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CANADIAN FOREIGN DIRECT INVESTMENT: RECENT TRENDS

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23 January 2004

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INTRODUCTION

Foreign direct investment (FDI) trends indicate that Canadian companies are becoming more globally oriented. Recent Canadian investments abroad include Alcan's acquisition of Pechiney, the French aluminum giant,(1) and Manulife Financial's $15-billion takeover of John Hancock Financial, a U.S.-based financial services company. Foreign entities are likewise pursuing direct investment opportunities in Canada. Examples include the acquisition, in 2000, of Ottawa-based Newbridge Networks by Alcatel, a French telecommunications giant, and the 2001 acquisition of Laval-based BioChem Pharma by Shire Pharma, a pharmaceutical company based in the United Kingdom.(2)

The aim of this paper is two-fold. First, it seeks to outline the growth in outward-bound Canadian direct investments in the past 20 years, a trend fuelled largely by the financial services industry. The second, related, objective is to demonstrate that Canada is now in fact a net direct investor abroad. This relatively recent phenomenon has been driven in large part by financial services and natural resources firms, areas where Canada has traditionally enjoyed a competitive advantage either because of historical factors or because of natural endowments. FDI trends reveal a growing vitality and maturity on the part of certain Canadian firms and the Canadian economy more generally, and broadly signal that Canada is becoming more active in the integrated global economy.

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(1) Once this transaction is completed, Montréal-based Alcan will be the second-largest aluminum company in the world, after Alcoa, the American aluminum giant.

(2) Newbridge Networks was a global player in developing next-generation networks, while BioChem Pharma was a world leader in life sciences research, and AIDS research in particular. Economic nationalists raise the alarm whenever Canadian companies get taken over by foreign interests. Some have raised concerns about the foreign ownership of high-quality assets, particularly when these foreign direct investments are concentrated in sectors of the so-called "new economy." Concerns about the foreign ownership of Canadian productive assets have a long history: in its early years, Canada was heavily dependent on foreign capital for the development of its infrastructure and industrial base.

WHAT IS FOREIGN DIRECT INVESTMENT?

Foreign direct investment is defined as an investment that "allows an investor to have a significant voice in the management of an enterprise operating outside his own economy."[(3)] The term "significant voice" is usually taken to mean ownership of at least 10% of the voting equity in a non-resident enterprise.[(4)] Foreign direct investment transactions, inclusive of reinvested earnings, also known as flows of FDI, are recorded at market value at the time of the transaction. The stock of FDI is measured as the value of the foreign direct investments, accumulated through time, on the balance sheets of the recipient entities.[(5)]

Individuals or companies can make foreign direct investments in one of two ways: 1) by investing in the financial capital (e.g., equity, including reinvested earnings) of an existing company in another country; or 2) by investing in a new productive project in a foreign country (known as "greenfield" FDI). Both types of FDI ultimately redirect profit flows to investors in the originating country. Direct investments made by Canadians or Canadian companies abroad are referred to as Canadian direct investments abroad (CDIA), or outward FDI. Direct investments made by foreign entities in Canadian enterprises or projects are known as FDI in Canada, or inward FDI.

FDI, whether inward or outward, can be an important tool for creating wealth. By enabling capital to be allocated where it can be most productive, regardless of national boundaries, FDI can lead to considerable efficiency gains. FDI allows companies to be more efficient by focusing on their strengths and/or reaching economies of scale, enabling them to

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(3) International Monetary Fund, *Balance of Payments Manual*, Fifth Edition, 1993; cited in C. Lajule, *Foreign Direct Investment: A Driving Force in Economic Globalization*, Statistics Canada, Research Paper No. 67F0001MIB01020 [n.d.]. According to Statistics Canada, foreign direct investment "reflects a significant influence in the other enterprise and does not need to be as intense as controlling investment." Ownership of more than 50% of the voting equity typically establishes a controlling interest. Direct investment "is measured as the total of the equity, including reinvested earnings, as well as long-term and short-term claims of the direct investor in the enterprise."

(4) Lajule [n.d.].

