Foreign Direct Investment:
Following the Global Cycle

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I. Highlights

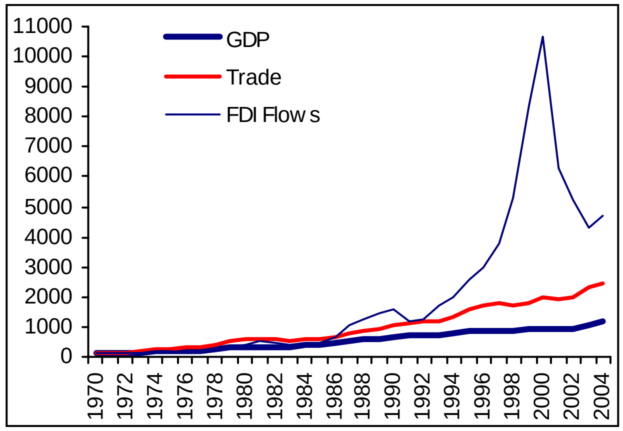
- Global GDP growth reached its summit in 2004, at 5.1%. EDC's Fall 2005 Global Export Forecast calls for growth to moderate to 4.2% this year and 4.1% in 2006.
- 2004 was not only a good year for global economic growth, but it was also a turning point for foreign direct investment (FDI). FDI inflows rose 2% in 2004 following 3 consecutive years of decline. Flows to developed economies continued to decline in 2004 from their 2000 peak, but this was more than offset by a rise in flows to developing countries. The question is whether the upturn in FDI will be sustained.
- The recovery in FDI was facilitated by surging global capital flows. Global capital flows, which sunk to a trough of about US$400 billion in 2001, reached US$870 billion in 2004. China was a key factor behind this growth. China's capital exports have soared more than four-fold since 2001, reaching close to US$70 billion in 2004. While China's capital has been primarily directed at US Treasury Bills, it has helped lubricate global capital markets and enabled FDI to flow to higher-risk sovereigns.
- Global capital flows likely increased again in 2005, albeit at a more moderate pace than last year, but flows may start falling off in 2006. The pace of decline will depend on large capital exporters such as China. FDI flows are less cyclically sensitive than other capital flows, but they may also start to ease next year.
- The bottom line is that global investors will become more selective in 2006 in terms of where they place their funds. This will make it a more difficult year for emerging market borrowers to navigate, particularly those with weaker economic fundamentals, as they compete for a smaller supply of global capital.
- Canada is expected to remain a net exporter of FDI this year and next. It is important for Canadian companies to continue to continue to seek investment opportunities abroad that will help them specialize and move up the productivity ladder at home.

II. Introduction

The global business cycle hit its peak in 2004. Not only did global output rise an impressive 5.1%, but global capital flows surged and foreign direct investment finally turned the corner, registering positive growth after three consecutive years of decline.

The 2% increase in FDI inflows in 2004 was aided by renewed investor interest in the US. The strength of productivity growth in the US clearly makes it an appealing location for investors, while the fall in the US dollar over recent years has helped make it a more affordable investment location. On the flip side, the US has to attract capital inflows to finance its growing current account deficit. While most of these inflows are in the form of portfolio investment, FDI inflows have increased in importance over the past year.

Figure 1: Globalization at a Glance (1970=100)



Source: IMF, EDC Economics

After the US, the United Kingdom and China were the second and third largest recipients of FDI in 2004, with FDI into China reaching yet another record high.

Merger and acquisition activity (M&A) is just one element of FDI flows, but it tends to be the component that is the most sensitive to overall economic conditions. Merger and acquisitions declined in each of the last three years, but jumped 28% in 2004 with the largest M&As taking place in the financial sector.

While 2004 was a stellar year for the global economy, the best is now behind us. EDC Economics expects global growth to slow, but still remain a very respectable 4.2% this year and 4.1% in 2006. Global capital flows are also likely past their prime, as flows should increase again this year but at a slower pace than in 2004. Flows are expected to start falling off in 2006.

