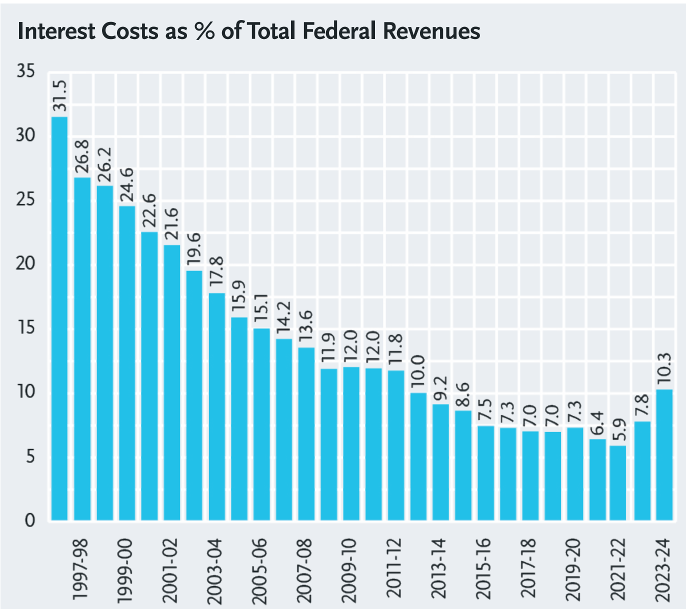
Debt-to-GDP Ratio for the Federal Government (%)

Sources: Finance Canada, Fiscal Reference Tables 2024, and Statistics Canada table 36-100104-01.

The federal interest-cost-to-revenue ratio is low compared to where it was in the 1990s, but it has risen sharply since COVID to above 10% in 2023–2024, because of both a higher debt and higher interest rates (Chart 4.9).

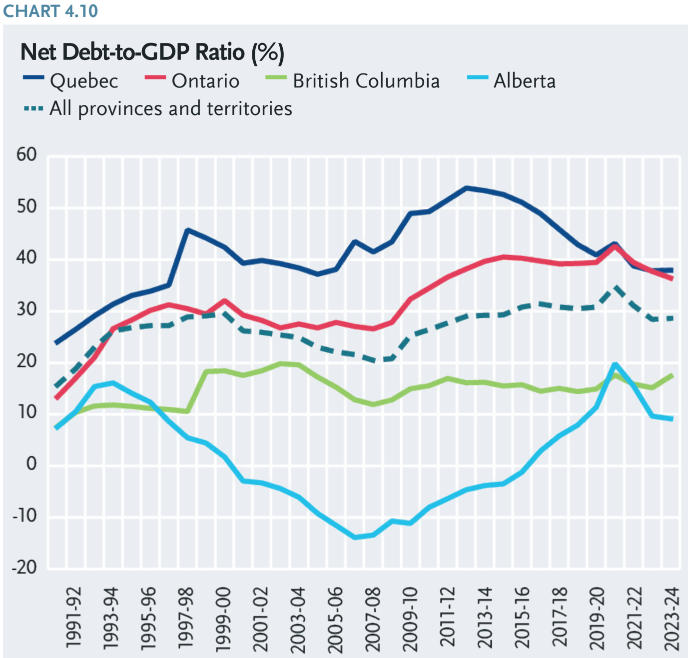
There is considerable variation in the evolution of provincial net-debt-to-GDP ratios across jurisdictions, but the average is higher than in the early to mid-1990s (Chart 4.10). Generally, the provinces did not have abrupt hikes in their debt ratios following the GFC or the pandemic because the federal government delivered most of the fiscal firepower needed to overcome these crises. Movements in provincial debt ratios have been more gradual. Debt ratios across some of the large provinces diverged for 10 to 15 years after the mid-1990s, but they have since moved closer together.

CHART 4.9



Source: Finance Canada, Fiscal Reference Tables 2024.

CHART 4.10



Sources: Finance Canada, Fiscal Reference Tables 2024 and Statistics Canada table 36-10-0222 01

Overall, while some international and historical comparisons appear favourable, federal and provincial governments are significantly exposed to debt markets that, together with intense pressures to spend and to invest, require that close attention be paid to debt dynamics and to how the fiscal situation may evolve under alternative scenarios.

