

“Sell Canada”?

No Cause for Pause in Foreign Investment

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Highlights

- Much ink has been spilled over Canadian Foreign Direct Investment (FDI) figures, with concerns that stronger net outflows in recent years reflect deteriorating economic competitiveness.
- It is equally, and we argue more probable, that net flows reflect Canada’s place as a small, mature and aging economy. Developments are consistent with other advanced economy peers.
- A large share of the net outflow since the turn of the millennium is due to the finance and insurance sector. This occurred from a position of strength and ultimately reflects the large growth opportunities outside Canadian borders.
- Many sectors, including manufacturing, continue to see net inflows of FDI. In other areas, net outflows can often be attributed to sizeable ‘one-off’ outward M+A transactions, while inward FDI shows no signs of wavering.
- Canadian policymakers should do all they can to boost competitiveness and prosperity, rather than respond to aggregate FDI movements where the interpretation is more nuanced than the headline data suggests.

Canada’s foreign direct investment position has been the focus of persistent debate, with some commentators raising a red flag when the pace of outflows quickened relative to inflows over the 2015 to 2017 period. Some argue that this pattern reflects Canada’s slipping competitive position. Embroiled in legal battles and delayed initiatives, the energy sector is often used as the posterchild of what ails Canada, creating a narrative of overall foreign investor skittishness.

However, there are a number of issues with this “sell Canada” story. First, it is unclear that the relative outflows are problematic at all. Both outward and inward FDI can reflect any number of benign or positive motivations. Second, there is a tendency for commentators to focus on the step-down into deeper deficit position that occurred in the stock of FDI in 2015 (Chart 1). However, this appears to largely reflect two back-to-back outsized impacts. In that year, Canada’s stock of investment abroad was revalued in a reflection of a weaker Canadian dollar, adding \$116 billion to the value of those assets. This effect persists on the stock thereafter. The other material impact stemmed from a handful of large transactions, but one in particular within the transportation sector in 2017 that allowed a domestic firm to gain greater market penetration. Put simply, it’s a bit of a stretch to assign the deterioration in net FDI as “flight” from Canada. Inward FDI showed no parallel deterioration, both in terms of stocks and flows (Charts 1 and 2).¹

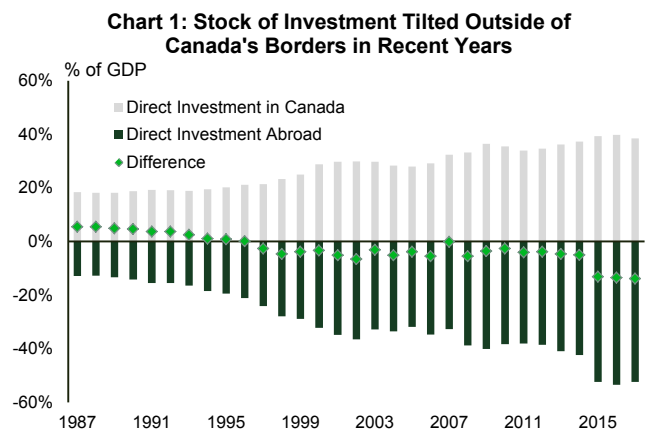
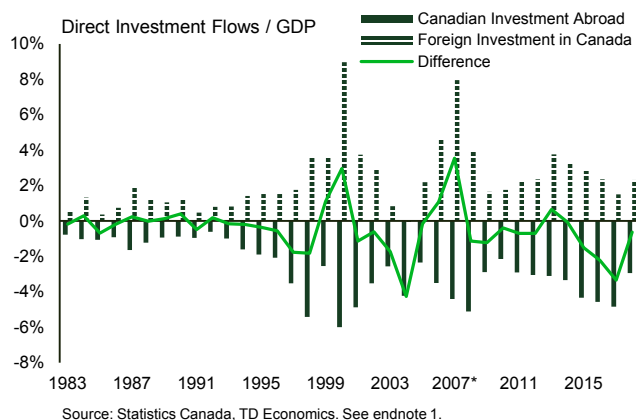


Chart 2: 2018 Net FDI Flows 'Back to Normal'



Third, pulling the lens back across a longer time period indicates that Canada’s performance has been in line with other mature, advanced economies. This suggests that the motivation behind investment flows is likely rooted in the changing sources of relative global growth. In a country that reflects a mere 1.4% of world economic activity, it is a pretty safe assumption that many more growth opportunities reside outside our borders.