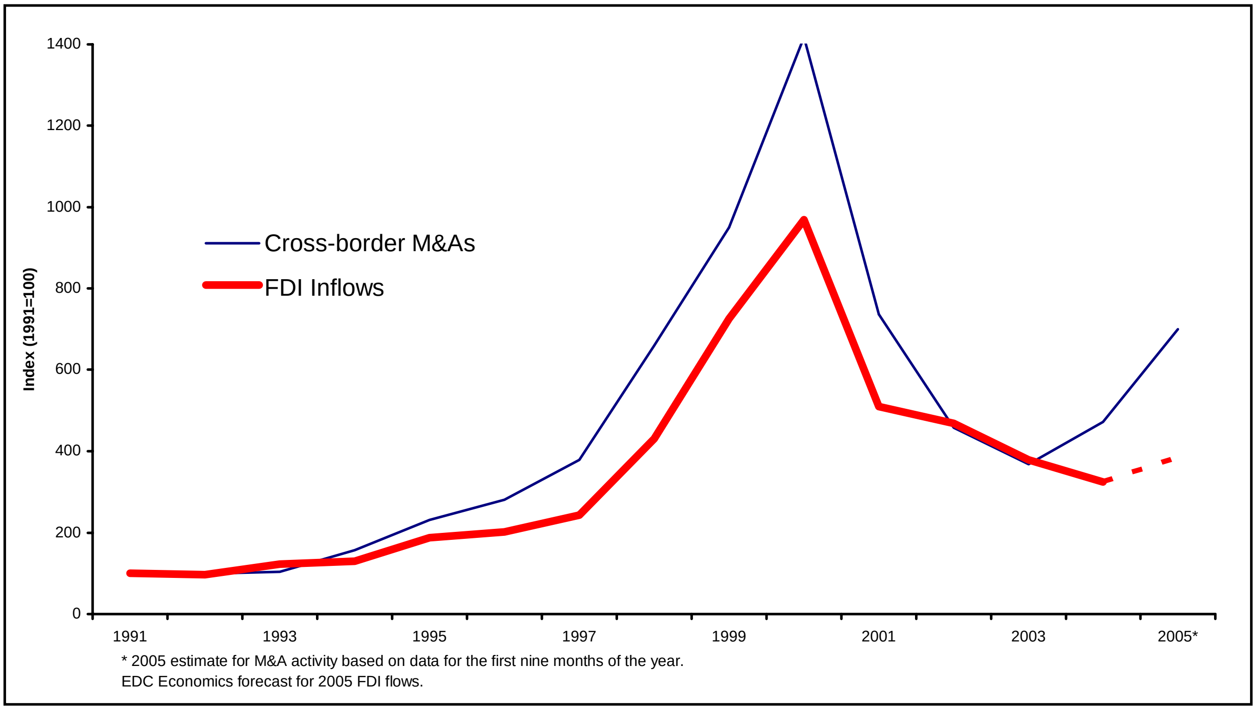
FDI is less cyclically-sensitive than other capital flows and should hold up fairly well. Data for the first 9 months of 2005 suggest that M&A activity is on track to reach its highest level in years. FDI inflows to the US, the UK, the euro area and Canada are running above year-ago levels. Flows to emerging markets should also remain strong as companies in the advanced economies continue to look for productivity gains by securing access to lower cost production facilities abroad. Other factors that bode well for FDI include the rebuilding associated with the tsunami and other natural disasters, and the adoption of new laws and regulations in some countries to improve their investment climates. On the downside, a one-off tax amnesty on foreign earnings awarded by the US is likely to reduce FDI outflows in 2005, negatively affecting global flows.

Table 1: Global FDI Inflows (billions $US)

	1993-98	1999	2000	2001	2002	2003	2004
World Total	**401.7**	**1092.1**	**1396.5**	**825.9**	**716.1**	**632.6**	**648.1**
annual % change	***--***	***172***	***28***	***-41***	***-13***	***-12***	***2***
Developed Countries	256.2	849.1	1134.3	596.3	547.8	442.2	380.0
annual % change	*--*	*231*	*34*	*-47*	*-8*	*-19*	*-14*
share of total (%)	*64*	*78*	*81*	*72*	*76*	*70*	*59*
Developing Countries	138.9	232.5	253.2	217.8	155.5	166.3	233.2
annual % change	*--*	*67*	*9*	*-14*	*-29*	*7*	*40*
share of total (%)	*35*	*21*	*18*	*26*	*22*	*26*	*36*

