FDI: Competitiveness Barometer Flags Warning

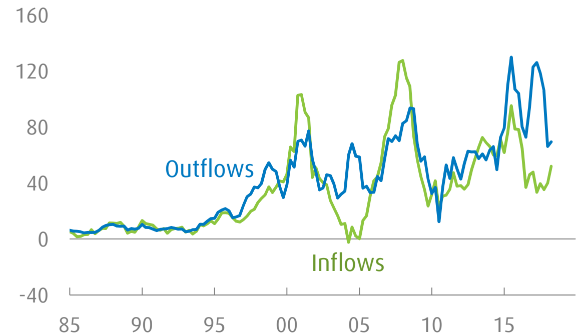
Douglas Porter, CFA, Chief Economist • douglas.porter@bmo.com • 416-359-4887

Amid all the uncertainty surrounding NAFTA over the past year, it comes as little surprise that **Canadian firms have been investing a lot more outside the country recently than foreign firms have been investing in Canada**. Little surprise, perhaps, but far from reassuring. Specifically, the latest quarterly balance of payments figures, released just this week, reveal that foreign direct investment (FDI) registered a net outflow of $10 billion in Q2, bringing the tally over the past four quarters to $17.5 billion *(Chart 1)*. In fact, Canada has seen net FDI outflows in fully 10 of the past 11 quarters (with Q1 of this year the lone exception). If anything, the massive U.S. corporate tax changes at the start of 2018 could tilt the FDI flow even further away from Canada in the years ahead, absent some sort of domestic response. The combination of a new NAFTA deal—which hangs in the balance this week—and competitiveness enhancers in a Fall Fiscal Update from Ottawa would go a long way to stemming the outflow.

Stepping back, the definition of FDI is an investment that carries some measure of control along with it—as opposed to portfolio investment, where investors are buying a small piece of the bigger pie (stocks, bonds, money market paper). Traditionally, any investment that absorbs 10% or more of a company is considered to be FDI. Sidebar: When takeover activity is running strong, it can produce some bizarre readings in the capital account—huge increases in direct flows, but sometimes massive declines in portfolio flows (e.g., when an 8% stake in a cross-border company becomes a 12% stake, it triggers a big FDI move yet nearly an opposite drop in portfolio investment). While there is no stable pattern to Canada's FDI flows over time, the balance has averaged a modest net outflow over the past 30 years, with a deeper deficit in the past four years *(Chart 2)*.

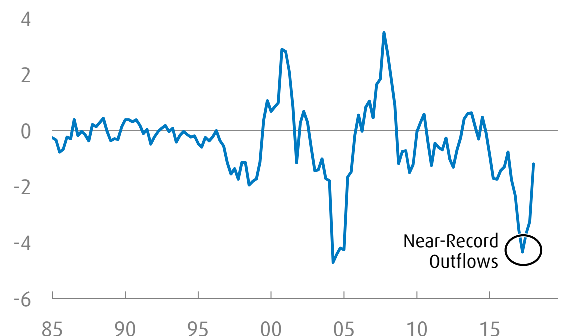
However, despite the unnerving net outflow seen in recent years, digging into the details reveals a somewhat less dire reality. First, looking at just FDI inflows—the investment by foreign firms in Canada—shows that they have not been exceptionally weak of late. In the past four quarters, for example, foreign firms have invested just under $52 billion in Canada. That works out to more than 2% of GDP, which is **actually a bit above the long-run median net inflow of FDI** *(Chart 3)*. We look at the median flow rather than the average, since the latter is skewed higher by the two dramatic spikes in FDI over the past three decades—the first surrounding the tech boom/bubble in the late 1990s, and the second during the commodity boom and mining takeover frenzy in 2007, just before the Global Financial Crisis. Those two episodes also serve as stark reminders that almost any boom—even in something as valued as FDI—should flash danger signals.

