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The use (and misuse) of tariffs in North America: A new trade war?

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TRADE WARS MAY HAVE STARTED. At the time this report was published, the Trump administration had threatened, then paused, a 25 percent tariff on Canadian and Mexican goods. Before the pause, Mexico and Canada were preparing retaliatory tariffs. After the pause, Trump ordered a 25 percent import tax on all steel and aluminum entering the United States (US) to start in March 2025 and announced a plan for reciprocal tariffs on US trading partners.

In this brief, we document the different perspectives and economic consequences of North American trade wars and beyond.

A Brief History of Trade Deals in North America

In 1964, the US and Canada signed the North American Auto Pact. Subsequently, trade in North America grew rapidly. Much of this growth was in intra-industry trade. Previously, tariff protections set by Canada and the US limited imports and exports, and in large, parallel operations were set up in each country to avoid paying tariffs, one in Canada and another in the US. American firms with Canadian subsidiaries were smaller in scale than their US counterparts and, therefore, were at a disadvantage.

The car industry is characterized by what economists call internal economies of scale. In such industries, as production rises, average costs decrease. This implies that a larger production (which can be realized when firms can sell final goods in both countries) is more cost-effective and, therefore, increases the profits of firms while reducing prices for consumers. Another benefit of allowing firms to increase production levels by accessing more markets is that more firms can participate, increasing the varieties offered to consumers. In this case, countries would both import and export cars (i.e., Intra-Industry Trade), and consumers would gain from more choices and lower prices. The latter is a textbook example of important gains from trade, e.g., see Krugman and Melitz (2023). The Pact confirmed this result: the number of varieties produced in Canada declined while the level of certain model cars increased. In essence, production was concentrated in fewer plants that produced higher levels. Therefore, American firms imported some models from Canada and increased their exports of others. Another benefit from rising trade was that firm-level productivity was observed. Later, in 1989, the Canada–US Free Trade Agreement expanded to include other manufacturing sectors.

Over time, the North American Free Trade Agreement between the US, Canada, and Mexico (NAFTA) was signed in 1994, and Mexico was included in the free trade zone. Eventually, trade in automotive parts, not just final goods, increased substantially. In 2018, during President Trump's first term in office, NAFTA was renegotiated as the US-Mexico-Canada Agreement (USMCA). In the new deal, provisions were added to improve labor standards and open the Canadian dairy market, among other adjustments.

During the renegotiation of NAFTA that resulted in the signing of the USMCA, economists calculated the costs of dissolving the free trade agreement in the continent. For instance, Head and Mayer (2019) found that consumers in all three countries would experience up to 1.4 million fewer cars being made in North America. The losses would fall disproportionally on Canada and Mexico. Given the new Trump administration's agenda on the US economy, it is likely that the US, Canada, and Mexico will revisit the USMCA trade agreement, and there are also opportunities for other countries to develop new trade pacts with the US.

Trump's Tariff Strategy 2.0

Given the net loss countries typically incur once trade barriers are implemented, it may be puzzling why such trade wars emerge. From an economic perspective, despite their negative effect, many countries use tariffs or taxes on imported goods to protect domestic industries, generate revenue, and address trade imbalances. Beyond economic purposes, political considerations and national security measures might also justify tariffs.

In the particular case of the recent trade wars initiated by the US, three major reasons have been used to justify Trump's decision to levy tariffs, "the most beautiful word in the dictionary." First, the US economy has witnessed a great decline in manufacturing jobs over the last 40 years; see, e.g., Dharshini (2025). Mr. Trump argued that jobs that used to exist in the US have migrated to other lower-wage countries like Mexico and China due to globalization and previous trade agreements. Second, Mr. Trump believes that the US is running a large trade deficit. At the same time, other countries, including its North American allies, Canada and Mexico, and those in the European Union, have had a record of significant trade surplus by selling their products to US consumers. By imposing tariffs, he expects that this would establish a level playing field. Leveraging the American economic power, he believes that these protectionist intentions would generate new trade agreements between the US and other countries that may lead to the resurrection of the manufacturing industry and boost the demand for products made in America (Reuters, 2025). The argument is that a tariff policy, mixed with an investment and growth strategy and national security policies, could boost US manufacturing. Third, the tariffs may be seen as a negotiating tactic. After the announcement of the tariffs (later paused), Mexico and Canada have both acted to address Mr. Donald Trump's border concerns (Boak, Verza, and Gillies (2025) and Stevis-Gridneff et al. (2025)). Mexico's President Claudia Sheinbaum agreed to take back thousands of the first wave of migrants deported from the US and send 10,000 members of its National Guard troops to the border to focus on fentanyl smuggling, migrants, and guns. Similarly, Canada offered $1.3 billion Canadian dollars ($900 million) for border security with a package that included drones, helicopters, more border guards, and the creation of a joint task force with the US. Additionally, Prime Minister Justin Trudeau agreed to have a new "fentanyl czar" and list Mexican drug cartels as terrorist organizations.[1]