Source: UNCTAD World Investment Report 2005

Figure 2: FDI Flows to Developed Economies and Cross-border M&A Activity

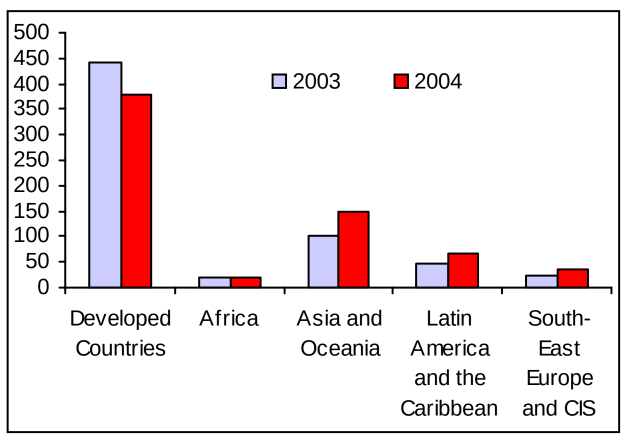


Source: UNCTAD

III. FDI Inflows by Region

FDI flows to **developing countries** increased 40% in 2004 to US$233 billion – the second highest level on record. Developing countries need FDI to help sustain the high growth rates required to raise their living standards closer to those of advanced economies. But developed economies also have much to gain by investing in the developing world.

Figure 3: FDI Inflows by Region



Source: UNCTAD

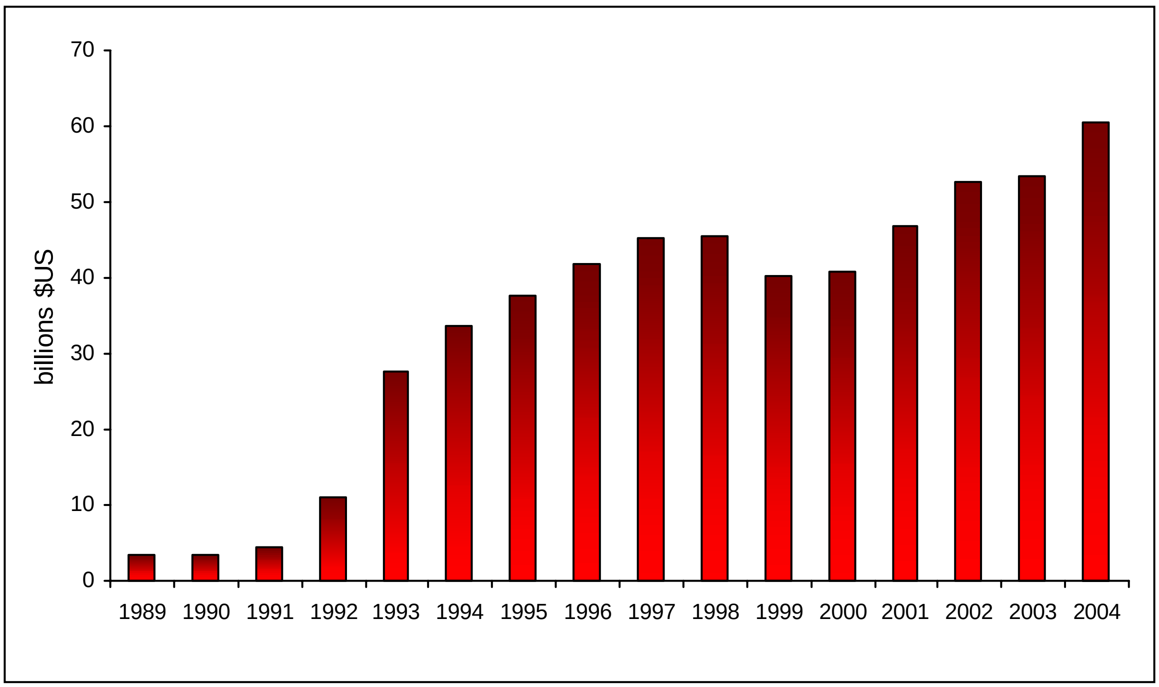
The strong growth in FDI flows to emerging markets reflects the trend towards offshoring. Advanced economies are setting up parts of their production operations abroad to take advantage of lower costs, particularly for labour, and free up their own resources to move up the productivity ladder to higher value-added products. Companies are also choosing to set up production facilities abroad to secure access to a growing consumer base, including in the populous BRIC economies (Brazil, Russia, India and China).

Strong growth in R&D investment has become an important incentive for FDI flows to developing countries, as host countries tap into human capital abroad. High commodity prices have also encouraged FDI flows to resource-rich countries.