(5) This stock, or "book value," reflects more than just the sum of incremental investment flows. It is affected, positively or negatively, by differences between the market value and book value of direct investment transactions, as well as by other revaluations, exchange rate fluctuations, and corporate reorganizations. See Lajule [n.d.].

compete better in the international marketplace.(6) It can also accelerate the introduction of new technologies and know-how in the recipient economy and can generate employment.

Foreign direct investment encourages greater economic integration and the creation of trade linkages that are economically beneficial. By strengthening commercial links between the recipient country and the investing country, FDI can set the stage for increased trade between the two countries well into the future. Researchers at the Organisation for Economic Co-operation and Development (OECD) have found that each dollar of outward FDI engenders two dollars' worth of additional future exports from the investing country. When outward FDI goes to developing countries, the multiplier is even more significant; in this case, each dollar of outward FDI is estimated to lead to seven dollars' worth of additional future exports from the investing country.(7)

Finally, there is evidence that firms that invest abroad tend to be industry leaders, which ultimately benefits the investing country. The Conference Board of Canada, drawing upon the findings of several studies, has found that "outward-oriented firms tend to be more dynamic and to exhibit productivity and profitability superior to those with a more domestic orientation."(8)

The growth in CDIA, explored in greater depth below, suggests that some Canadian firms, particularly in the financial services and energy and mining sectors, are positioning themselves as globally competitive firms and are setting the stage for Canada to reap the benefits of economic integration.

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(6) Foreign direct investments are generally considered to be more stable and beneficial to the recipient country than portfolio investments, which typically are passive investments in equities and bonds. (Portfolio investors do not have an important influence on the management of the enterprise(s) in which they are investing, unlike direct investors.) Portfolio investments are usually more liquid and interest-rate sensitive, and therefore more likely to be transitory. The rapid liquidation of portfolio investments has in some instances exacerbated international financial crises, as was the case during the Asian crisis of the late 1990s.

(7) Lionel Fontagné, *Foreign Direct Investment and International Trade: Complements or Substitutes?* Working Paper 1999/3, OECD Directorate for Science, Technology and Industry, 14 October 1999; cited in Department of Foreign Affairs and International Trade, *Second Annual Report on Canada's State of Trade*, 2001.

(8) Conference Board of Canada, *Performance and Potential 2001-2002*, Ottawa, 2001.

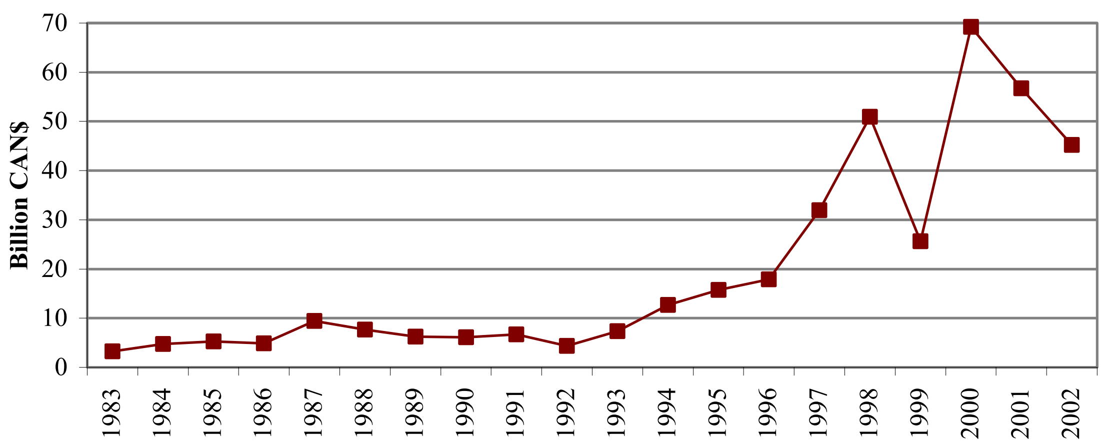
CANADA'S DIRECT INVESTMENT POSITION: HOW IS IT EVOLVING?