However, there are several strong counter-arguments for the motivations listed above for the trade wars. First, the US is still the "world's largest economy of the world" (Reuters, 2025, n.d). Although the country lost manufacturing jobs that employ many working-class individuals, the American economy has also generated tremendous growth in other sectors, including technology, innovation, automation, outer space, and services, among many others. Additionally, the tariffs imposed on China during the first Trump administration failed to increase the number of jobs in manufacturing, in fact, they continued to decline. Even without a significant change in trade policy, the US is on a higher growth trajectory than other advanced economies. Secondly, economists typically doubt the importance of bilateral trade balance as a barometer of economic health. We discuss this in the following section.

The Irrelevance of Bilateral Trade Balances

As we mentioned in the previous section, the second justification President Trump has floated for using tariffs against Mexico and Canada is to "correct" the US's bilateral trade deficit with these countries; see, e.g., Wile (2025). However, economists have long recognized that bilateral trade balances are essentially irrelevant, as the following hypothetical example illustrates.

Imagine that a school teacher buys meat from a butcher every month, while the butcher never buys anything from the school teacher. When examining the monthly trade balance between these two economic actors, it turns out that the teacher has a trade deficit every month. But is it a problem for the school teacher to have a permanent trade deficit (or for the butcher to have a permanent trade surplus with this school teacher)? The answer is no because the school teacher still produces something of value (teaching services) for people who need teaching services and who, in turn, are selling goods and services to the butcher. In that sense, having a bilateral non-zero trade balance opens up different avenues for trading and specialization (e.g., the possibility that the butcher buys bread from the baker, who in turn buys teaching services from the school teacher). Similar to the transactions of the teacher with the butcher, bilateral trade balances between countries are essentially irrelevant.

A slightly more informative magnitude would be the net trade position (also known as the "trade balance") of the school teacher, which means adding all of the bilateral trade positions of this school teacher with any other economic actor. If the school teacher ends up with an aggregate trade surplus, then the school teacher is saving some of his or her income and, as a consequence, accumulating assets that represent future consumption. The school teacher cares about current consumption and the level of saving, but whether it has a very positive trade balance with some actors or a very negative trade balance with other actors is usually irrelevant. The school teacher would not complain to the butcher about the fact that the butcher does not buy teaching services—to the contrary, the school teacher would be happy to obtain meat.

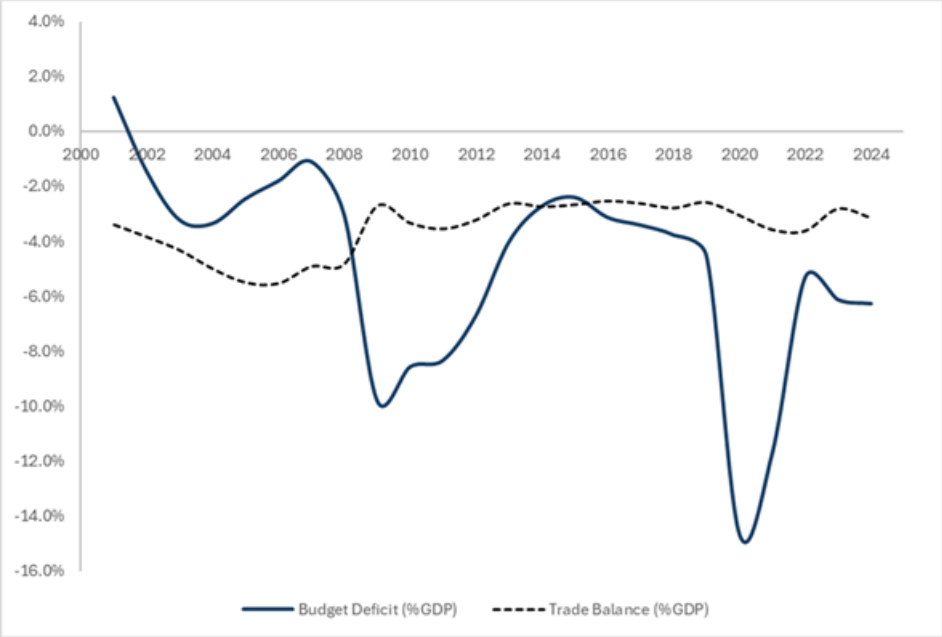
The same analogy applies to countries in that the net trade position (once all of the trade positions with all countries are aggregated) will have a mirror representation with respect to asset accumulation: an aggregate trade surplus represents an economy that is accumulating foreign assets (thus accumulating purchasing power for future consumption from output produced in other countries). In contrast, an aggregate trade deficit represents foreign economies accumulating US assets.