FDI is the major source of private financing flows for developing countries -- in 2004, it accounted for more than half of resource flows to developing countries and was considerably larger than official development assistance. However, FDI flows remain concentrated in a small group of countries.

The **Asian and Oceania region** remains the top destination of FDI flows to developing regions, with the US$46 billion increase in inflows in 2004 marking the biggest increase ever. China's inward FDI keeps hitting new record highs, reaching US$61 billion in 2004 – almost 10% of global inflows. While Hong-Kong based investors are the source of much of this growth, investments from other regions are also increasing. However, the strength of FDI flows to China is not all good news, as it is contributing to concerns over an asset price bubble. Data for the first 9 months of 2005 suggest that FDI flows to China may moderate somewhat from their 2004 level, but China is expected to remain an FDI magnet.

Figure 4: China's Annual FDI Inflows



Source: UNCTAD

FDI flows into **India** have registered steady growth in recent years, although at US$5.3 billion in 2004 they are dwarfed by flows to countries such as China and Singapore. The rise in flows to India is a positive trend for that country and should continue provided further progress is made on domestic economic reforms. Data for the first half of 2005 suggest that FDI flows will strengthen further this year.

FDI flows **to Latin America and the Caribbean** rebounded sharply in 2004, following 4 years of decline. Brazil and Mexico were the largest recipients and, together with Chile and Argentina, accounted for 2/3 of FDI flows to the region. A stronger regional economy in addition to higher commodity prices contributed to the rebound. However, FDI flows fell to countries such as Bolivia, Venezuela and Ecuador. Data for the early months of 2005 suggest that flows to Brazil strengthened further, but flows to Mexico and Argentina have declined from year-ago levels.

FDI flows to **Africa** remained virtually unchanged in 2004, amounting to just 3% of global FDI flows, despite strong FDI flows to the natural resource sector. While there have been a series of measures taken to try to attract more FDI to Africa, much more needs to be done in terms of strengthening the economic and social frameworks in the region.

FDI flows to **South-East Europe and the CIS** registered a fourth year of growth in 2004. **Russia** is the largest recipient of FDI inflows in the region, with inflows concentrated in the energy sector. Data for the first 6 months of 2005 indicate that FDI flows to Russia are running above year-ago levels

FDI flows to **developed countries** fell again in 2004. The United States and United Kingdom were the two notable exceptions in 2004, with both seeing substantial gains in inflows due to M&A activity. The EU generally fared poorly in the year, with inflows falling 36% from the previous year, in part reflecting the area's poor economic performance. Declines were most pronounced in Germany, Luxembourg and the Netherlands. Flows into Canada edged down, for a fourth consecutive annual decline. Data so far for 2005 suggest that flows will increase to the US, the UK, Canada and the euro area.

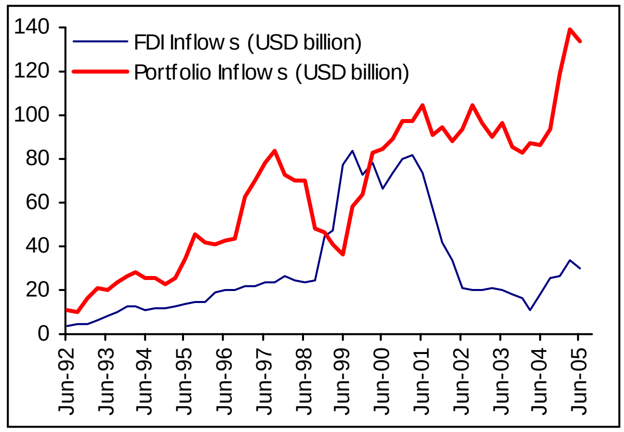
US Reliance on Foreign Capital

The large and growing US current account deficit implies a growing demand for capital. The current account deficit reached a record 6.5% of GDP in 2005Q1, falling to 6.3% of GDP in 2005Q2. This has led to strong growth in the demand for foreign capital and a rise in US net international indebtedness, raising concerns over the sustainability of the US's external position. Some analysts are concerned that there could be a turn in investor sentiment against US financial assets, generating a precipitous fall in the US dollar.

Strong portfolio inflows have been the primary source of capital flows to the US, with Asian central banks playing a major role. However, after plunging following the telecom boom in the late 1990s, FDI inflows have started to pick up. The weakening in the US dollar has helped make investment in the US more affordable. A rebound in FDI inflows would be a positive factor as such flows are much more stable than portfolio flows.