A. Canadian Direct Investment Abroad

The growth in Canadian direct investment abroad offers evidence that Canadian firms are taking advantage of the global movement towards liberalization of trade and investment[(9)] by looking for economic opportunities in foreign countries. Figure 1 shows annual CDIA flows for the last 20 years. Those flows were $45.2 billion in 2002, well above the historical average.

FIGURE 1

Annual Flows of Canadian Direct Investment Abroad, 1983-2002



Source: Statistics Canada, Table 376-0014, Balance of international payments, flows of Canadian direct investment abroad and foreign direct investment in Canada, by industry and type of transactions, annual.

Mergers and acquisitions (M&A) have, of late, become a driving force behind CDIA. This was particularly true in 1998 and 2000. The number and value of mergers and acquisitions has since fallen considerably in the wake of corporate scandals (e.g., Enron, Tyco) and a downturn in equity markets. In 2002, M&A activity accounted for less than one-fifth of CDIA. Instead, in 2002 Canadian firms invested more capital into their existing foreign assets, notably in foreign subsidiaries under their control. The following figure shows the composition of CDIA flows in the last six years.

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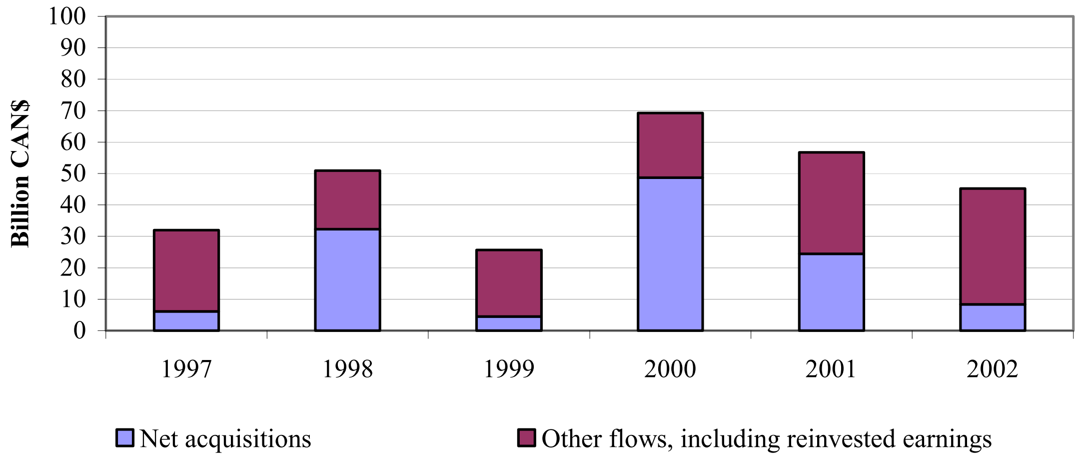
(9) The United Nations Conference on Trade and Development (UNCTD) has concluded that 94% of the more than 1,000 regulatory changes made internationally between 1991 and 1999 have facilitated investment flows. See UNCTD, *World Investment Report 2000*, United Nations, 2000.

