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## Working Party on International Trade in Goods and Trade in Services Statistics

### A BALANCE OF PAYMENTS PERSPECTIVE ON RECENT FINANCIAL EVENTS

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## A BALANCE OF PAYMENTS PERSPECTIVE ON RECENT FINANCIAL EVENTS

### Note by Canada – OECD Working Party on Trade in Goods and Services

#### I. Introduction and Context

1. Cross-border financial transactions have been an important element of Canada's balance of payments statistics for a number of years, a main factor in the evolution of Canada's international investment position. For many years, Canada net borrowed from abroad in the form of portfolio transactions, financing both current account and government deficits. In addition, the established pattern was net inflows of funds on direct investment, from the post-war years until the mid-1990s.

2. Over the last 20 years Canada has invested substantial funds abroad, especially in the last decade given the generally expanding surplus on current account. A significant portion of these outflows was in the form of portfolio investment abroad in marketable securities, largely concentrated in corporate shares<sup>1</sup>. This development was underpinned by the substantial growth of institutional investors – largely, pension funds – seeking wider opportunities to invest. This trend was facilitated by legislative changes, as the ceiling on foreign investment allowed in pension funds and other tax-deferred retirement plans was raised a number of times beginning in 1990 and eliminated in 2005. As a result, Canada's exposure to foreign financial markets correspondingly increased with respect to market risk – that is, fluctuations in both exchange rate and valuation of securities.

3. The pace of globalization also ushered in new types, and uses of, financial instruments – in particular, the growth of investment in financial institutions' receivables<sup>2</sup> via asset-backed securities. The risk associated with these instruments was effectively diffused to investors around the world through the securitization process, which proved important to the speed and severity with which the contagion in credit markets spread after August 2007.

4. On the corporate side, globalization led to a broader view of trade and investment, which encouraged a trend toward substantial Canadian direct investment abroad. While most increases in Canadian direct investment abroad in the last decade were in countries other than the US, about half the holdings still resided in US affiliates at the end of 2008. Traditionally, direct investment in the US economy is dominated by the finance and manufacturing sectors, with an increased share in the finance sector observed in recent years. The resource sector is also, and has always been, an important dimension of the Canadian direct investment abroad, with American and European countries receiving the bulk of the

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<sup>1</sup> Canada, along with the U.S. and Australia, tended to have equity making up between 60-80% of foreign investments from 2001-2007. In contrast, other countries were less exposed to foreign equity markets, with Japan between 20 -25% and the UK and the rest of the world below 50%.

<sup>2</sup> In particular, this was the case for mortgages and securities derived from them.

investment from Canada. However, this type of investment was also curtailed in the face of global financial concerns and declining commodity prices.

5. The onset of unsettled global credit markets in August 2007, and the marked deterioration of financial markets worldwide a year later, were clearly evident in the international accounts for Canada. This note underlines some of the salient developments, with emphasis on outward investment. Data in this analysis are drawn from Canada's integrated system of national accounts<sup>3</sup>, in particular, the monthly *Canada's International Transaction in Securities*, the quarterly *Canada's Balance of International Payments*, the quarterly *Canada's International Investment Position* and the annual and detailed *Foreign Direct Investment Statistics*.

## II. Global credit concerns, slowing economic growth and international financial flows

### *Turmoil in global markets began in mid-2007*

6. As concerns about global credit conditions came to the fore in the summer of 2007, which began with credit tightening in the U.S., economic activity started to soften in Canada as well as in other countries. Cross-border investment flows followed a similar pattern in Canada. Especially pronounced was Canadian institutional investors' response in terms of reducing exposure to foreign markets – that is, curtailing foreign investment in securities.