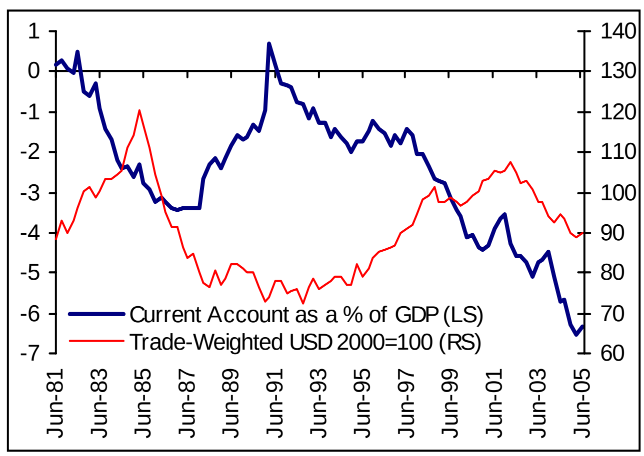
Another factor that may mitigate concerns over the size of the US current account imbalance is that about 2/3 of the US trade deficit is internal to multinational companies – that is, shipping goods and services between a US-based parent company and its foreign subsidiaries, or a foreign company located in the US trading with its parent. EDC Economics considers the high level of intra-firm trading to be self-sustaining and largely self-financing.

Figure 5: US FDI and Portfolio Inflows



Source: Bureau of Economic Analysis. Data is given a 4 quarter moving average.

Figure 6: US Current Account and Exchange Rate



Source: Bloomberg

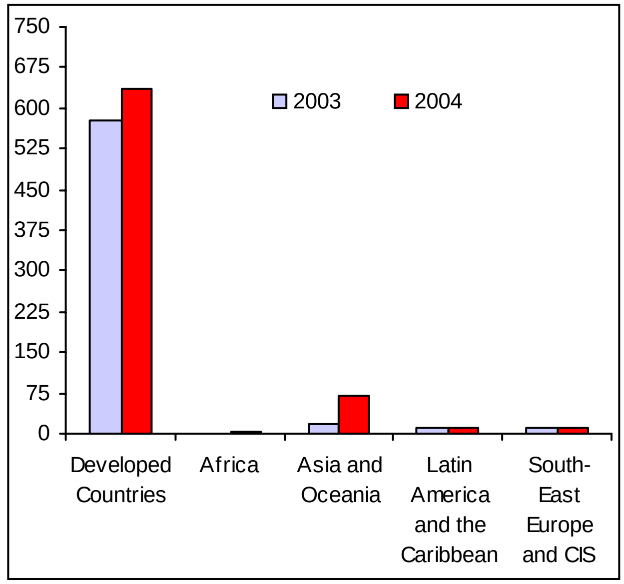
IV. FDI Outflows by Region

While globally, FDI outflows should equal inflows, measurement issues can drive a sharp wedge between the two.

FDI outflows in 2004 rose a strong 18%, with the bulk coming from developed countries. FDI outflows increased by 18% in 2004 to US$730 billion, of which US$637 billion came from firms based in developed countries. Almost half of outflows were from the United States and the United Kingdom.

A key trend to watch for is the emergence of developing economies as outward investors.
The **Asian and Oceania** region is not only a destination for FDI, but it is also becoming an important source of FDI outflows. Outflows rose fourfold, from US$17.2 billion in 2003 to US$69.4 billion in 2004. Much, but not all, of the investments remained in the region.

Figure 3: FDI Outflows by Region



Source: UNCTAD

Box 1: China -- A source of Global Capital

Global capital flows have increased more than four-fold from their trough in 2001, and China is a key factor behind this increase. In 2001 China accounted for about 4% of global capital exports, but its share has doubled to about 8% today. Most of China's capital has been channeled into the US Treasury Bill market, but China is becoming increasingly visible as a potential FDI investor as it tries to find alternative uses for its rapidly expanding foreign exchange reserves. One area of interest has been the resource sector, as China needs to secure access to energy and other natural resources abroad to sustain its own rapidly growing industrial base.