FIGURE 2

Annual Flows of Canadian Direct Investment Abroad, 1997-2002



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

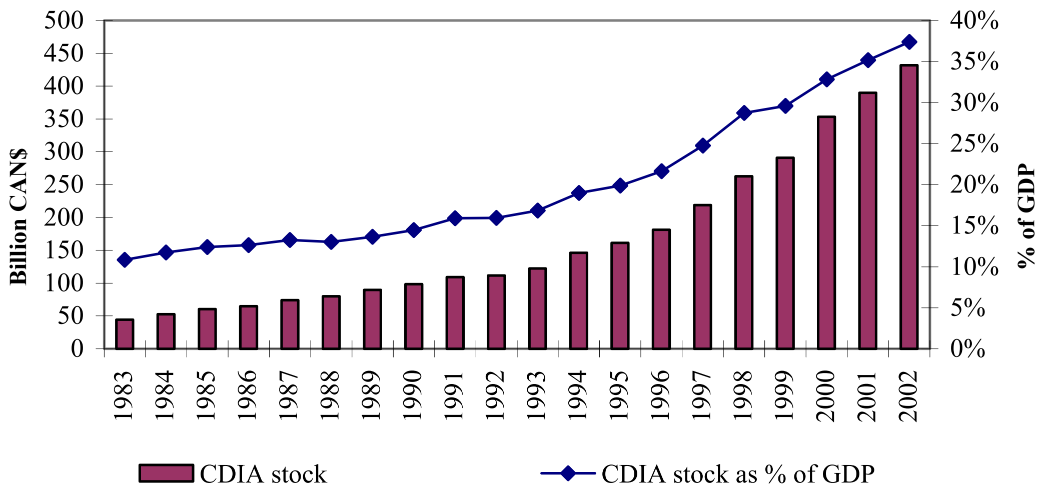
Another way of measuring the growth in CDIA is by tracking the evolution in the book value of these foreign direct investments. The value of CDIA has consistently been growing; it reached $431.8 billion at the end of 2002,(10) more than a four-fold increase over the 1990 year-end total of $98.4 billion.(11) More tellingly, CDIA has been growing as a percentage of Canada's Gross Domestic Product (GDP). At the end of 2002, the value of CDIA was equivalent to 37% of GDP. In comparison, from 1983 to 1990 the value of CDIA as a percentage of GDP fluctuated between 11% and 14%. Figure 3 illustrates the trend.

(10) Statistics Canada estimates that the value of CDIA had fallen to $380.9 billion by the middle of 2003, due almost entirely to the recent surge in the Canadian dollar, which has dampened the value of foreign investments in Canadian dollar terms. See Statistics Canada, *Canada's International Investment Position*, Cat. No. 67-202-XIE, Second Quarter 2003.

(11) Since 1992, over 80% of the stock of CDIA, most of it equity, has been in subsidiaries controlled by Canadian firms.

FIGURE 3

Stock of Canadian Direct Investment Abroad, 1983-2002

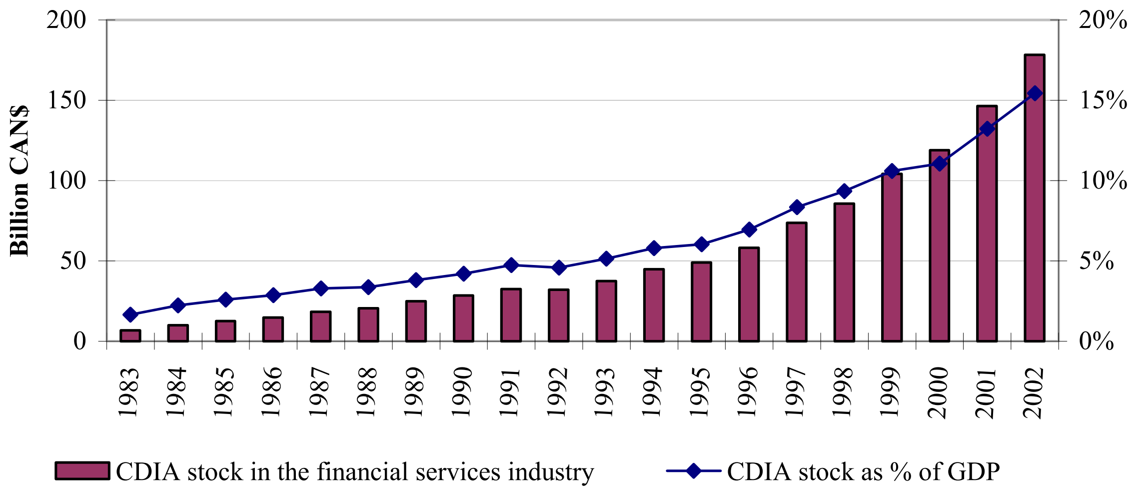


Source: Statistics Canada, Table 376-0038, International investment position, Canadian direct investment abroad and foreign direct investment in Canada, by industry, annual; and Statistics Canada, Table 380-0030, GDP/GNP at market prices, net national income at basic prices.