Governments must ensure that they will continue to be able to access debt financing in capital markets at a reasonable rate; this requires a commitment to fiscal discipline. Governments in Canada do not have the exorbitant privilege that comes in the United States from being the issuer of the global reserve currency. They also do not benefit from the high domestic saving rate in Japan that is assuring low-cost funding to the Japanese government despite much higher debt ratios than Canada's. Interest rates on our public debt will be sensitive over time to real and perceived fiscal discipline.

The discussion below focuses on the sustainability of federal public finances, but there are similar responsibilities and, in some cases, even more acute challenges for provinces and territories.

A REFERENCE INDICATOR OF FISCAL SUSTAINABILITY: THE TREND IN THE DEBT-TO-GDP RATIO

For the GoC, a broadly accepted indicator of fiscal sustainability is a declining *federal* debt-to-GDP ratio. The federal debt is defined as the accumulated deficit. A fiscal plan that projects and achieves a declining federal debt-to-GDP ratio over the medium term can help anchor fiscal choices and establish market credibility. It can provide assurance that the government will be able to finance its debt at a low and stable rate, in turn providing a solid benchmark for the pricing of debt of other creditors, including provinces, corporate issuers, and mortgage borrowers. A temporary increase in the debt ratio does not mean that the fiscal framework is unsustainable. Under sound fiscal management, the ratio may rise in a cyclical downturn. It may spike in a crisis, such as the GFC or the COVID pandemic, which can require a large fiscal stimulus to mitigate economic losses. Indeed, it is in part to preserve the capacity to withstand shocks that the government needs to drive the debt ratio down in better or normal periods.

Importantly, a fiscal plan that targets a declining *federal* debt-to-GDP ratio may accommodate an increase (or a lesser decrease) in the *gross* debt-to-GDP ratio where rising debt is incurred to acquire non-financial or financial assets that generate a stream of income. There must be strict financial discipline in the accumulation of any public debt. Where debt is incurred to invest in assets that will advance policy priorities and also generate a stream of income, then this income will offset the debt charges and there will be no impact on the budgetary deficit over time. This may be important in a period where public investment (for example, in financial Crown corporations) may be mobilized to complement or lever large private investment.

DEBT DYNAMICS AND FISCAL SUSTAINABILITY

Over the medium to long term, the trend in the debt-to-GDP ratio is driven principally by three key variables: the (nominal) rate of interest on government debt, or *r*, the rate of (nominal) economic growth, or *g*, and the primary budget balance relative to GDP. The primary budget balance is the difference between revenue and expenditure, not including debt service costs.

In short, for any level of accumulated debt, the difference between *r* and *g* determines the primary budget balance that is required going forward to keep the debt-to-GDP ratio stable or on a downward track:[7]

- **If *r* is greater than *g*, the *debt dynamics* are unfavourable:** the debt grows faster than the economy, and the debt ratio rises unless there is a commensurate surplus in the primary balance.
- **If *r* is less than *g*, then the debt dynamics are favourable:** debt grows slower than the economy, and the debt ratio diminishes, unless the government incurs an offsetting primary deficit.

Looking forward, different models and different assumptions about economic parameters and fiscal policy can lead to very different conclusions about the trend in the debt-to-GDP ratio and the sustainability of public finances.

Under a set of assumptions where *r* is less than *g* and where the structure of government revenue and spending is held constant, some long-term projections show that the federal debt-to-GDP ratio can decline gradually over time. Scenarios presented by Finance Canada in the 2024 Fall Economic Statement (FES) and by the Office of the Parliamentary Budget Officer (PBO) in August 2024 cast future government revenue, expenditure, and deficit by applying the *existing* fiscal structure to demographic and economic trends based on a set of reasonable assumptions.[8] These analyses suggest that current fiscal policy is sustainable. The PBO scenarios indicate that the GoC could permanently reduce revenue, or raise spending, by the equivalent of 1.5% of GDP annually and still hold the federal debt-to-GDP ratio steady.[9]

However, such analyses do not represent projections, nor do they provide comfort that public finances are sustainable under a wide range of plausible future economic developments and policy scenarios. First, the models are very sensitive to the assumptions determining the *r* minus *g* debt dynamic. Second, they do not incorporate economic or financial shocks that may cause government borrowing to spike and that may have durable effects on growth potential. Third, they presuppose constant policy and thus assume no new discretionary initiatives with positive (or negative) fiscal impacts. For example, transfers to persons (the elderly or children) are indexed to the CPI such that they represent a diminishing share of fiscal revenue (which is projected to grow in line with nominal output). Spending on some core items like national defence is assumed simply to increase at the rate of nominal economic growth. Similarly, the tax structure is held constant, despite global competitive pressures.