Strong growth in global capital flows has lubricated the global economy, making it easier for emerging market economies to attract the capital they need to meet external payments obligations and pursue structural reforms. 2005 is expected to be another good year for global capital flows, but the story will change next year as global capital flows start to moderate. Emerging markets that have not prefinanced their 2006 capital needs and have weaker underlying economic fundamentals will find 2006 a more difficult year to navigate. And global investors will need to be more wary as well.

China is expected to continue to expand its supply of global capital in 2006. Provided this holds true, 2006 will be more difficult for global capital market players, but still manageable. But a sharp retrenchment by China would be more problematic.

Global Capital Flows*

	2001	2004
Total Flows:	US$408 Billion	US$870 Billion
Major Sources:	Japan (21%) Russia (8.2%) Norway (6.4%)	Japan (20%) Germany (12%) China (8%)

*Measured by summing global current account surpluses. Source: IMF

V. Canadian FDI Overview

On balance, Canada remains a net exporter of FDI to the rest of the world. Net FDI outflows totaled Cdn$53.6 billion in 2004, more than double the Cdn$21.2 billion in 2003. Given Canada's strong current account position, it is expected to remain a net exporter of FDI over the foreseeable future. However, the pace of outflows has fallen and the pace of inflows has risen over the first half of 2005, implying a moderation in the net FDI position relative to 2004.

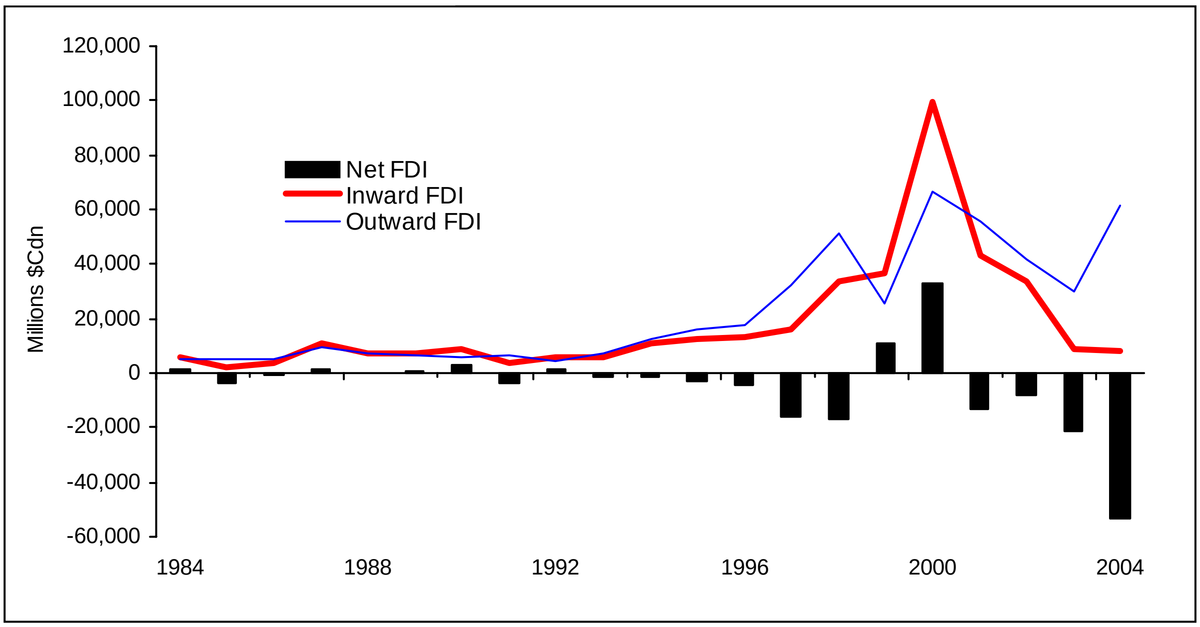
Canadian FDI Inflows

FDI inflows fell slightly, from Cdn$8.9 billion in 2003 to Cdn$8.2 billion in 2004. The US continues to be the major source of FDI inflows. By industry, the bulk of inflows in 2004 went into the energy and mineral sector.

Globally, Canada ranked only 19th in terms of FDI inflows in 2004. UNCTAD has developed an index to rank countries by their potential to attract FDI, using such variables as GDP per capita and structural indicators. By this ranking, Canada places 4th out of 147 countries. UNCTAD's analysis suggests that Canada is not reaching its 'potential' as a destination for FDI flows.

