

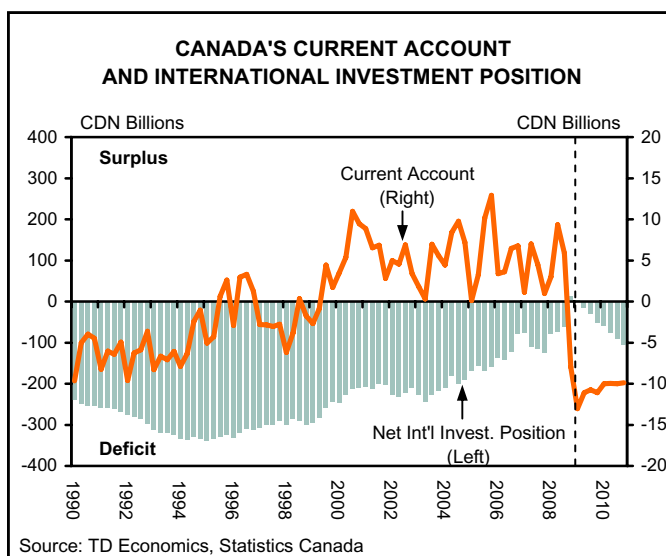
CANADA'S POSITIVE INTERNATIONAL INVESTMENT POSITION IS AN ACHIEVEMENT BUT WILL BE SHORT-LIVED

Canada posted its first recorded positive net international investment position (IIP) at the end of the fourth quarter of 2008, swinging into a \$13.5 billion surplus¹. Although the quarterly shift owed strongly to the depreciation of the Canadian dollar, the move towards a net positive IIP has been underway for some time. Since the third quarter of 1999, Canada had run current account surpluses, as exports boomed and terms-of-trade shifted to Canada's favour. This decade of current account surpluses allowed Canadians to reduce the country's net international liabilities. During this decade, Canada's acquisition of assets abroad and the federal government's pay-down of foreign debt also reduced the net outflow of investment income, further buoying Canada's current account balance.

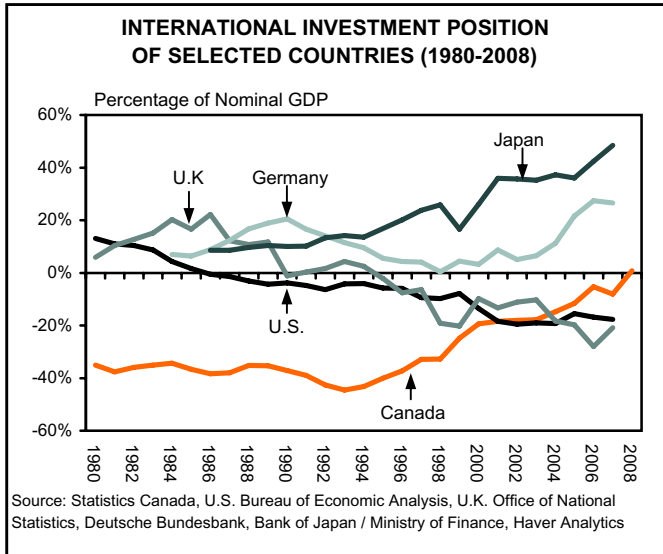
Over the last 15 years, Canada has certainly accomplished a stunning reversal of an IIP that bottomed in 1994 at 45% of nominal GDP in the red. The rapid accumula-

HIGHLIGHTS

- While Canada posted its first recorded positive net international investment position (IIP) of \$13.5 billion in the fourth quarter of 2008, this will be short-lived.
- Canada impressively reduced its foreign indebtedness since bottoming in the mid-1990s at a net liability IIP worth 45% of GDP. Canada's net position benefited from steady current account surpluses since mid-1999, allowing rapid purchase of foreign assets.
- The change in the net position during the fourth quarter was strongly influenced by currency depreciation, masking financial flows – particularly in portfolio investment. Amid credit market turmoil, Canadians were rapidly shedding foreign assets and returning funds home-ward during the fourth quarter.
- Despite a depreciated-driven increase in their Canadian assets, foreigners reduced their portfolio of Canadian securities, divesting from stocks and bonds over the fourth quarter.
- As exports plunge, Canada's current account has swung into deficit, and Canada will revert to a net negative position in the coming year. But, even with this trade reversal, Canada's foreign indebtedness won't plunge to earlier levels.



tion of strong current account surpluses allowed Canada to increase its foreign assets at a breakneck pace. Assets grew at an average 8% annually between 1998 and 2008 while liabilities only climbed 4% on average. Compared