By contrast, an alternative exercise conducted by the PBO that considers a wide range of scenarios, starting from the 2024 FES, suggests that there is only a 61% chance that the federal debt-to-GDP ratio in 2029–2030 will be below its 2023–2024 level of 42.1%.[10] This analysis is based on methodology developed by the IMF to help governments achieve debt stabilization (or better).[11] The PBO established a distribution of paths for the federal debt-to-GDP ratio based on probable outcomes, including economic shocks and responses, based on historical experience. Before consideration of any discretionary tax cuts or spending, the PBO estimated that there was roughly a 39% chance that the federal debt-to-GDP ratio in 2029–2030 would be *higher* than in 2023–2024.

In sum, while some scenarios show a stable or declining federal debt-to-GDP ratio over the medium to long term, these scenarios are assumption-dependent and they do not provide a high level of confidence that the current structure of revenue and expenditure is sustainable.

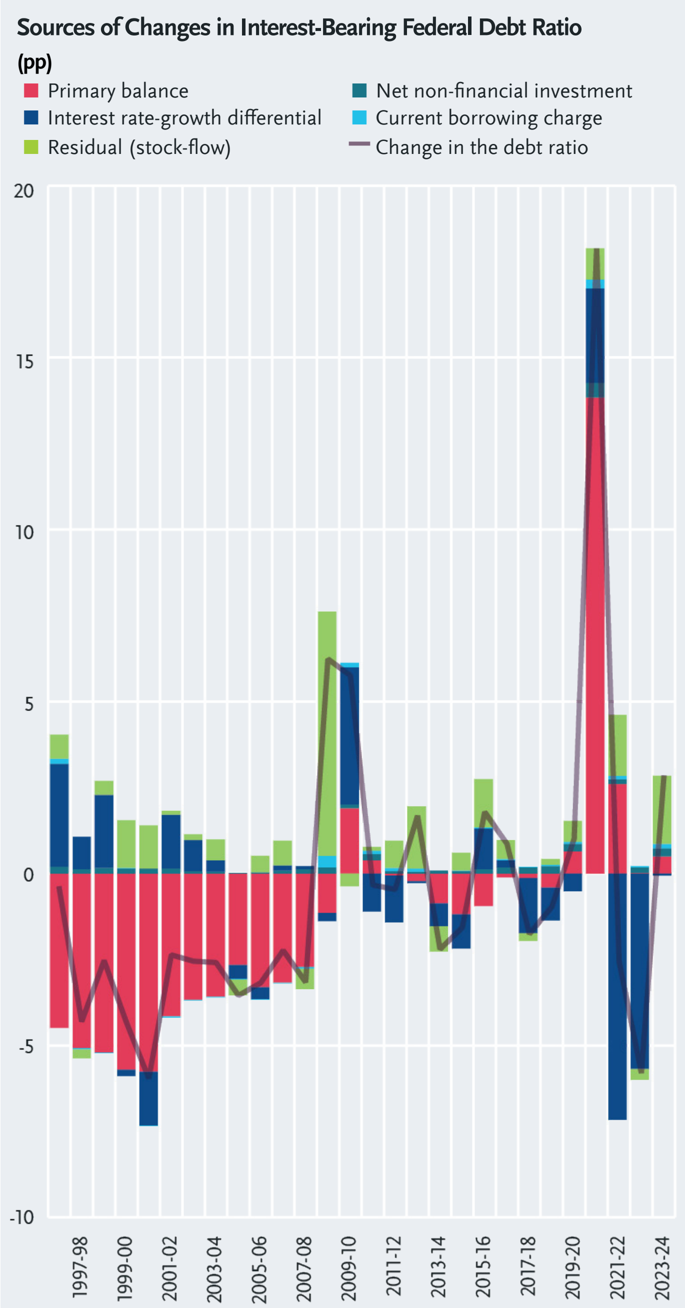
In fact, the historical record shows that to place the debt-to-GDP ratio on a firm downward track, the fiscal plan cannot rely on an assumption that *r* will be less than *g* over time and that debt dynamics will be favourable. From the mid-1990s to the GFC, a period of relative macroeconomic stability, the consistent downward shift in the ratio of federal interest-bearing debt to GDP was achieved overwhelmingly by the generation of large primary surpluses (Chart 4.11). *r* minus *g* was a contrary factor early in that period and then a variable and comparatively marginal one in the years preceding the GFC. The *r*–*g* differential was favourable in the years immediately preceding COVID because of historically low interest rates globally, but its impact was still relatively small.[12]