Lastly, stripping out from the tally a single sector – finance and insurance – changes the picture significantly. Most of the net deterioration of FDI flows from 1999 onwards is attributed to the finance and insurance sector, which stretched its wings from a confined domestic market to take on a stronger international presence. This trend also flies in the face of long-held perceptions that define Canada as a commodity country. Historically, the energy sector has not been the driving force of net foreign investment outflows.

The basic message is that a deeper dive into the data suggests that concern over net FDI flows are overplayed and may be an inversion of the classic idiom about forests and trees. Analyses that miss the details (trees) in favour of the aggregate picture (forest) ultimately miss the interpretation of the economic significance (if any).

The Ins And Outs Of FDI

Foreign Direct Investment is defined as establishing a “lasting interest” in a business in another country. This is defined as controlling at least a 10% stake in the business (or one of sufficient size to play a role in its management),

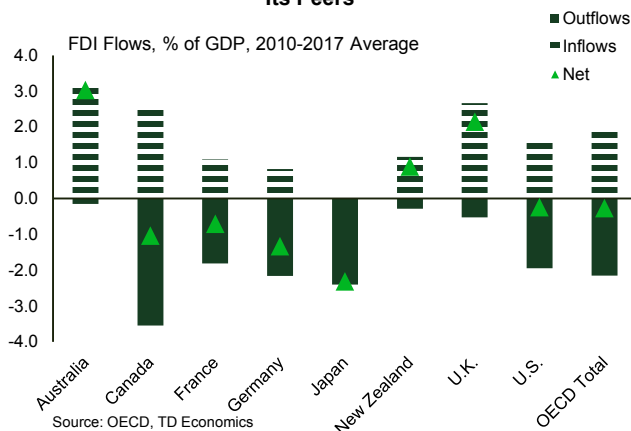
which distinguishes FDI from portfolio investment. Looking at the two sides of the coin, outward FDI measures the flow of money ‘out’ of a country into foreign jurisdictions, while inward FDI is the converse: money flowing ‘into’ a country from beyond its borders.

There’s an adage that goes something like: where a company puts its capital, is where they think the future lies. The challenge for economists is that there’s no single theory that appropriately captures the motivation for firms that engage in FDI. The explanations vary from capturing scale, to market and risk diversification, to cost considerations, to tapping into unique firm characteristics, such as access to technology, firm clusters, labour pools and so forth.

Indeed, using OECD data for cross-country comparability indicates that Canada’s experience with net FDI flows is not all that unusual (Chart 3). Canada may look a bit different from its antipodean peers (which have experienced a China-driven lift), but the recent performance is roughly in line with other advanced economies such as France, Germany, and Japan. Indeed, even the U.S. experienced a modest overall outflow over this time. One would hardly make the parallel claim that the U.S. lacks competitiveness based on these figures alone. In fact, as a share of GDP, Canada has consistently attracted more foreign direct investment than the U.S., both in the near term and over the full OECD data sample.

The benefit of foreign assets ultimately accrues to their domestic owners.² The ‘sending’ country benefits as firms expand markets, improve profitability and build their productive asset base. As with most aspects of international

Chart 3: Canada Hardly an Outlier Against Its Peers



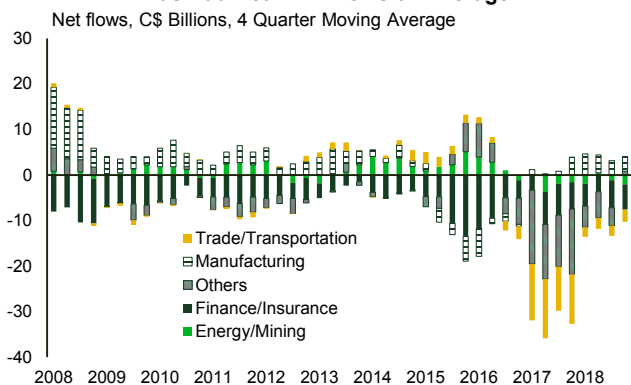
trade/transactions, FDI is not about winners and losers, but about greater opportunities, bringing production closer to target markets, and the diffusion of knowledge.