Figure 1 displays the US trade balance since 2001. It has been negative for the whole period and has fluctuated between 2.5 percent (2016) and 5.5 percent of GDP (2005). In 2024 this number was 3.1 percent of GDP, very close to the minimum. While unfair trading practices do happen (e.g., ignoring US property rights by some countries), and these can affect bilateral trade balances, a crucial factor often missing from discussions about the persistent US trade deficit is the low US saving rate relative to the level of US investment. A negative trade balance is necessarily a consequence of national savings being lower than domestic investment.

By definition, national savings is the sum of private and public (government) savings. Governments can run fiscal deficits, meaning that they spend more than they collect in taxes, which leads to the accumulation of public debt. A fiscal deficit is commonly known as the "budget deficit" (budget deficit: government's saving is actually negative), which under some circumstances can lead to a trade deficit. This scenario has been referred to as the "twin deficits," where a government's budget deficit causes (or is a significant factor in producing) a trade deficit.

Figure 1 also illustrates the US budget deficit as a percentage of US GDP since 2001, showing how much the government needs to borrow each year to cover its expenses. Note that 2001 was the last year the US had a fiscal surplus. It is also apparent that in recent years, the budget deficit dwarfs the US trade deficit. A persistent budget deficit can represent a problem because it means that the government is growing its debt as a percentage of GDP (see Figure 2, where US public debt in 2023 is a staggering 123 percent of GDP), which after some point (not clear where is that threshold, which is different for different countries for a host of reasons) might be unsustainable.

Figure 1: The Twin Deficits: The US Budget Deficit and the US Trade Deficit



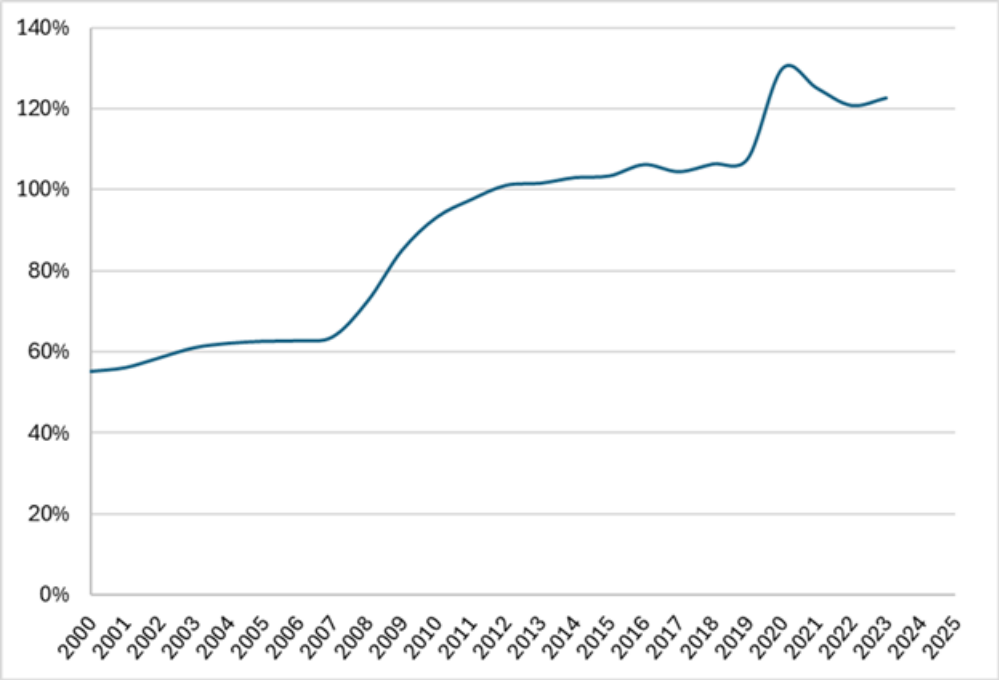
Sources: Gross Domestic Product [GDP], retrieved from FRED, Federal Reserve Bank of St. Louis; `https://fred.stlouisfed.org/series/GDP`, February 12, 2025. Budget Deficit, US Department of Treasury. National deficit data. Retrieved from `https://fiscaldata.treasury.gov/americas-finance-guide/national-def.`: US Census Bureau and US Bureau of Economic Analysis, Trade Balance: Goods and Services, Balance of Payments Basis [BOPGSTB], retrieved from FRED, Federal Reserve Bank of St. Louis.