At the end of 2002, over 40% ($178.3 billion) of the total CDIA stock was concentrated in the finance and insurance industry. In 1983, by contrast, CDIA in the finance and insurance industry was valued at a little under $7 billion.

FIGURE 4

Stock of Canadian Direct Investment Abroad in the Financial Services Industry, 1983-2002



Source: Statistics Canada, Table 376-0038, International investment position, Canadian direct investment abroad and foreign direct investment in Canada, by industry, annual; and Statistics Canada, Table 380-0030, GDP/GNP at market prices, net national income at basic prices.

Canadian banks and insurance companies, mindful of the challenge to be globally competitive and aware that growth or even synergetic opportunities within Canada are currently limited,(12) have been aggressively looking to acquire assets and grow their businesses outside Canada.

The evolution in CDIA by industry is illustrated in Figure 5. The emergence of the finance and insurance industry as a significant source of Canadian direct investments abroad is notable: its share of total CDIA grew from 15% in 1983 to 41% in 2002.

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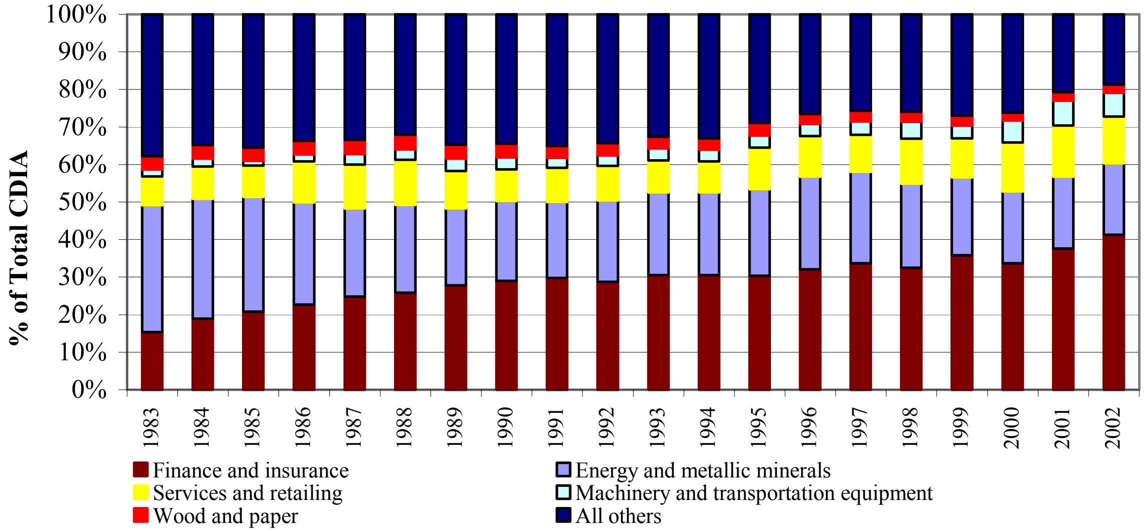
(12) For example, the large Canadian banks have not, to date, received the necessary approval from the federal Minister of Finance to go ahead with domestic mergers.