### *Canadian institutional investors react decisively at the outset of global credit concerns*

7. Canadian investors disposed of a record amount of foreign securities in August of 2007, at the outset of global credit concerns. This included liquidating \$7.0 billion of their holdings of foreign money market instruments, in the context of sharply diminishing liquidity in the asset-backed finance sector<sup>45</sup>. This divestment was made up of \$1.6 billion of U.S. corporate paper and \$6.3 billion of non-US corporate paper. The reduction in non-US securities was largely comprised of paper issued by European financial institutions, reflecting a failure on the part of those issuers to roll over the instruments. The divestment continued in September of 2007. By the end of the third quarter of 2007, Canadian investors had disposed of \$10.4 billion of foreign short-term debt instruments, to the point where holdings had been reduced by more than 50% in a single quarter<sup>6</sup>.

8. The seizure in credit markets also led to a sharp slowdown in the market for foreign bonds. In the second half of 2007, the market for maple bonds evaporated. Maple bonds are bonds issued in Canadian dollars by non-residents, which had developed into a very popular foreign investment vehicle. The drying-up of this market shifted additional risk of exchange rate movements back to Canadian investors.

<sup>3</sup> Data from the quarterly *Financial Flow Accounts*, quarterly *National Balance Sheet Accounts* and quarterly *Income and Expenditure Accounts* (for GDP) are also referenced.

<sup>4</sup> The initial impact of concerns about exposure to US sub-prime mortgages was to freeze the market for asset-backed securities (ABS). Some of these securities were exposed to sub-prime mortgages, which were suddenly viewed as toxic by investors.

<sup>5</sup> The turmoil also affected Canadian financial markets. In Canada, after three years of steady growth, the market for asset-backed commercial paper (ABCP) shrank by almost \$10 billion in the fourth quarter of 2007, and continued to contract every quarter in 2008.

<sup>6</sup> Notably, no net investments were realized in foreign corporate paper by Canadians until the second quarter of 2009.

9. Essentially, the initial reaction by Canadian institutional investors to global credit concerns in the third quarter of 2007 was sustained over the next year, until the credit crunch intensified in September of 2008. In the first and second quarters of 2008, Canadian investors continued to shy away from foreign debt instruments in favour of equity. Most of the divestment arose from net sales of foreign paper and net retirements of maple bonds. However, by mid-2008, Canadians had added foreign shares to their portfolios for 21 consecutive quarters, with investment focussing on non-US shares in the second quarter.

10. By the third quarter of 2008, international transactions in securities reflected deteriorating conditions in global debt markets, and were likely further influenced by a weakening domestic currency and declining short-term interest rates in the Canadian and US markets. As a result, Canadian investors purchased foreign securities at a much reduced pace compared with the previous three quarters, as divestment in foreign debt instruments extended to US Treasury bonds. Meanwhile, Canadian investment in foreign stocks remained robust with large acquisitions of US stocks.

#### *Non-resident investors response to credit concerns seemingly less pronounced*

11. Non-resident investors' adjustments with regards to their portfolios of Canadian securities were less pronounced than that of their Canadian counterparts<sup>7</sup>. Foreign investors' demand for Canadian bonds increased steadily between July 2007 and June 2008, while mixed signals were observed on the Canadian stock market during the same period; non-residents divested Canadian shares in the second half of 2007 but returned to buy shares in the first half of 2008. Foreign investors shed Canadian corporate short-term paper in the third quarter of 2007 but this remained an isolated action that did not spill over to in subsequent quarters.

12. The trend to foreign investment in Canadian bonds was interrupted in the third quarter of 2008 on net retirements of federal bonds, partly offset by higher purchases of federal Treasury bills. This activity, combined with large sales of Canadian shares by non-residents, resulted in non-resident investors selling Canadian securities for the first time in 2008. This was the precursor to intensified foreign activity with respect to the Canadian debt market in the fourth quarter.

#### *Direct investment flows decelerate*

13. Foreign direct investment in Canada lost steam in the first three quarters of 2008 as foreign takeover activity was reduced substantially compared to 2007.

14. The global slowdown in mergers and acquisitions activity also had an impact on activities of Canadian direct investors in 2008, but to a lesser extent. In contrast to inward direct investment, outward investment remained relatively robust during the period as Canadian firms provided substantial funds to existing foreign subsidiaries in the context of the turbulence in financial markets. Specifically, funds were concentrated in the finance and insurance sector mainly in the U.S.

