IV CAPITAL AND FINANCIAL ACCOUNT

This account measures capital and financial transactions of Canadian residents with non-residents. It comprises the capital account, which measures capital transfers and non-produced, non-financial assets, and the financial account, which measures transactions in financial instruments. Capital transfers represent changes of ownership of savings and wealth across the border with no *quid pro quo* whereas transactions in non-produced, non-financial assets give rise to rights and obligations that create an opportunity to generate cash or other assets. Transactions in financial instruments give the right to receive or the obligation to provide cash or other financial instruments. There are two types of financial instruments: primary instruments — such as bonds, receivables, and equities — and derivative instruments[1] — such as financial options, futures and forwards.

For the purpose of this Report, the financial account is of most interest because it provides information about the financing and investing activities of Canadian residents with non-residents. Transactions in financial instruments have a direct impact on the international investment position of the country by creating, extinguishing, or modifying these assets and liabilities. We begin with an examination of direct investment.

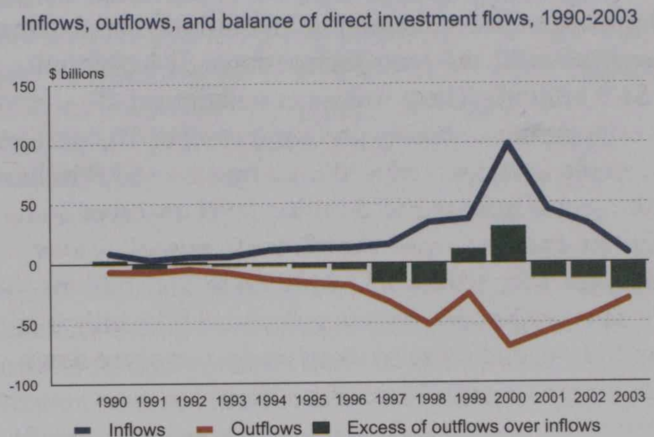
Direct investment (flows)

Canadian foreign direct investment (FDI) flows continued to contract in 2003, as it had in the past few years, reflecting macroeconomic rather than microeconomic developments; this despite the findings of the management consulting firm KPMG that found that Canada is the most cost-competitive nation among the countries of North America, Europe and Japan, with lowest overall costs for labour, land and construction, and electricity, and one of the lowest corporate income tax rates.

For 2003, FDI inflows into Canada fell dramatically (to $8.3 billion) — down to only one-quarter of the $32.3 billion of direct investment that flowed into Canada only one year earlier. It was the third straight year of decline following nine years of uninterrupted expansion of FDI flows into Canada (Figure 4-1). Inbound flows from all major trading partner areas were down last year.

Figure 4-1

Inflows, outflows, and balance of direct investment flows, 1990-2003



Regionally, the United States has accounted for the lion's share of inward investment into Canada over the recent past. (In fact, the U.S. has been a major investor in Canada over the past three-quarters-of-a-century-or-so.) The exception to this was the year 2000 when there was a one-time surge of European investment led by the French takeovers of Seagrams by Vivendi and of Newbridge by Alcatel. While still the dominant investor, the U.S. share of total FDI inflows has slipped from 91.5 per cent in 2001, to 76.4 per cent in 2002, to 53.0 per cent in 2003.

EU investors were next in importance last year, at just under one-quarter of all FDI inflows, or 24.7 per cent. Japanese investors leap-frogged over investors from all other non-OECD countries to place third in importance, representing 9.9 per cent of total FDI inflows in the year just past.

Five of every six dollars of the decline were attributable to U.S. investors: that is, U.S. direct investment into Canada plummeted by 82.3 per cent of their 2002 levels, or by $20.3 billion, to just under $4.4 billion. European investors were responsible for about 8.25 per cent of the decline, as FDI inflows from the U.K. plunged by more than 80 per cent from their 2002 levels, from about $1.25 billion to nearly $0.25 billion. Direct investment inflows from the remainder of the EU were down by more than a third: from $2.8 billion to $1.8 billion. Canada also saw a significant decline in FDI inflows from non-OECD countries; they fell by about two-thirds, from $2.2 billion to $0.7 billion.