Chart 1
FDI: More Outflow than Inflow
Canada (C$ blns : 4-qtr m.s.)
Foreign Direct Investment



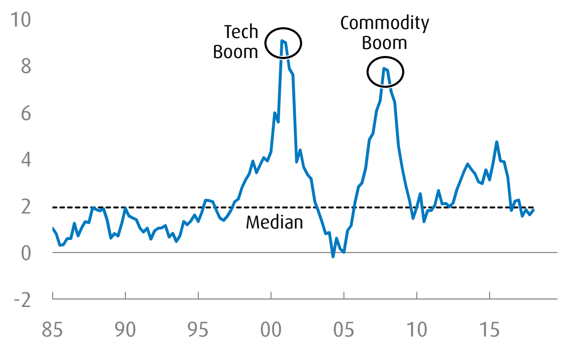
Sources: BMO Economics, Haver Analytics

Chart 2
Net FDI: Negative
Canada (% share of GDP)
Net Foreign Direct Investment



Sources: BMO Economics, Haver Analytics

Chart 3
FDI Inflows: Nothing Special
Canada (% share of GDP)
Foreign Direct Investment — Inflows



Sources: BMO Economics, Haver Analytics

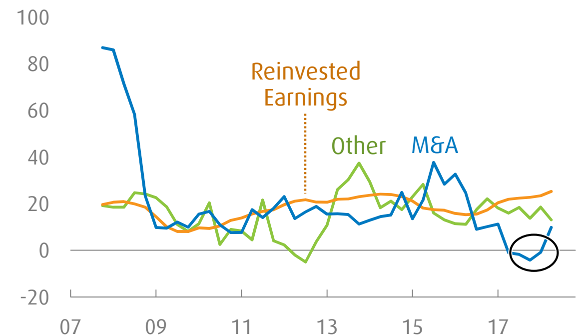
The composition of the FDI inflows also sends a more reassuring message. We often point out that **there are three types of FDI, and they are not created equally**, a nuance that is often lost on many commentators. Some analysts make the blanket assertion that FDI is unambiguously positive, and that more is always better; the reality is more subtle. **FDI consists of a) new greenfield investments; b) reinvested earnings from existing investments; and, c) takeovers and mergers.** We would assert that the "quality" of those FDI inflows for the host economy starts high with "a", is similar to any domestic investment with "b", and is at best a neutral for "c". Readily recognizing this is a contentious stance, but we strongly assert that the quality of the FDI flow matters as much as the quantity, at least for the economy's long-term well-being. Admittedly, that's not the case for the impact on financial markets and the currency, where the quantity is simply the big driver.

Most **of the recent weakness in net FDI flows has been in M&A** *(Charts 4 and 5)*, and that's not necessarily a bad thing. On inflows, M&A activity actually saw a rare negative print in 2017—meaning that foreign companies on net sold their Canadian holdings back to Canadian companies. There's little mystery what happened, as many foreign firms walked away from their previous investments in the oilsands. On the flip side, Canadian purchases of foreign firms abroad were extremely robust from 2015-to-2017, but have since simmered down. In the other two types of FDI, reinvested earnings have tended to be stronger by Canadian firms abroad, but greenfield investments have seen a steady net inflow in recent years (a solid $17 billion in the past four quarters).

The overall net tally of FDI is still an outflow, but the gap has eased substantially—from a record of $92 billion in the year to 2017 Q2, to $17 billion in the past year. That's a much more manageable bite for the capital account, but still a net requirement that must be financed elsewhere. Combined with a deficit on goods, services and income of $66 billion, the capital account needs to be in hefty surplus. As *Table 1* shows, the current account and FDI shortfalls have been primarily financed by large portfolio investment inflows over the past year—**primarily the purchase of Canadian bonds**, which have regularly topped $100 billion annually recently (more than 5% of GDP).

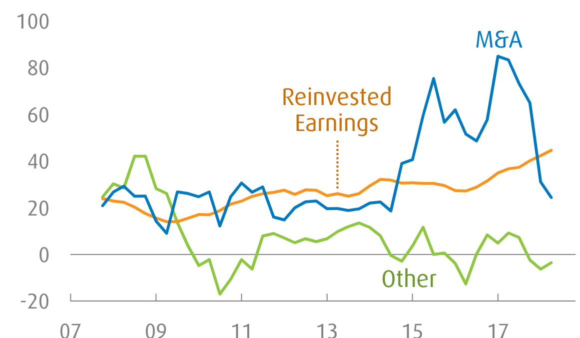
Bottom Line: While the relatively large net outflows of foreign direct investment in recent years is a concern, there are at least three reassuring factors: 1) the gap has narrowed notably in the past year, 2) most of the shortfall reflects heavy investment abroad by Canadian firms, rather than weakness of investment into Canada, and 3) the net outflow has been in M&A activity, which we assert is the lowest "quality" of FDI. Still, the persistent net outflows could deteriorate anew depending on what transpires with NAFTA and Ottawa's coming Fiscal Update, so there is zero room for complacency on the competitiveness front.