### **III. Global financial crisis, sagging GDP and international investment**

15. The initial turmoil in financial markets in 2007 was only a prelude to its escalation in September 2008. Following the failure of a major U.S. investment bank in September of 2008, and a growing realization of the number of financial institutions in distress, the crisis spread quickly. In less than a week it expanded from inter-bank lending, to money market funds, and then to a freezing up of the global market

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<sup>7</sup> This note only takes into account cross-border flows as they relate to Canada. Therefore, only foreign investors' transactions in Canadian securities are considered.

for commercial paper. Paralyzed by fear of default or non-payment, liquidity quickly dried up in credit markets around the world.

16. There were several ramifications of the deterioration of the global financial situation late in 2008. The spread between interest rates for government and corporate debt hit a record high, as investors shunned corporate debt and put a premium on the lower risk associated with sovereign debt. Global and Canadian stock markets lost substantial value. The Canadian dollar posted a record quarterly decline, as commodity prices fell sharply.

17. As a consequence, economic activity declined in a number of affected countries, including Canada<sup>8</sup>. After slowing since mid-2007, the fourth quarter GDP estimates for Canada posted a 3.4% decline. While weakness was diffused, the continued drop in demand for Canadian exports was a significant contributing factor, as the current account surplus melted away into the first deficit since the second quarter of 1999.

### ***Canadian investors shed foreign securities at an unprecedented rate***

18. In the fourth quarter of 2008, Canadians repatriated substantial funds placed abroad to the perceived safe haven of Canada. In addition to the cumulative divestment of debt securities since mid-2007, fourth quarter sales included significant amounts of foreign equity, as stock markets collapsed worldwide. Divestment reached \$21.1 billion in debt and equity instruments, with most of this activity in October, and marked the end of 29 years of net annual investment in foreign securities by Canadians.

19. The collapse of stock markets would have further reduced the value of Canadian investors' holdings of foreign equity securities. However, the exchange rate effect on Canadian foreign assets (largely denominated in foreign currencies) more than offset both these losses and the substantial divestment of foreign securities by Canadian institutional investors in the fourth quarter of 2008. In fact, the revaluation effect of the depreciation in the national currency largely resulted in Canada recording a net international asset position in the fourth quarter of 2008<sup>9,10</sup>.

20. With the substantial repatriation by resident institutional investors of funds abroad, and the simultaneous withdrawal of funds from Canadian stock markets<sup>11</sup>, investors sought out the security of Canadian public debt. The federal government issued over \$50 billion of new debt in the fourth quarter of 2008 to meet this demand and to address liquidity issues in the Canadian financial sector. Part of the proceeds of federal government issues of Treasury-bills was deposited with the Bank of Canada, which in turn provided liquidity via loans to the Canadian banking system. The other portion of the proceeds was advanced to a federal financial government business enterprise, which used this to purchase \$25 billion of mortgage-backed securities, providing a further injection of liquidity into domestic financial institutions.

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<sup>8</sup> In the U.S., the economy contracted sharply (-6.2%), with similar declines posted elsewhere – in the EU (-5.9) and in Japan (-12.7%). The emerging employment effects of this downturn did little to restore confidence in economies or in financial markets.

<sup>9</sup> The Canadian dollar depreciated against most major foreign currencies except the British pound. It depreciated 12.6% against the US dollar, 11.7% against the Euro, 25.4% against the Japanese Yen, but gained 6.4% against the British Pound.

<sup>10</sup> Substantially higher holdings of foreign securities increased exposure to changes in the exchange rate, as occurred during the commodity price boom after 2003 (when the dollar rose above parity with the US dollar) and its bust in the second half of 2008 (when the dollar quickly retreated to near US80 cents).

<sup>11</sup> The S&P / TSX index fell 23.5% in the fourth quarter of 2008.