Going back to trade, classical economic theory illustrates that negative trade balances in the present will imply positive trade balances in the future. Essentially, trade deficits mean borrowing from the rest of the world, and in periods in which the country repays those claims, it runs a trade surplus. But there is one special circumstance that allows the US to run permanent trade deficits (at least of "moderate" size) and that is not available to other countries.

Since the US dollar is used as reserve currency worldwide, when other countries receive dollars in exchange for their goods, instead of buying American goods and services with those assets, they decide to keep those green pieces of paper as a store of value (or to conduct international transactions between foreign countries), so that the US can permanently run a negative trade balance every period.

These are actually good news for Americans in that we obtain real goods and services from the rest of the world in exchange for green pieces of paper (other assets can also be used, but that possibility is available for other countries also; what matters is the possibility of paying for foreign goods and services with an intrinsically worthless asset called a dollar, not backed by gold or anything else). If the citizens and governments of other countries stop using the

Figure 2: US public debt as percentage of GDP



Sources: Gross Domestic Product [GDP], retrieved from FRED, Federal Reserve Bank of St. Louis; `https://fred.stlouisfed.org/series/GDP`, February 12, 2025. Total Public Debt, US Department of the Treasury. Fiscal Service, Federal Debt: Total Public Debt [GFDEBTN], retrieved from FRED, Federal Reserve Bank of St. Louis; `https://fred.stlouisfed.org/series/GFDEBTN`, February 14, 2025

dollar as a store of value (or use it less than currently), trade surpluses would be more likely for the US.

In summary, a trade deficit can result from a budget deficit: too much government spending relative to taxes collected, not because other countries are taking advantage of the US (which can happen in individual cases or industries). Some countries might be engaged in unfair trade practices. But a bilateral trade deficit is not evidence of this; in general, it is an irrelevant figure. The aggregate trade balance of the US can also be negative because of the special place of the dollar in the world monetary system.

Effects of Tariffs on Product Markets and Consumers

Policymakers typically face two competing issues when enacting a tariff policy. On the one hand, it may stimulate the import from competing industries, boost domestic supply, and generate new jobs and investment. On the other hand, tariffs can yield an increase in prices (and inefficiency as domestic firms protected by tariffs spend resources on rent seeking to keep tariffs in place rather than improve productivity). So, the net effect of the tariff policy depends on the size of each dimension. However, typically, trade liberalization in countries, when accompanied by reform policies, tends to be accompanied by economic growth, a decrease in the price of imported goods, and improved productivity in the exporting sector. Additionally, there is a consensus that imposing a tariff policy on a specific product leads to higher prices for this product and other related goods and services. It is worth noting that the time horizon also matters in assessing the effect of higher trade barriers. It is for this reason that President Trump, when announcing his tariff policy, acknowledged that "there may be a little pain for Americans in the short term."

As a concrete example, between 1981 and 1984, there was a trade restriction of Japanese automobiles to the US. This policy led to an increase in the price of automobiles for American consumers. With a US-Japan trade agreement in the long run, Japanese manufacturers invested in the US, and nowadays, the US has a vibrant automobile industry. Other scholars, such as Meredith Crowley, Professor of Economics at the University of Cambridge, have suggested that other forms of direct government support may have generated more substantial support for the US industry than trade barrier policies (Dharshini, 2025).