SOME RULES OF THUMB FOR FISCAL SUSTAINABILITY

To provide, with greater confidence, that the federal debt-to-GDP ratio will be on a downward path over the medium term, the federal government needs to target a (cyclically adjusted) primary surplus in a range of 0.5% to 1% of GDP. By drawing on accounting identities and by fitting a simple model against the fiscal track since the mid-1990s, we developed rough estimates of the annual, cyclically adjusted primary balance (as a proportion of GDP) necessary to bring the federal debt-to-GDP ratio down by 0.5 pp year by year.[13] Table 4.1 shows the results for different combinations of *r* (illustratively, the nominal rate of interest on 10-year government bonds) and *g* (the nominal rate of potential GDP growth). Specifically:

- If *r* is equal to g: for example, if the economy grows over the cycle at an average nominal rate of 3.5% (1.5% real) and if the 10-year bond rate is also 3.5%, then the annual primary surplus must average about 0.5% of GDP to bring down the debt ratio over time.

CHART 4.11



Source: Calculations by Bennett Jones.

TABLE 4.1

Primary Balance Ratio Required to Reduce the Federal Debt Ratio by 0.5 pp
Lagged Debt Ratio = 0.45

		Nominal GDP growth rate (%)			
		3.0	**3.5**	**4.0**	**4.5**
10-Year Canada bond rate (%)	**3.0**	0.5	0.3	0.0	-0.2
	3.5	0.7	0.5	0.3	0.0
	4.0	1.0	0.7	0.5	0.3
	4.5	1.2	1.0	0.7	0.5

Source: Bennett Jones calculations.

- If r is less than g, the required primary surplus to keep the debt ratio on a downward track is lower—for example 0.3% or less. There would be comparatively more fiscal room.
- If r is greater than g: for example, if the interest rate is elevated but economic growth potential is hampered because of poor trend productivity growth, then a primary surplus of 0.7% to 1% of GDP or more would be required to bring down the debt ratio over time.
- On balance, we consider it prudent to target a primary surplus of 0.5% to 1% of GDP, corresponding to diverse scenarios where both r and g are in a range of 3% to 4%.

ESTIMATION OF A NECESSARY STRUCTURAL FISCAL ADJUSTMENT

The December 2024 FES projected that the federal primary balance would shift from a *deficit* of 0.5% of GDP in 2023–2024 to a *surplus* of 1.2% of GDP by 2029–2030, but this was under economic and policy assumptions that no longer hold. The federal debt-to-GDP ratio was projected to fall from 42.1% in 2023–2024 to 38.6% by 2029–2030, with the rate of decrease in the ratio accelerating over the period. However, the economic slowdown caused by the tariff war with the United States and by uncertainty will cause fiscal deterioration that may extend over two or more years. Some of the losses of economic output and fiscal revenue may be permanent. Tax cuts promised by the new Liberal government will amount to permanent fiscal losses. The result is most likely to be a primary deficit and an increase in the debt-to-GDP ratio in the 2025–2026 fiscal year and the next one, even *before* addressing new and emerging expenditure pressures. Meanwhile, as per the commitment of the Prime Minister, any tariff revenue, of course not reflected in the FES projection, would be allocated to relief for workers and industries affected by the tariff war.

Accordingly, a prudent assumption is that on the current fiscal track the underlying primary balance is not greater than zero. Indeed, there should be caution in interpreting any projection that shows an improvement in the fiscal balance over a medium-term horizon without a firm commitment to fiscal anchors. Canada is not alone in adopting an optimistic bias in fiscal planning. The IMF observes that "past experience internationally shows that (...) realized debt-to-GDP ratios three years ahead are, on average, higher than projected by 6 percentage points of GDP."[14]

Meanwhile, the government must increase defence spending to 2% of GDP or more by 2030 or earlier. Under the fiscal track set out in Budget 2024 and under the April 2024 *Our North, Strong and Free: A Renewed Vision for Canada's Defence*, Canada's defence spending ratio was expected to rise from 1.4% of GDP in 2024–2025 to 1.76% of GDP by 2029–2030.[15] For planning purposes, we consider it prudent to factor in an annual defence spending increment of 0.25% to 0.75% of GDP (mid-point of 0.5%) by 2030 to bring our defence spending to 2% to 2.5% of GDP.