Recent developments: No cause for pause

Putting the debate aside on whether FDI flows are a good or bad outcome, it's useful to dive into Canada's actual performance and relative drivers. The most logical place to start is at the highest level. Scaled to GDP, recent developments in FDI stocks do not look out of step with history, but do show a step-down in 2015 that continues to persist (Chart 1). As noted earlier, the impact on foreign asset values from the loonie's depreciation had a large hand in this outcome. More importantly, looking at the historical pattern on inflows offers little reason for concern, as it remains highly consistent with past behavior (Chart 2).

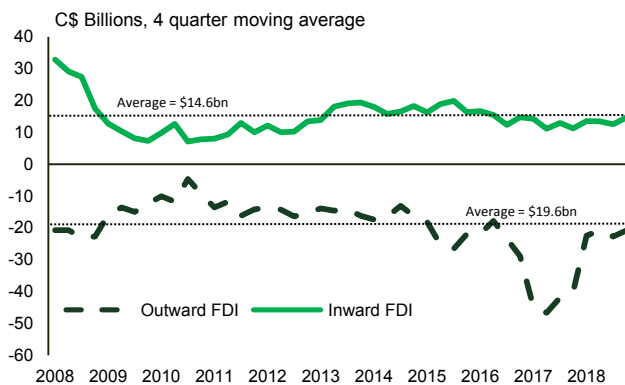
Honing in on the flow from year to year offers greater insight into the near and long term drivers. However, it's important to place caution in drawing too much of a conclusion from one year's data, due to volatility and Canada's small size, where a single deal can drive a large wedge in the aggregate data. Indeed, this was a key factor behind 2017's deterioration in net flows. February 2017 saw Enbridge complete its acquisition of Spectra Energy, a U.S. energy infrastructure firm, for roughly C\$38 billion. This had the effect of causing the 2017 tally as a whole to show a sizeable net outflow of FDI, even though the transaction was concentrated in the first quarter (Chart 4). Inward FDI in that sector continued to hold up over this time, suggesting the story is largely one of a Canadian firm obtaining scale, rather than a negative narrative of 'sell Canada'.

Chart 4: Stripping out Finance/Insurance, Canada Has Had Net FDI Inflows on Average



Source: Statistics Canada, TD Economics.

Chart 5: Inward FDI On Trend



Source: Statistics Canada, TD Economics.

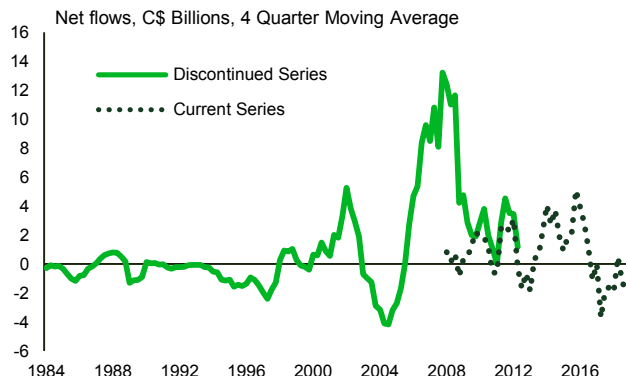
Digging further into the details, the 'others' category also appears to have been a driver of outflows in that year. However, this reveals a similar story with a handful of large, outbound M+A deals. Again, separating outflows from inflows reveals that inbound FDI did not deteriorate over this time and remained in line with its history (Chart 5). Interestingly, the negative Canadian narrative on the commodity sector fails to be a material factor in either of these near-term data trends.