Tariffs act as taxes and, like most government interventions, distort free exchanges between demanders and suppliers of goods and services. The tax distribution depends on the price elasticity of consumers and suppliers in the market. While in the short-term, some suppliers may be reluctant to pass the resulting additional cost to consumers,

they tend to do it gradually. As Meredith Crowley put it, "Once you realize the tariff is in place permanently, the manufacturer realizes everyone's going to have to pay it, and they gradually raise their prices" (Dharshini, 2025, n.d). Since tariffs are levied on goods rather than services, and lower-income individuals tend to buy more goods, they bear a heavier tariff incidence. Non-economic rationales for supporting tariffs do not erase the economic costs and potential inflationary effects of tariffs. Whether the primary motive is economic or geopolitical, without well-calibrated tariff policies, the inefficiencies and welfare losses remain.

Effects of Tariffs on Exchange Rates

One final variable that has not yet been discussed is the exchange rate between the US dollar and the Mexican peso and, in general, between the US dollar and any other currency or basket of currencies in the world. An indirect effect of trying to protect US industries (before any retaliation by other countries) is that foreigners find it more difficult to obtain dollars, which are required for paying for American goods and services. In terms of supply and demand for dollars, the supply decreases when tariffs are imposed and this leads to an appreciation of the dollar (the dollar becomes more expensive).

An appreciation of the dollar in itself (in the absence of considering that tariffs make imports more expensive) is good for American consumers as it makes imports cheaper. But it is not good news for American exporters. That is, the exchange rate appreciation induces American goods and services to become more expensive to foreigners, something that tends to increase foreign imports in the US and decrease American exports, arguably the opposite of the intended effects of protecting domestic industries via tariffs. Put differently, generalized tariffs on imports appear to give an advantage to exporters but produce an exchange rate effect that affects them negatively.

While a unilateral increase in tariffs leads to an appreciation, in a trade-war scenario, the ultimate effect on the exchange rate is hard to forecast as it also depends on the response of the other countries and on which countries end up affecting the most in terms of foregone output. What is clear is that the volume of trade decreases, and all consumers and producers in all countries end up paying the tariffs imposed by other countries, and everything becomes more expensive, leading to misallocation of resources and less specialization, thus producing an aggregate decrease in welfare.

Finally, one additional undesirable effect for the US is that a full-blown trade war could induce more countries to organize efforts to replace the dollar with something else (e.g., BRICS), something that is arguably not in the best interest of Americans for reasons specified above.[2]

Implications of a Trade War on Unauthorized Migration

In 2023, approximately 80 percent of Mexican exports and 78 percent of Canadian exports went to the US. From the US perspective, about 15 percent of total imports came from Mexico and 14 percent from Canada (O'Neil and Huesa, 2025). The sum of exports plus imports as a percentage of GDP is a measure of the degree to which each economy depends on trade. In 2023, Mexico's total exports were worth $603 Billion (B), while imports were worth $528B. Since Mexico's GDP was $1,790B, exports plus imports were 63 percent of the value of the Mexican GDP. In the case of Canada, the figures for the same year were respectively $574B, $533B, and $2,140B, for exports plus imports representing 51.7 percent of GDP. In contrast, for the US, these figures are $1.86 Trillions of exports, $3 Trillions of imports, and a GDP of $27.72 Trillions, for exports plus imports representing only 17.5 percent of US GDP.[3] These numbers clearly show that Mexico and Canada are more dependent on trade with the US than the US is on trade with those countries.

Economic shocks have effects on immigration flows. There is significant migration from Mexico to the US of both the legal or authorized (family-based and jobs-based) type and illegal or unauthorized type. Unauthorized migration, in particular, is responsive to the business cycle, increasing during US economic booms and decreasing during Mexican booms, driven by several "push" and "pull" factors of immigration.[4] A full-blown trade war would harm all involved countries, but it would be particularly damaging to Mexico and Canada due to its significant exposure to the external sector and, more importantly, due to the volume of trade with the US.

If the US imposes general tariffs on Mexican imports and other factors remain constant, the incentives to emigrate to the US without authorization would increase. The bigger the gap between US GDP growth and its Mexican counterpart (or the worse the recession in Mexico is), the larger the expected unauthorized migration flows to the US. The Trump administration has already shown that enforcement actions will be used to curb unauthorized immigration. However, within this type of immigration, the overstaying of temporary permits (e.g., tourist visas) has historically been hard to detect as the entry of these foreigners into the US is legal. According to Warren and Kerwin (2017), the percentage of over-stayers within the unauthorized population (as opposed to entries without inspection) increased from 29 percent in 1995 to 66 percent in 2014.