***Non-residents reduce and adjust their portfolios of Canadian securities***

21. Foreign activity in Canadian securities resulted in foreign investors reducing their holdings in the fourth quarter, in particular bonds. Divestment of \$11.7 billion in Canadian bonds was attributable to net retirements of federal and private corporate bonds. At the same time, non-residents adjusted their portfolios significantly in favour of more liquid investments in the Canadian money market, mainly federal and federal enterprise issues, as the Canadian dollar depreciated and the differential on short-term rates between Canada and the US moved substantially in favour of investment in Canada. This may have also reflected the large supply of Canadian Treasury bills in the fourth quarter.

***Inward and outward direct investment also moderate***

22. Canadian direct investment abroad was \$14.4 billion in the fourth quarter of 2008. While relatively strong, this was slightly less than half the level of investment in the previous quarter. Takeover activity remained modest in the fourth quarter, with outflows mainly comprised of funds placed in existing foreign subsidiaries. Over 90% of the investment was directed to the US economy, and a similar proportion was placed in the energy and financial sectors. Despite the slowing in the fourth quarter, this capped a year of robust Canadian direct investment abroad, marked by substantial funds sent to existing foreign subsidiaries.

23. Foreign direct investment in Canada was again lower than Canadian direct investment abroad in the fourth quarter. Inflows slowed to \$8.9 billion, as Canadian corporate earnings and equity values fell. Foreign direct investment was concentrated in the Canadian energy and metallic mineral sector. Direct investment into Canada in 2008 was less than half of the level reached in 2007, as acquisitions were significantly lower — down by more than \$60 billion.

**IV. Aftermath of recent financial events**

24. Canadian investors returned to foreign stock markets but still continued to have very limited interest in foreign debt securities in 2009. In the first half of 2009, Canadians acquired \$14.7 billion of foreign shares, with most of the activity in the first quarter. Acquisitions reflected strong demand for US and non-US shares, as major world stock markets posted gains over the period.

25. For their part, foreign investors returned to Canadian securities, purchasing both debt and equity securities in 2009. The most notable activity was in the Canadian debt market with non-residents investing \$52.7 billion in the first half of 2009, already exceeding any previous annual investment activity. The surge in foreign investment in debt instruments was mainly accounted for by purchases of new bonds issued by Canadian corporations<sup>12</sup> and by provincial governments, in the wave of budget deficit announcements by Canadian provinces. Foreign acquisitions of federal bonds on the secondary market also contributed to the inflows in 2009.

***Direct investment flows yet to recover***

26. Foreign direct investment flows are yet to recover in 2009, as corporate profits in Canada and the U.S continued to decline. The slowdown in 2008 was even more pronounced in the first half of 2009. Mergers and acquisitions activity, both inward and outward, was marginal, in line with the worldwide trend.

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<sup>12</sup> At this time, corporations were facing improved borrowing conditions, as the spread between interest rates for government and corporate debt narrowed.

27. Funds placed in existing foreign subsidiaries by Canadian direct investors, which were significant in 2008, also slowed considerably. As a result, the lower foreign direct investment activity in the first half of 2009 was almost exclusively comprised of earnings reinvested in operations of foreign subsidiaries.

## V. Summary

28. The financial crisis had pronounced effects on the Canadian real economy, financial markets as well as resident institutional investors and lenders. Both economic and financial activity slowed from mid-2007 and then collapsed in the fall of 2008.

29. The immediate, marked and sustained reaction of Canadian institutional investors starting in mid-2007 with respect to their holdings of foreign securities may have reflected the pending financial crisis that erupted in the late summer and fall of 2008. The current reluctance of these same investors to rebuild their holdings of foreign securities, especially debt instruments, may still be sending a signal about perceived fragility in financial markets, despite a certain stabilization of conditions on financial markets over the last few months.

30. These developments serve to underline the usefulness of Canada's integrated system of national accounts, in particular the frequent and timely monthly release *Canada's International Transactions in Securities*.