Drilling down

Moving away from the idiosyncratic year-to-year movements shows that around the late-1990s, Canada went from being a net recipient of FDI to a net global supplier of capital. Since 2008 (the earliest period available using the current Statistics Canada data), Canada has experienced small positive FDI inflows on net in the energy and mining sector, as well as in other sectors excluding finance and insurance (Chart 4).³ Notably, the overall direction of flows in the manufacturing sector are inward, excluding the brief period around 2015/2016. Despite some headwinds and more than its share of negative headlines, the manufacturing sector in Canada continues to attract foreign capital.

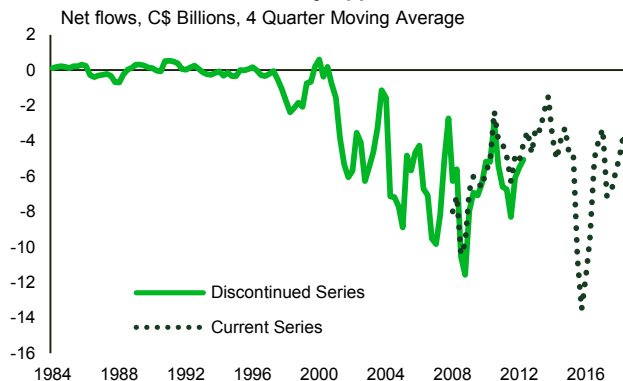
In another instance of perception versus reality, concerns around investment flows within the energy and mining sector seem somewhat overstated when put into a historic context (Chart 6).⁴ There's no question that the heydays of past periods came to an end a couple years ago, but the net outflows are not a large departure from past patterns. Also, the cyclical nature of these flows is obvious and by no

Chart 6: Energy/Mining Sectors Have Been Significant FDI Magnets



Source: Statistics Canada, TD Economics. Last datapoint: 2018Q4.

Chart 7: New Millennium, New Finance/Insurance Industry Approach



Source: Statistics Canada, TD Economics. Last datapoint: 2018Q4.

means can one conclude that the current environment is the best predictor of the future environment. Things can and do change. For example, the Kitimat LNG project in B.C. is expected to be a significant source of inward FDI in this industry going forward.

However, if there is one sector that stands out, it's the clear and persistent trend within finance and insurance. This group has driven much of the swing in Canada's net FDI position (Chart 7).⁵ In fact, this sector has been influential enough that if it is excluded from the tally, the average outflow reported in Chart 5 drops by more than \$6 billion, while the change in inflows is reduced by less than \$2 billion per year. Without finance and insurance, net FDI outflows become net inflows over the long term.

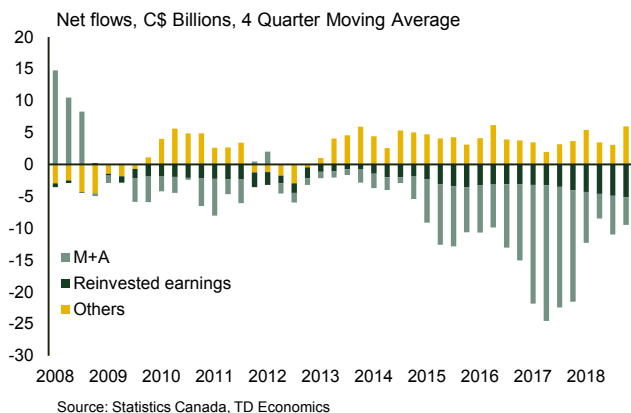
The driver is a change in behaviour. Around the beginning of the millennium, firms in this sector became increasingly outwardly focused in a more aggressive expansion strategy that resulted in significant cross-border M+A activity. Is this a harbinger of Canada's lack of competitiveness? Ultimately, domestic strength and the relative comparative advantage of those firms allowed for an expansion into other markets for scale and growth opportunities. We would argue that far from signalling a deterioration of competitiveness, this trend is a reflection of a solid foundation from which firms were able to build a global footprint.