Chart 4
Breaking Down the Inflows
Canada (C$ blns : 4-qtr m.s.)
Foreign Direct Investment — Inflows



Sources: BMO Economics, Haver Analytics

Chart 5
Breaking Down the Outflows
Canada (C$ blns : 4-qtr m.s.)
Foreign Direct Investment — Outflows



Sources: BMO Economics, Haver Analytics

Table 1
Funding the Current Account
Canada — 4-quarter total to 2018:Q2 ($ blns)

	Outflows	Inflows	Net
Current Account Balance:			-66.4
Direct Investment	69.3	51.8	-17.5
Portfolio Investment	80.4	135.3	+54.9
Other Flows	22.8	35.0	+12.2
Statistical Discrepancy:			+16.8
			+66.4

Source: BMO Economics

General Disclosure

"BMO Capital Markets" is a trade name used by the BMO Financial Group for the wholesale banking businesses of Bank of Montreal and its subsidiaries BMO Nesbitt Burns Inc., BMO Capital Markets Limited in the U.K. and BMO Capital Markets Corp. in the U.S. BMO Nesbitt Burns Inc., BMO Capital Markets Limited and BMO Capital Markets Corp are affiliates. This document is issued and distributed in Hong Kong by Bank of Montreal ("BMO"). BMO is an authorized institution under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) and a registered institution with the Securities and Futures Commission (CE No. AAK809) under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong). BMO does not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered or dealt with, in compliance with any regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. This document is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Their contents have not been reviewed by any regulatory authority. Bank of Montreal or its subsidiaries ("BMO Financial Group") has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO Capital Markets. The opinions, estimates and projections contained in this report are those of BMO Capital Markets as of the date of this report and are subject to change without notice. BMO Capital Markets endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Capital Markets makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Capital Markets or its affiliates that is not reflected in this report. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This document is not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such Information be considered as investment advice or as a recommendation to enter into any transaction. Each investor should consider obtaining independent advice before making any financial decisions. This document is provided for general information only and does not take into account any investor's particular needs, financial status or investment objectives. BMO Capital Markets or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Capital Markets or its affiliates, officers, directors or employees have a long or short position in many of the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should assume that BMO Capital Markets or its affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein.

Dissemination of Research

Our publications are disseminated via email and may also be available via our web site http://economics.bmocapitalmarkets.com. Please contact your BMO Financial Group Representative for more information.

Conflict Statement

A general description of how BMO Financial Group identifies and manages conflicts of interest is contained in our public facing policy for managing conflicts of interest in connection with investment research which is available at http://researchglobal.bmocapitalmarkets.com/Public/Conflict_Statement_Public.aspx.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A., Member FDIC. Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets. BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A, BMO Ireland Plc, and Bank of Montreal (China) Co. Ltd. and the institutional broker dealer businesses of BMO Capital Markets Corp. (Member SIPC), BMO Nesbitt Burns Securities Limited (Member SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Canadian Investor Protection Fund) in Canada, Europe and Asia, BMO Capital Markets Limited in Europe, Asia and Australia and BMO Advisors Private Limited in India.

"Nesbitt Burns" is a registered trademark of BMO Nesbitt Burns Inc., used under license. "BMO Capital Markets" is a trademark of Bank of Montreal, used under license. "BMO (M-Bar roundel symbol)" is a registered trademark of Bank of Montreal, used under license.

® Registered trademark of Bank of Montreal in the United States, Canada and elsewhere.

™ Trademark Bank of Montreal in the United States and Canada.

© COPYRIGHT 2018 BMO CAPITAL MARKETS CORP.

A member of BMO Financial Group