FIGURE 5

Composition of Stock of Canadian Direct Investment Abroad, 1983-2002

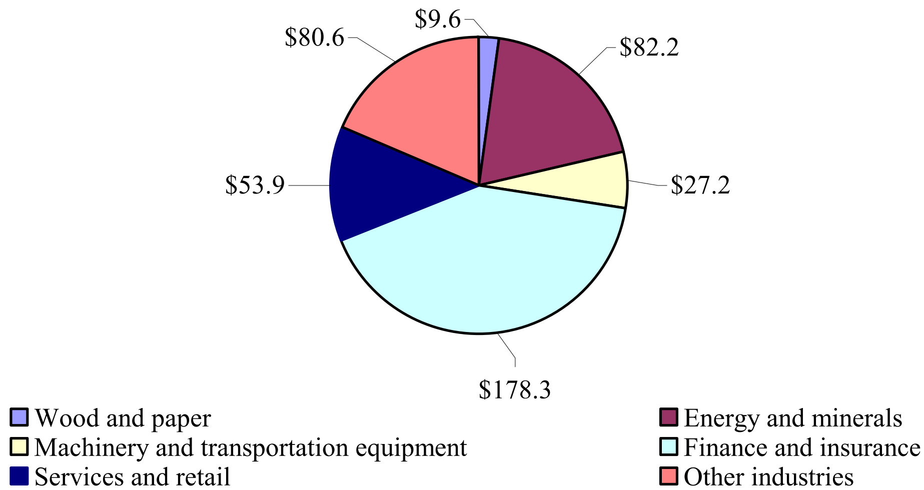


Source: Statistics Canada, Table 376-0038, International investment position, Canadian direct investment abroad and foreign direct investment in Canada, by industry, annual.

The energy and minerals industry was the next-largest component of CDIA after finance and insurance, with a 2002 year-end value of $82.2 billion, or 19% of the total. Canadian firms have considerable expertise in this sector, given Canada's extensive natural resource endowments. Canadian companies in this industry are continuing to pursue projects in other countries, for example in the United States and in Chile. The value of CDIA in the energy and minerals industry grew from $20.9 to $82.2 billion between 1983 and 2002, at roughly the same pace as overall growth in CDIA. Its share of the total has dropped, however, as the finance and insurance industry has gained in importance.

FIGURE 6

Stock of Canadian Direct Investment Abroad by Industry, 2002 (billion CAN$)



Source: Statistics Canada, *Canada's International Investment Position*, Cat. No. 67-202-XIE.

Nearly half (46% as of the end of 2002) of the total stock of Canadian direct investment abroad is held in the United States. Significantly, this proportion has been falling steadily since the early 1980s, and is down from 61% in 1990: Canadian companies are looking beyond the United States for investment opportunities. Those companies also invest substantial sums in European Union countries and in developing countries. Approximately 20% of annual CDIA flows now go to non-OECD countries – up from 13% in 1990. For example, Canadian direct investment in Mexico, a partner in the North American Free Trade Agreement (NAFTA), was valued at $3.3 billion at the end of 2002, up from $245 million in 1990.(13)

B. Foreign Direct Investment in Canada

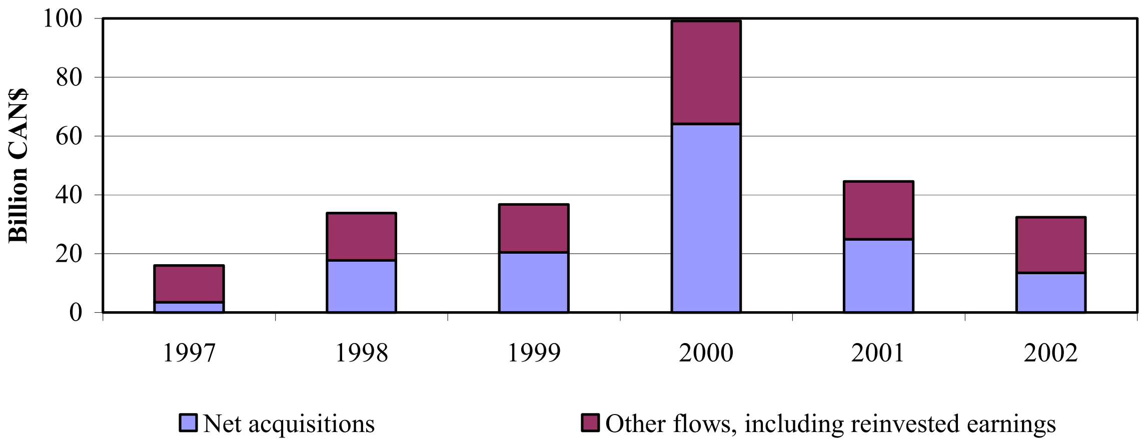
As with CDIA, there has also been considerable foreign direct investment activity in Canada in the last decade. With the notable exception of 2000, FDI flows into Canada have been relatively stable over the past few years. Acquisitions of Canadian companies by foreign