Thus, to achieve a primary surplus of 0.5% to 1% of GDP and to provide, with a reasonable level of confidence, that the federal debt-to-GDP ratio is on a downward track, the government needs to target permanent savings in non-defence program spending in the order of 1% to 1.5% of GDP, or C$30 billion to C$45 billion in today's dollars. Our calculation, admittedly based on high-level analysis, judgment and approximation, is summarized in Table 4.2.

TABLE 4.2

Structural Fiscal Adjustment to Lower Federal Debt-to-GDP Ratio over the Medium Term

Factor	% of GDP
Estimation of the ***target*** annual primary surplus to achieve an annual reduction in the federal debt-to-GDP ratio of 0.5 pp, based on prudent combinations of *r* and *g*.	0.5% to 1%
Minus: Approximation of the ***current***, underlying primary balance over the medium term under a prudent outlook.	0%
Plus: Incremental annual expenditure, as % of GDP, to raise defence spending to 2% to 2.5% of GDP by 2030 from 1.75% of GDP built into the fiscal track in Budget 2024.	0.5% (mid-point estimate)
Equals: Needed permanent savings (cuts) in non-defence program spending to achieve the target primary surplus of 0.5% to 1% of GDP over the medium term.	1% to 1.5%

Source: Bennett Jones calculations.

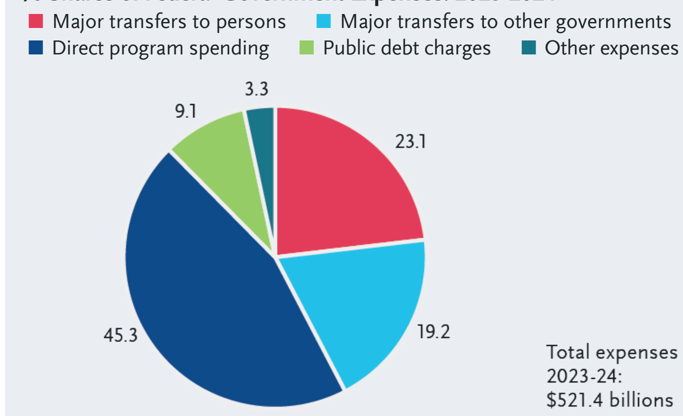
THE FISCAL ADJUSTMENT IN CONTEXT

This fiscal adjustment would pale in comparison to the drastic action taken in the 1995 federal budget to deal with a far more severe fiscal situation. Changes effected in the 1995 and subsequent budgets shifted the federal primary balance from about zero in the 1993–1994 fiscal year to a surplus of 4.5% of GDP by the 1996–1997 fiscal year and 5% of GDP or more in the subsequent four fiscal years. This fiscal adjustment enabled the government not only to lower sharply the debt-to-GDP ratio but in fact to eliminate the deficit, to begin repaying debt in 1997–1998 and to do so every year until the GFC.

Still, fiscal savings ranging from C$30 billion to C$45 billion annually cannot be achieved merely by eliminating waste or generating productivity gains in the delivery of programs. The Speech from the Throne stated that transfers to provinces, territories or individuals will be maintained. Thus, excluding also debt service charges, the envelope available to find permanent savings is small (Chart 4.12). In 2023–2024, direct federal program spending was C$236 billion, including operating expenses of C$140 billion and other transfers (e.g., grants, subsidies, contribution agreements) of C$96 billion.[16] As per Main Estimates for 2023–2024, projected spending for that fiscal year included about C$26.5 billion for the Department of National Defence.[17] The proposed fiscal adjustment would thus require cutting C$30 billion to C$45 billion per year out of a spending envelope of some C$210 billion, representing cuts of roughly 15% to 20%. No doubt, productivity gains can be achieved in the public service, including by deploying AI. However, the achievement of productivity gains requires investment in technology, systems and training, and the net savings may be modest. More substantial savings require that the government eliminate or cut some programs and then maintain strict fiscal discipline.

CHART 4.12

% Shares of Federal Government Expenses: 2023-2024



Source: Finance Canada, Fiscal Reference Tables, 2024, table 7.