However, data for the first half of 2005 were strong, totaling Cdn$14.2 billion, suggesting that FDI inflows could increase substantially in 2005 for the first time in four years. The US is expected to remain the prime source of inflows, but inflows are showing a greater dispersion across industries.

Figure 8: Canadian FDI Flows



Source: Statistics Canada, Canada's Balance of International Payments, Cat. No. 67-001-XIB

Canadian FDI Outflows

Canada experienced one of the world's largest increases in FDI outflows in 2004, with outflows more than doubling to Cdn$62 billion from Cdn$30 billion in 2003. Canada tied with France, placing fifth in the world as an outward direct investor. The strong showing reflected, in part, the largest takeover in history by a Canadian enterprise of a foreign company (Canadian Manulife Financial Corp's acquisition of John Hancock Financial Services of the United States). Overall, outflows were concentrated in the finance and insurance and energy and minerals sectors.

In 2004, Cdn$41 billion in FDI outflows went to the US. While the US has remained the dominant destination for outflows, there has been more diversification in recent years to other destinations. In 1989 63% of Canadian FDI was located in this US. This fell to just 52% in 1995 and 44% today.

Outflows totaled just Cdn$17.6 billion in the first half of 2005. Almost all were destined to the US, and continued to be concentrated in the finance and insurance sector.

EDC Economics expects outflows to be between Cdn$30 to Cdn$40 billion for the year as a whole, which would still be a good result by historical standards. EDC's forecast of continued, albeit moderating, strength in the Canadian dollar bodes well for outflows into 2006 as foreign assets have become cheaper in Canadian dollar terms. EDC's Trade Confidence Survey conducted in May and June showed that 25% of the companies surveyed plan to invest in foreign countries. Strong growth in Canada's FDI outflows bodes well for future gains in productivity and competitiveness as it is indication of greater product specialization.

Table A1: Foreign Direct Investment in Canada by Geographic Source (Annual and quarterly flows – millions of Canadian dollars)

		United States	United Kingdom	Other EU	Japan	Other OECD	All Others	Total
2000		17,518	9,663	67,177	165	1,659	3,014	99,196
2001		39,159	9,465	-8,308	224	1,195	1,108	42,843
2002		28,732	338	2,468	805	-506	1,916	33,753
2003		4,079	1,255	2,050	442	435	636	8,897
2004		9,921	1,891	-14,601	1,017	2,527	7,431	8,186
2005 H1		9,263	1,397	2,015	387	299	860	14,221
2002	Q1	16,287	-125	683	56	17	164	17,082
	Q2	5,935	1,152	1,147	444	-121	228	8,785
	Q3	748	218	656	168	-74	242	1,958
	Q4	5,762	-907	-18	137	-328	1,282	5,928
2003	Q1	4,008	-93	822	180	140	286	5,343
	Q2	3,528	992	450	30	133	161	5,294
	Q3	-2,589	415	439	158	-1	-34	-1,612
	Q4	-868	-59	339	74	163	223	-128
2004	Q1	5,031	711	830	154	232	263	7,221
	Q2	1,058	1,123	-8,573	281	88	374	-5,649
	Q3	5,854	231	-5,922	276	1,321	6,648	8,408
	Q4	-2,022	-174	-936	306	886	146	-1,794
2005	Q1	7,495	643	753	316	-165	339	9,381
	Q2	1,768	754	1,262	71	464	521	4,840

Source: Statistics Canada. Canada's Balance of International Payments. Cat. No. 67-001-XPB.

Table A2: Foreign Direct Investment in Canada by Industry (Annual and quarterly flows – millions of Canadian dollars)

		Wood and paper	Energy and minerals	Machinery and trans. equipment	Finance and insurance	Services and retail	Other industries	Total
2000		4,285	13,492	13,717	4,123	1,804	61,775	99,196
2001		441	23,940	4,640	3,599	529	9,694	42,843
2002		1,214	16,189	6,051	679	3,531	6,087	33,751
2003		-239	2,954	-885	3,568	324	3,172	8,894
2004		-341	5,655	3,359	-1,753	1,375	-107	8,188
2005 H1		1,317	3,391	-1,099	1,982	1,756	6,873	14,220
2002	Q1	308	12,448	2,595	-187	924	994	17,082
	Q2	330	2,967	1,751	553	1,191	1,992	8,784
	Q3	211	1,164	-511	432	716	-55	1,957
	Q4	365	-390	2,216	-119	700	3,156	5,928
2003	Q1	-133	2,588	-643	2,582	300	649	5,343
	Q2	-153	793	2,863	1,054	216	520	5,293
	Q3	40	126	-3,125	-916	5	2,257	-1,613
	Q4	7	-553	20	848	-197	-254	-129
2004	Q1	73	1,741	-1,161	786	384	5,398	7,221
	Q2	584	634	112	1,034	27	-8,041	-5,650
	Q3	284	1,633	3,494	558	271	2,169	8,409
	Q4	-1,282	1,647	914	-4,131	693	367	-1,792
2005	Q1	183	1,954	-560	563	370	6,870	9,380
	Q2	1,134	1,437	-539	1,419	1,386	3	4,840