Type matters too: 'quality' flows still there

Aside from industry flows, the type of net FDI matters for informing potential economic impacts. Flows can be broken into three categories, ranked in terms of how much information they contain:

1. **Others (Greenfield).** The catch-all term, 'Others', may not sound like it should be informative, but this category actually captures greenfield-type investment, where a foreign firm sets up new operations or expands existing ones. We consider this the most informational category. Firms undertaking these investments likely have a positive view of the competitive advantage offered by the recipient country. Or, in the case of "in the ground" resources, firms at least have the confidence to conduct new operations and exploration in the destination country. This type of investment is also more likely to introduce or deepen products, skills, technology, services and operational processes in the domestic economy.
2. **Reinvested earnings.** This category contains information on firms making the decision to put foreign earnings back into that country, rather than repatriate those funds. This too can signal the expansion of productive capacity in the host economy.
3. **Mergers and acquisitions.** This category is more debatable. On one hand, an acquisition implies a foreign firm's confidence in the host country as a secure market or opportunity. But, from the perspective of real economic impacts, it may simply reflect a transfer of wealth from a domestic firm to a foreign firm with little new value-add to the economy. Firms may be purchasing foreign rivals to capture intellectual property or to gain market share. So, it's not conclusive that this represents net 'new' capacity in the recipient country, unless it subsequently provides the needed scale for future initiatives, or technology, intellectual property and skills transfer that otherwise would not have occurred.

Chart 8: 'Greenfield' Investment Has Held Up, M+A Reflects Nuances



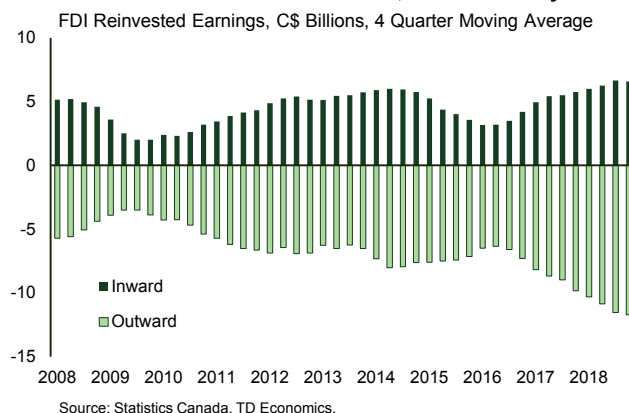
Keep in mind, this flow can go the other way too: the host country transferring scale to the foreign firm, offering few net new advantages to the host.

It is for all of these reasons that caution is needed in simply looking at aggregate FDI flows and coming to a binary conclusion that it is a reflection of good or bad competitiveness trends.

Net Canadian FDI flows can be characterized as a continued inflow in the 'other' category, a relatively small outflow of reinvested earnings, and a large outflow in the M+A space in recent years (Chart 8). Healthy flows in the 'other' category is reassuring, while the trend in reinvested earnings would be, on its face, somewhat concerning to the extent that it is a signal about foreign confidence in the Canadian economy.

However, this statement cannot be made conclusively. Inward investment in this category has been steadily rising in the past two years (Chart 9). This is being more than offset by a stronger outward reinvestment trend. The acceleration in recent years may be associated with changes to the U.S. tax system favouring investment, and we would suspect that based on the industry trend data, much of the activity in this category is being driven by finance and in-

Chart 9: Net 'Outflows' in Reinvested Earnings a Factor of Canadian Behaviour; Inward Healthy



urance, although data by type of industry is not available at this level. Ultimately, we again see little in this data that requires rushing to ring the alarm regarding Canada's competitiveness in attracting foreign capital.