The required fiscal adjustment will be reduced, but not substantially eliminated, if policy creates the conditions for stronger economic growth and/or improved market confidence in fiscal sustainability such that the *r* minus *g* dynamic may be as favourable as possible.

Again, a sustainable fiscal policy *can* allow a stable or increasing ratio of gross debt to GDP *if* the incremental borrowing is applied to *investments* that generate an economic or financial return to offset the higher debt charges over time. If market confidence is sustained, the government can draw on its capacity to borrow and to use its balance sheet to facilitate or accelerate public or private investment in new productive assets in the economy. However, it does not suffice to relabel expenditure as investment. There must be a demonstrable case that the investment that is debt-financed or backstopped will generate a future income stream.

POLICY CONCLUSIONS

The federal government has a responsibility to establish a fiscal plan that allocates resources to a finite set of priorities and that secures fiscal sustainability for the medium to long term.

This is even more important in a period of geopolitical stress and structural adjustment, with interest rates on government debt higher and potentially more volatile than in the previous decade.

Obviously, an economic slowdown or recession as now predictable is not a period for fiscal austerity. However, even while addressing immediate pressures, the government must develop a sustainable medium-term fiscal plan. This should include providing that the federal debt-to-GDP ratio will be on a firm downward track.

In our estimation, this requires a fiscal adjustment (permanent savings in non-defence program spending) in the order of 1% to 1.5% of GDP, together with ongoing financial discipline.

Steps to effect this adjustment over the medium term should include the following:

- A **comprehensive review of federal programs** to identify and cut those are not aligned with core federal responsibilities and priorities. Moreover, if departments are unable to demonstrate a track record of results on the basis of objective indicators, programs should be eliminated and funds returned to the Consolidated Revenue Fund. The streamlining of programs should be realized together with a program of workforce adjustment.

- A firm target for **across-the-board gains in productivity** (e.g., up to 5%–10%) that may be facilitated by the internal reallocation of a portion of the savings in technology (including AI), systems and worker training.

- An expert, **comprehensive review of the structure of the income tax system** to improve efficiency such as to meet revenue needs while strengthening the incentives to work, save and invest. Some savings may be achieved through this exercise (for example by eliminating or streamlining inefficient or ineffective tax expenditures). However, the ultimate goal would be to enhance growth potential, that is, *g*. Given the complexity of the income tax system, this exercise may need to be broken down into parts or phases over time.

There must also be discipline in federal borrowing for investment and in the use of the federal balance sheet.

- **Except where explicitly and prudently planned, the financial assets of the GoC should earn a financial return that is at least equal to its cost of debt.** This applies, for example, to investments in Crown corporations, including the CIB and the CGF.

- **Through the CIB, and in collaboration with provinces, municipalities and private sector partners, the government should privilege financial arrangements where more of the country's infrastructure is priced.** This would ensure that more costs are borne by users rather than taxpayers.

- **Governments should explore asset sales or long-term leases to monetize income streams from existing infrastructure that can be operated commercially.** This could free up funds for investment in new assets and reduce new public borrowing. Creative public–private partnerships should be explored where the private sector can contribute innovation, productivity gains and new value to the operation of public infrastructure.

Fiscal discipline must be enshrined across the federal system and communicated externally through the adoption of simple, transparent fiscal anchors that will be aligned with the goal of reducing the debt-to-GDP ratio consistently over time while allowing for cyclical responses. The two-year rolling deficit targets of former Finance Minister Paul Martin may be a starting point.

If these steps are insufficient to effect a meaningful fiscal adjustment and to secure fiscal sustainability, then the government should explain to Canadians that a tax increase will be necessary to deliver promised services.

Leadership by the GoC should inspire and support provincial efforts to secure the sustainability of their public finances, such that Canadians pay for the services they receive, that the services are delivered efficiently and that governments have the balance sheet to support the investment necessary to prosper in a shifting world order.

ANNEX 1 TO CHAPTER 4

Alternative Measures of Public Debt

There are many measures of public debt, reflecting different forms of accounting and different scopes and purposes of analysis.

The **federal debt** in the Public Accounts of Canada represents the accumulated deficits of the GoC (Table 4.3). The annual **deficit**, or fiscal balance, in turn is presented in the public accounts on an accrual basis of accounting: revenue is recorded when earned during the fiscal year, and expenses when incurred, regardless of when cash transactions are made. The annual deficit incorporates the effect of non-cash transactions, such as amortization of tangible capital assets as well as pension and employee future benefit expenses not funded in the period.