Source: Statistics Canada. Canada's Balance of International Payments. Cat. No. 67-001-XPB.

Table A3: Canadian Foreign Direct Investment Abroad by Geographic Destination (Annual and quarterly flows – millions of Canadian dollars)

		United States	United Kingdom	Other EU	Japan	Other OECD	All Others	Total
2000		33,739	8,565	7,391	3,690	5,530	7,438	66,353
2001		27,759	7,523	1,719	1,823	8,678	8,302	55,804
2002		17,245	-238	11,312	1,747	4,947	6,977	41,990
2003		4,245	4,169	11,257	348	1,099	8,939	30,057
2004		41,423	1,758	6,040	1,175	1,278	10,065	61,739
2005 H1		15,577	717	-3,521	324	884	3,608	17,589
2002	Q1	1,783	11	1,151	750	475	1,782	5,952
	Q2	2,368	-294	3,425	128	326	1,581	7,534
	Q3	26	619	4,800	109	3,245	3,874	12,673
	Q4	13,068	-574	1,936	760	901	-260	15,831
2003	Q1	1,578	155	3,383	110	-1,614	820	4,432
	Q2	150	-940	430	138	1,018	1,791	2,587
	Q3	468	362	586	56	-47	2,968	4,393
	Q4	2,049	4,592	6,858	44	1,742	3,360	18,645
2004	Q1	2,891	957	1,035	408	304	1,578	7,173
	Q2	24,910	-559	1,587	428	-849	2,712	28,229
	Q3	8,836	208	1,685	142	999	2,346	14,216
	Q4	4,786	1,152	1,733	197	824	3,429	12,121
2005	Q1	10,010	-1,889	-99	148	681	1,081	9,932
	Q2	5,567	2,606	-3,422	176	203	2,527	7,657

Source: Statistics Canada. Canada's Balance of International Payments. Cat. No. 67-001-XPB.

Table A4: Canadian Foreign Direct Investment Abroad by Industry (Annual and quarterly flows – millions of Canadian dollars)

		Wood and paper	Energy and minerals	Machinery and trans. equipment	Finance and insurance	Services and retail	Other industries	Total
2000		-83	9,981	12,532	7,278	3,032	33,610	66,350
2001		2,469	10,740	5,159	27,838	3,566	6,027	55,799
2002		618	8,960	3,948	26,039	1,730	697	41,992
2003		1,173	15,914	2,869	7,800	-736	3,037	30,057
2004		4,076	17,783	6,463	29,961	6,561	-3,105	61,739
2005 H1		2,228	2,869	711	14,454	796	-3,469	17,589
2002	Q1	3	1,328	1,046	2,778	452	347	5,954
	Q2	340	3,941	967	2,101	-36	220	7,533
	Q3	57	2,644	1,655	7,485	595	237	12,673
	Q4	218	1,047	280	13,675	719	-107	15,832
2003	Q1	405	2,253	-791	2,239	22	302	4,430
	Q2	201	2,854	2,009	-889	-2,738	1,151	2,588
	Q3	300	3,039	50	541	-2	465	4,393
	Q4	267	7,768	1,601	5,909	1,982	1,119	18,646
2004	Q1	194	1,571	532	2,974	1,261	641	7,173
	Q2	2,991	7,804	963	22,504	1,034	-7,067	28,229
	Q3	711	4,504	2,541	2,116	3,303	1,041	14,216
	Q4	180	3,904	2,427	2,367	963	2,280	12,121
2005	Q1	738	1,334	687	7,435	342	-605	9,931
	Q2	1,490	1,535	24	7,019	454	-2,864	7,658

Source: Statistics Canada. Canada's Balance of International Payments. Cat. No. 67-001-XPB.