A few tariffs in certain sectors are unlikely to cause significant labor movements if the Mexican economy grows at a rate close to that of the US, especially if the other countries refrain from escalating. However, a full-blown trade war would reduce overall trade and likely deliver a more significant blow to the very open Mexican economy, leading to increased unauthorized migration to the US. These expected effects are inconsistent with the Trump administration's objectives on unauthorized immigration: keeping unauthorized migration at a low level is incompatible with harming the Mexican economy and other source countries of unauthorized immigration.

Likely Scenarios for The Rio Grande Valley

The Rio Grande Valley (RGV) depends on trade with Mexico, facilitated by the ports of Roma, Brownsville, McAllen, Hidalgo, Progreso, and Rio Grande City. Many local businesses rely on goods from Mexico. Exports from the Maquiladora industry, which assembles goods in Mexico using parts from the US, generate jobs for trucking, warehousing, and logistics companies in the RGV. Several retail stores in the two major metropolitan areas, Brownsville-Harlingen and McAllen-Edinburg-Mission, benefit from Mexican shoppers who live across the Texas border. Increasing tariffs on imports and exports could generate adverse consequences, including manufacturing and supply chain disruption, trade, job losses, and economic slowdown. RGV farmers, who export citrus and other agricultural products to Mexico, could face reduced demand if Mexico imposes retaliatory tariffs. The burden on farmers can be significant if the tariff dispute includes additional costs of seeds, fertilizers, and agricultural equipment. If farmers and retailers can't pass on extra costs to their customers or receive other support from the government, they will exit the market.

Concluding Remarks

The current US administration has positioned tariffs as a central tool of economic and political leverage. While tariffs can counteract unfair trade practices, their indiscriminate application poses significant economic risks, potentially destabilizing not only the US economy but also key trade partners like Mexico and Canada. These nations, heavily reliant on trade with the US, would face severe economic repercussions under an extensive tariff regime. Strategically, the threat of tariffs can serve as a bargaining tool to secure concessions on issues such as border security, control of illicit substances (e.g., fentanyl), and deportation agreements. However, broad-based protectionism can lead to unintended consequences, including currency appreciation that undermines US export competitiveness. Additionally, economic strain in Mexico due to restrictive trade policies may exacerbate unauthorized migration, contradicting US immigration objectives. Economically, addressing trade deficits through tariffs is misguided, as bilateral trade balances are not a primary macroeconomic concern. More pressing is the US budget deficit, which poses a greater risk to financial stability. Furthermore, an all-out trade war could accelerate global efforts to reduce reliance on the US dollar, diminishing American economic influence. The administration's tariff strategy appears to be more about political leverage than full-scale economic confrontation. While targeted tariffs against unfair trade practices—such as intellectual property violations—may be justified, widespread protectionism risks economic instability and geopolitical backlash. A measured, strategic approach to tariffs is the most pragmatic course of action. Beyond trade policy, globalization has disproportionately impacted low-skilled workers, widening economic disparities despite high US productivity driven by labor-saving technologies. Addressing these challenges requires comprehensive industrial and subsidy policies that promote well-paying jobs and economic well-being. Protectionist policies alone are insufficient, as they often encourage monopolies and create unintended global spillovers. A balanced strategy that leverages comparative advantages while ensuring fair trade terms, coupled with investment in growth, is essential to revitalizing US manufacturing and fostering sustainable economic progress.

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Notes

[1]See, e.g., *BBC News* and *BBC Central America* on February 3, 2025, accessible at https://www.bbc.com/news/articles/c805jjk2klko.

[2]BRICS is an intergovernmental organization consisting of ten countries—Brazil, Russia, India, China, South Africa, Egypt, Ethiopia, Indonesia, Iran, and the United Arab Emirates.

[3]Data on exports and imports are available at The Observatory of Economic Complexity at https://oec.world/en. GDP figures available from World Development Indicators, available at https://databank.worldbank.org/.

[4]Some recent evidence of the response of unauthorized immigration flows to push and pull factors on immigration is found in Lopez-Velasco (2025). Lee (1966) is the author who first describes the "push" and "pull" factors of immigration.

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