TABLE 4.3

Alternative Measures of the Federal Debt, Public Accounts, as at March 31, 2024

	$ millions	% of GDP
Federal debt – accumulated deficits	**1,236,151**	**42.1**
plus: non-financial assets[1]	116,603	4.0
Net federal debt	**1,352,754**	**46.1**
plus: financial assets	705,028	24.0
Gross federal debt (total liabilities)	**2,057,782**	**70.1**
of which:		
Accounts payable and accrued liabilities	264,056	9.0
Foreign exchange account liabilities	44,106	1.4
Derivatives	4,131	0.1
Interest-bearing debt	**1,745,489**	**59.5**
of which:		
Pension, benefit and other liabilities	368,667	12.6
Marketable debt (unmatured)	**1,376,822**	**46.9**

1. These are “net” (i.e., depreciated) tangible capital assets, plus inventories and prepaid expenses.

Source: Annual Financial Report of the Government of Canada, Fiscal Year 2023–2024

The annual deficit is an accounting measure that is different than the **financial requirements** that measure the difference between cash coming into the government and the cash coming out during the fiscal year. For example, the financial requirements include cash transactions in loans, investments and advances, and other non-budgetary changes in the government’s assets and liabilities. In 2023–2024, the federal deficit was C$61.9 billion whereas the financial requirements were C$85.7 billion. The government met these requirements, and it increased its cash balances by C$26.1 billion by net new borrowing in the debt market of $111.8 billion, equivalent to 4% of GDP.

The **net federal debt** in the public accounts is calculated by adding to the federal debt the (depreciated) value of the government’s non-financial assets.

The **gross federal debt** in the public accounts is equal to the federal net debt plus the financial assets of the GoC, including cash, loans, investments and advances (e.g., investments in Crown corporations), and public sector pension assets (not including the CPP).

The gross federal debt, representing the total liabilities of the GoC, may be broken down into:

- accounts payable and accrued liabilities (for example, provisions for contingent losses); and
- **interest-bearing debt** that in turn includes both unmatured marketable debt (funded in the debt market) and unfunded pensions and other future employee benefits (recognized as a liability by the GoC and adjusted annually by taking into account both interest accruing on the liability and new expenses incurred in the period).

The interest-bearing debt, in particular marketable debt that must be financed or refinanced in the market through the government’s debt strategy and borrowing plan, represents direct exposure to the debt market. While part of the interest-bearing debt is matched by the financial assets of the government, the return on these assets is not necessarily greater than or equal to the rate of interest on the debt, and it does not necessarily evolve in the same way as the changes in the cost of the debt.

The *Annual Financial Report* of the GoC provides a useful reconciliation between the federal net debt recorded in the Public Accounts of Canada and the total government net debt presented in the IMF international fiscal comparisons as a share of GDP (Table 4.4).

TABLE 4.4

Reconciliation of 2023–2024 Federal Debt-to-GDP Ratio to Calendar 2023 Total Government Net Debt-to-GDP Ratio

		% of GDP
Federal debt (public accounts basis)		**42.1**
Plus:	Non-financial assets	4.0
Net federal debt (public accounts basis)		**46.1**
Less:	Liabilities for public sector pensions	(5.6)
	Liabilities for other future benefits	(6.7)
	National accounts/public accounts methodological differences and timing adjustments	(8.0)
Net federal debt (national accounts basis)		**25.7**
Add:	Net debt of provincial/territorial and local governments	11.6
Less:	Net assets of the CPP/QPP	(24.4)
Total government net debt (as per IMF comparisons)[1]		**12.9**

1. The net debt figure was revised by Statistics Canada after the publication of the IMF's October 2024 Fiscal Monitor, from 13.1% to 12.9%.

Source: Annual Financial Report of the Government of Canada, Fiscal Year 2023–2024.

For purposes of consistency, international comparisons are typically based on national accounts measures of government deficits (or debt) that represent the government's share of the flows (or stocks) of value in the economy as recorded in each period (or accumulated and adjusted over time). In the national accounts, the government is one of the components of total economic activity.