(13) Statistics Canada, Table 376-0051, International investment position, Canadian direct investment abroad and foreign direct investment in Canada, by country, annual. In contrast, Mexican direct investment in Canada was valued at $83 million in 2002.

interests accounted for the majority of the flows between 1998 and 2001 (see Figure 7, below) and replaced reinvested earnings as the major source of inbound FDI flows.[14]

FIGURE 7

Annual Flows of Foreign Direct Investment in Canada, 1997-2002



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

The value of foreign direct investment in Canada reached $349.4 billion in 2002, as compared with $130.9 billion in 1990.[15] At the end of 2002, approximately 23% of the total stock of FDI in Canada was in the energy and minerals industry ($79.7 billion). The Canadian finance and insurance industry was the other major beneficiary of FDI, with total foreign direct investment valued at $67.2 billion. In recent years, FDI flows into Canada have been diversified across many industries. However, 2001 was a notable exception: foreigners invested over $27 billion in the energy and minerals sector, or three times as much as in 1998, in part because of renewed interest in Canada's natural gas resources in the wake of prodigious spikes in the price of natural gas in 2000 and 2001.[16]

(14) Mergers and acquisitions gradually gained in importance during the 1990s as a driver of FDI in Canada. From an FDI perspective, 2000 was an anomaly: the exuberance in the stock market contributed to a significant spike in the number and value of acquisitions of Canadian companies by foreign entities.

(15) Statistics Canada, *Canada's International Investment Position,* Cat. No. 67-202-XIE, Second Quarter 2003. FDI in Canada is largely denominated in Canadian dollars.

(16) Across different regions of North America, natural gas market prices were between 7% and 61% higher in 2001 on a year-over-year basis. California saw the biggest increase. See Natural Resources Canada, Natural Gas Division, *Canadian Natural Gas: Review of 2002 & Outlook to 2015*, November 2003.

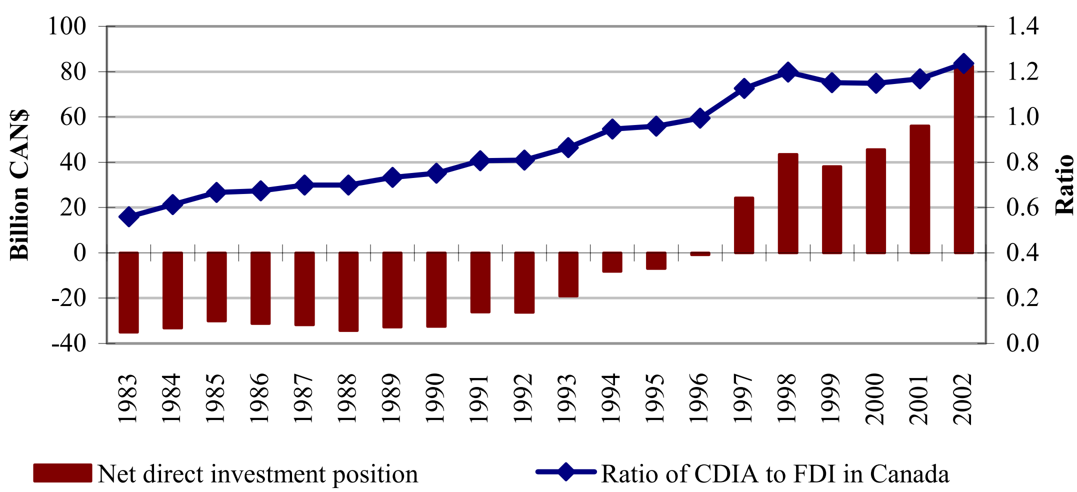
The United States accounted for 64% of the stock of FDI in Canada at the end of 2002. This proportion has been fairly steady over the last decade. American firms have a long history of investing in Canada. The European Union was next, with 27% of the stock.

