IV. CAPITAL AND FINANCIAL ACCOUNT

As noted earlier, 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.

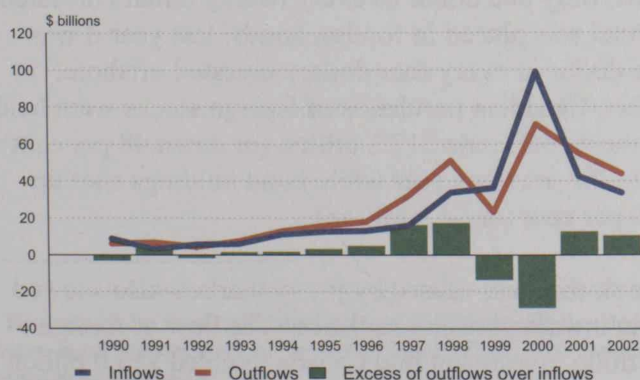
We are mostly interested in the financial account because it provides information about the financing and investing activities of Canadian residents with non-residents. Transactions in financial instruments have a direct impact on the international investment position of the country by creating, extinguishing, or modifying these assets and liabilities.

Direct investment (flows)

Canadian foreign direct investment (FDI) flows continued to decline in 2002, down by about 20 per cent from the previous year's level. Inflows fell by 21 per cent and outflows by 20 per cent. It was the second consecutive year of decline following nine years of uninterrupted expansion of FDI flows. The decline in inflows was broadly in line with, but slightly better than, UNCTAD's prediction of a 27 per cent reduction in world FDI inflows for 2002 (UNCTAD: TAD/INF/PR/63 - 24/10/02), suggesting that Canada remains a highly attractive place to invest in the world-wide competition for global investment.

Figure 4-1

Inflows, outflows, and balance of direct investment flows, 1990-2002



The continuing contraction of inflows into Canada reflects two key factors: the continuing sub-par economic activity in the other major industrialized economies and a bearish stock market world-wide. In turn, these forces have combined to slow down new investment into Canada and reverse the trend towards rising cross-border mergers and acquisitions (M&As) that has driven much of the recent inward FDI flows. Cross-border M&A activity in Canada has plummeted from $64.1 billion in the year 2000 to $13.5 billion last year, falling some 62 per cent and 45 per cent over these two years, respectively.

For 2002, FDI inflows into Canada amounted to $33.6 billion, down $8.9 billion from the previous year's level. Net mergers and acquisitions activity was down by slightly less than $11.0 billion, more than accounting for the entire decline in FDI inflows between 2001 and 2002.

Regionally, the United States has accounted for the lion's share of inward investment into Canada over the recent past. With the exception of the year 2000, when there was a one-time surge of EU investment led by the French takeovers of Seagrams by Vivendi and of Newbridge by Alcatel, U.S. investment into Canada has accounted for about three-quarters-or-more of total FDI inflows. The year 2002 was no exception, as U.S. investors accounted for nearly $25.1 billion of the total $33.6 billion, or 74.7 per cent. EU investors were second in importance last year, accounting for 13.9 per cent of total inflows, or $4.7 billion. Non-OECD foreign investors were responsible for a further 7.0 per cent of the 2002 total, followed by Japan at 3.4 per cent and by the remaining OECD countries not mentioned above, at 1.1 per cent.

On a sectoral basis, foreign investors channelled just over half the total investment (or $16.9 billion) into the energy/metallic minerals industries and about one-fifth (or $6.7 billion) to several other industries within the "other industries" category. For the remainder of the sectors, $3.8 billion of foreign investment flows were directed to the machinery and transportation equipment industries and $2.8 billion went to each of the finance and insurance, and the services and retailing segments of the market.