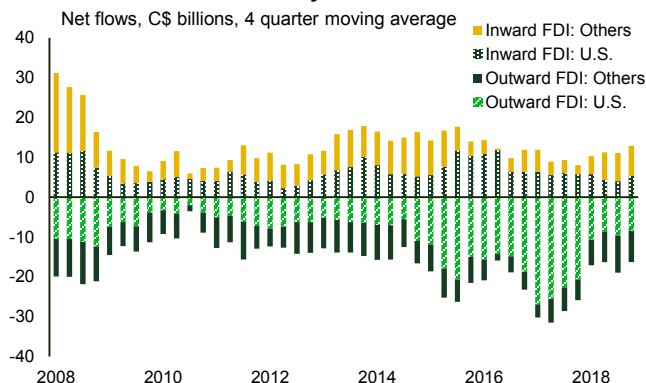
If anything, the outbound data may suggest some timidity within Corporate Canada. Firms appear happy to engage in both cross-border M+A activity and increase the size of their foreign plays via reinvested earnings. Each of these categories accounted for roughly half of outbound FDI from 2007 onward (Table 1). The dominance of these categories leaves little room for greenfield ('Other'), which makes up less than 10% of outward flows. This is well below the equivalent share of inflows (roughly 30% of foreign investment in Canada over this time). We wouldn't dwell on this given the volatility of the data and predominance of finance and insurance outbound activity. But, it is nevertheless interesting that despite many negative headlines, one could argue that Canadian firms may not be aggressive enough in their beyond-border activity, at least compared to their foreign counterparts.

U.S. Still Front and Center

Switching the lens a bit, we can also examine the FDI story from a geographic perspective. The gravity model of trade,

Table 1: Canadian Firms Cautious On Outward Greenfield FDI	
Total Outward FDI	Total, 2007 to 2018
Mergers and Acquisition	405bn (49.6%)
Reinvested Earnings	333bn (40.8%)
Others	78bn (9.6%)
Source: Statistics Canada, TD Economics.	

Chart 10: Both Inward and Outward FDI Still Dominated by the United States



which suggests that countries trade more with those that are a) bigger and b) closer, seems to hold for FDI as well (Chart 10). Both inward and outward flows are dominated by the United States, although the effect is greater in outbound FDI – roughly 60% of Canadian FDI is destined for the States, which in turn makes up at least half of our inflows in the last decade or so.⁶ No surprises here, as this is pretty much what economic theory would predict, and makes intuitive sense given the long standing ties, economic and otherwise, between the two countries.

Bottom Line

If commentators have made you fret over the state of Canadian FDI, fear not. Even ignoring the ambiguous economic associations, the details of these flows are not raising red flags. Once the finance and insurance industry is taken into account (where net outflows likely reflect a mature do-

mestic market), the sign flips: the last decade or so has seen inflows of investment to Canada, on net, including much-discussed sectors such as manufacturing. Some more eye-popping net outflows are revealed on closer inspection to be due to Canadian firms bulking up beyond our borders, with foreign inflows holding steady throughout – again hardly a sign of deteriorating competitiveness. On top of this, the indicators of quality remain intact, with inward greenfield-type investment steady and positive. Foreign firms also continue to reinvest their Canadian earnings in local operations. M+A outflows have been sizeable, but the economic significance of this category is debateable at best. None of this is to suggest that Canadian policy makers should be resting on their laurels – a continual review and focus on competitiveness will serve to increase Canadian prosperity. However, the FDI metric is probably not the one to watch as the tell-all signal.

Endnotes

1. Note that pre-2007 data comes from a discontinued Statistics Canada table, and is thus not completely comparable with the 2007 onwards period. In the overlapping period (2007 to 2011), the two measures were within 3% of each other on average, and so we have presented them together. ([back to text](#))
2. In the case of shifting production, this typically comes in the form of greater capital income relative to labour income in the source economy. ([back to text](#))
3. Both averaged roughly C\$800 million in net inflows over this time. ([back to text](#))
4. As with Chart 1, we have relied on discontinued Statistics Canada series to fill in the historic picture. However, definitional and methodological changes are more significant in this sub-category; we have thus chosen to present the series separately. ([back to text](#))
5. See note 4. ([back to text](#))
6. We say 'at least' as this figure may be understating the true share attributable to the United States; the data is not presented on an ultimate investor basis. In effect, if an American firm uses a Dutch subsidiary (for example) to invest in Canada, that would show up as Dutch FDI. Statistics Canada found that, in 2016, this effect understated the level of U.S. direct investment in Canada by about 9% (See <https://www150.statcan.gc.ca/n1/daily-quotidien/180425/dq180425a-eng.htm>). ([back to text](#))

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