C. Canada's Net Direct Investment Position

As noted above, FDI in Canada has increased considerably in the last decade. But the growth in Canadian direct investment abroad has been even more rapid. With little fanfare, Canada became a net direct investor abroad beginning in 1997. In other words, the value of total CDIA has surpassed the value of FDI in Canada in recent years. At the end of 2002, Canada's net foreign direct investment position stood at $82.4 billion(17) (see Figure 8, below).

FIGURE 8

Stocks of Canadian Direct Investment Abroad Compared With Foreign Direct Investment in Canada, 1983-2002



Source: Statistics Canada, Table 376-0038, International investment position, Canadian direct investment abroad and foreign direct investment in Canada, by industry, annual.

Although significant FDI flows into Canada's energy and minerals industry in 2001 raised concerns about control over Canadian natural resources, Canada has consistently maintained a positive net foreign direct investment position in that industry since 1994. This net FDI position stood at $2.5 billion at the end of 2002. Canada's net FDI position is largest in the

(17) This position had fallen to $23.2 billion by the end of the second quarter of 2003 as a result of the dramatic appreciation of the Canadian dollar vis-à-vis the U.S. currency.

finance and insurance industry, surpassing $110 billion at the end of 2002. Canada also maintains a positive net FDI position in the services and retail industry. In other sectors, however – the wood and paper industry, the machinery and transportation equipment industry, and the "other industries" category (e.g., food, chemicals, electrical and electronic products), the value of FDI in Canada exceeds the value of CDIA.(18)

IMPLICATIONS OF CANADA'S CHANGING DIRECT INVESTMENT POSITION

Canada has historically relied on inflows of foreign capital to finance domestic investment. Our country is endowed with rich natural resources but initially lacked the technologies and capital necessary for industrial development. As a result of that financing, Canada's foreign liabilities have long exceeded our foreign assets, resulting in an outflow of profits (interest and dividends).

As discussed above, however, this trend may be changing. CDIA has grown to the point that in 1997 Canada became a net direct investor abroad (or an FDI creditor, as opposed to an FDI debtor).(19)

What does this development imply? Some maintain that a country's investment performance should be judged primarily by the degree to which that country is open to both inward and outward direct investments. Openness, it is argued, allows resources to go to their best use and fosters competition, learning and innovation, which are all characteristics of a dynamic economy.(20) By this measure, recent FDI trends indicate that Canadian firms, and the Canadian economy more broadly, are open to the world. Canadian companies are looking abroad for economic opportunities that do not exist or are limited in Canada. This is particularly true in the financial services and energy and mining sectors, which have traditionally been amongst Canada's most successful.

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(18) The "other industries" category includes food, beverage and tobacco; chemicals, chemical products and textiles; electrical and electronic products; construction and related activities; and communications. See Statistics Canada, *Canada's International Investment Position*, Cat. No. 67-202-XIB, 2001.

(19) It should be pointed out that, despite Canada's status as a foreign direct investment creditor, outflows of profits on FDI in Canada continue to surpass the inflows of profits on CDIA. In 2002, profits on foreign direct investments in Canada were $19.3 billion, while profits on Canadian direct investment abroad were $14.8 billion. This situation may reflect the fact that foreign direct investment in Canada is more mature, and therefore more profitable, than Canadian direct investment abroad. See Statistics Canada, *Canada's International Investment Position*, Cat. No. 67-202-XIE, Second Quarter 2003.

(20) Conference Board of Canada, *Performance and Potential 2001-2002*, Ottawa, 2001.

CONCLUSION

Economic theory suggests that foreign direct investment allows companies to be more efficient and can contribute to a country's economic success over the medium to long term by significantly improving trade linkages. A review of trends in Canada's foreign direct investment shows that Canadian enterprises are increasingly looking abroad for economic opportunities, which denotes a growing vitality and maturity on their part. This is to be expected, given that Canada's economy is open, relatively small and mature. The trend is particularly evident in the finance and insurance industry. Over the last decade, Canadian financial services companies, such as insurance companies and banks, have been accelerating the pace at which they are growing their businesses outside Canada. Canada is now, since 1997, a net direct investor abroad.