Accordingly, **net federal debt on a national accounts basis** is equivalent to federal net debt on a public accounts basis after deducting liabilities for public sector pensions and other future benefits and after adjusting for methodological and timing differences between the two sets of measures.

The **total government net debt** as presented by the IMF is obtained by adding together the net federal debt and the net debt of subnational governments, including provincial/territorial and local governments, and then deducting the net assets in the CPP/QPP.

The deduction of the assets of the CPP/QPP is appropriate to allow consistent comparisons of net public debt across countries with different regimes for public pensions, including pay-as-you-go regimes that do not have dedicated investment funds. However, the net debt thus calculated understates the total liabilities of our governments, which cannot be offset by the CPP/QPP assets.

Notes

EXECUTIVE SUMMARY

1. *G7 Finance Ministers and Central Bank Governors' Communiqué* [Internet], G7 Kananaskis, May 22, 2025.

CHAPTER 1

1. See note 1.
2. *State of U.S. Tariffs* [Internet], The Budget Lab at Yale, May 12, 2025. Chart 1.1 shows the average effective tariff both before (17.8%) and after (16.4%) consumption shifts.
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15. *The Potential Impacts of US Tariffs on the Ontario Economy* [Internet], FAO, April 30, 2025. The FAO conducted its analysis based on trade actions announced as of April 17, with additional assumptions that it made. The FAO noted the significant uncertainty about the status of U.S. policy.
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18. *FOMC Statement* [Internet], Federal Reserve, May 7, 2025.
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CHAPTER 2

1. Our estimation of an annual IS curve for Canada over the period 1984 to 2024, which relates growth in Canadian real GDP to growth in U.S. real GDP, changes in real U.S. dollar commodity prices, changes in

the Canadian dollar exchange rate, lagged real interest rates in Canada and a dummy variable for COVID shows highly statistically significant elasticities to U.S. real GDP growth of 0.7 for the first year and 0.2 for the second year. Such high elasticities reflect not just the intensity of trade linkages but also the influence of factors that affect both U.S. and Canadian growth in the same direction and that are not explicitly controlled for in the model, such as global financial conditions, economic policy uncertainty and important geopolitical developments that affect confidence. Another important factor at play is that monetary policy objectives and reaction functions are similar in the two countries and therefore tend to have roughly similar impacts on the business cycle.

CHAPTER 3

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CHAPTER 4

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12. In some years, residual (or *stock flow*) factors, including net changes in the financial assets of the Government of Canada, contributed to sizable changes in the ratio of interest-bearing debt to GDP. For example, in 2008–2009 the government made large purchases of mortgage bonds to improve liquidity in this market. Such transactions did not affect the ratio of *federal* debt to GDP because by definition federal debt excludes debt incurred to acquire financial (and non-financial) assets.
13. We conducted the exercise by using the ratio of the federal debt (or accumulated deficits) to GDP. Technically, the measure most pertinent to an analysis of the identities linking r, g and the primary balance would be the ratio of the interest-bearing debt to GDP, while the measure of r should be the effective interest rate calculated as total debt charges divided by interest-bearing debt. In practice, however, we use a regression analysis on historical data to predict changes in the federal debt ratio based on the use of the 10-year Canada bond rate instead of the effective interest rate. In addition, in this analysis the constant term is set to zero so that changes in the debt ratio can only be driven by the primary balance ratio and the interest-growth differential term in interaction with the lagged debt ratio. Note that the resulting calculations of the primary surplus ratio required to keep the debt ratio constant or declining are somewhat sensitive to the value of the lagged debt-to-GDP ratio. Since the debt ratio may be expected to rise in the short term in a period of economic slowdown and recession, from a level of 42.1% in 2023–2024, we have used as an approximation for the medium term an initial ratio of 45%.
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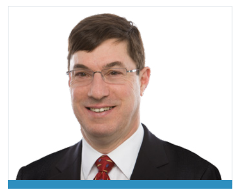

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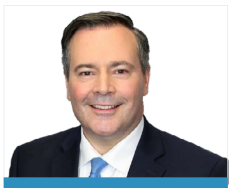

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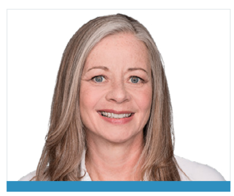

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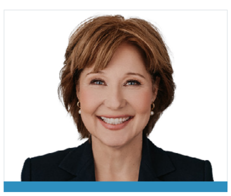

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