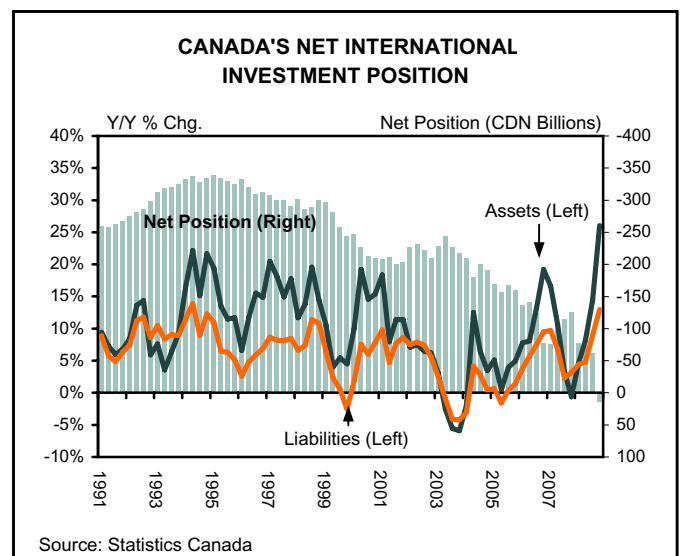
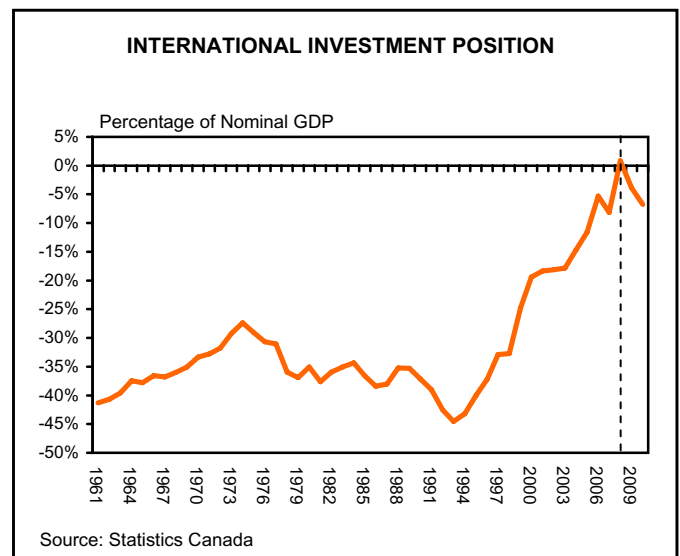
with other industrialized nations, Canada's rapid reduction of its net debtor status is remarkable. It stands in contrast with the tumbles of the U.S. and U.K. into net debtor positions.

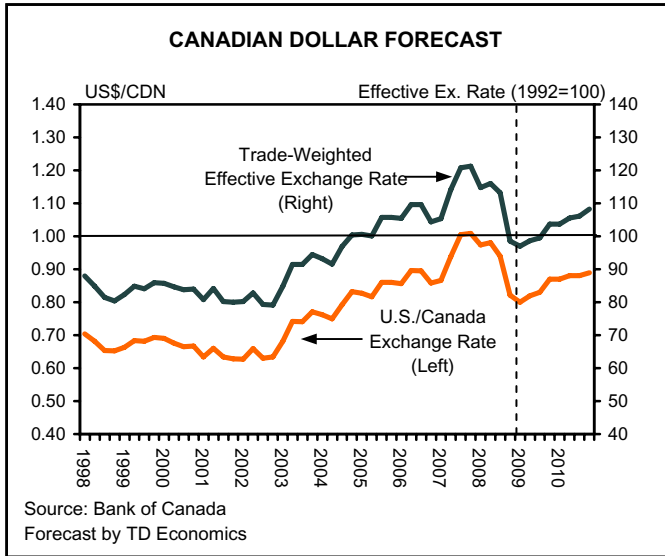
Nonetheless, we expect that Canada's positive net position will be temporary and will revert to a negative net position in the first quarter of 2009. Firstly, Canada shifted into a trade deficit position with the rest of the world in December – although the trade balance was still positive for the quarter. As Canada's exports continue to plunge during 2009, this net trade deficit will further widen. Moreover, we expect Canada's current account balance to remain in deficit over the next five years. Secondly, commencing in the second quarter of 2009, we expect an appreciation of the loonie – both relative to the U.S. dollar and as represented by the trade-weighted effective exchange rate. Since most of Canada's foreign assets are denominated in foreign currencies and with less than half of Canada's foreign liabilities in foreign currencies, an appreciation of the loonie will drag down Canada's net position in Canadian dollars. Given our forecast of a \$42 billion current account deficit during 2009, we project that Canada's net international investment position will tumble to \$58 billion in the red by the fourth quarter of 2009. Yet, even while Canada will revert into net debtor position, the decline will not be so precipitous as to return Canada to its earlier levels of net international indebtedness.

Positive position owes much to the loonie's dive

The changes to Canada's net investment position in the fourth quarter reflect very strong currency effects. Cana-

da's investment position comprises direct investment (ownership of foreign capital), portfolio investment (foreign securities) and other investments (loans and deposits). For Canadians, direct investments abroad comprise approximately 44% of total foreign assets and portfolio investment represents 27%. In contrast, foreign direct investment comprises 36% of Canada's total liabilities to foreigners while foreign holdings of Canadian securities constitute 38%. As well, foreign holdings of Canadian bonds during 2008 moved towards those denominated in Canadian dollars rather than in foreign currencies. These trends mean much greater influence of currency changes on Canada's assets abroad (a depreciation of the Loonie increases their value in Canadian dollars) than on foreigners' holdings of Canadian assets (depreciation only in-





creases those liabilities denominated in foreign currencies).

Nonetheless, during the fourth quarter of 2008, Canadians' foreign assets increased by \$158 billion while liabilities to foreigners increased by \$83 billion. The greatest contributor to the gain in assets was Canada's direct investment abroad, which increased by \$72 billion – a 12.3% quarterly increase. Given the 13% depreciation in Canada's effective trade-weighted exchange rate during the quarter, this was largely a currency re-valuation effect, but Canadians still made \$11.6 billion of outward direct investment.

Securities flows show funds fleeing homeward

Statistics on Canada's international transactions in securities provides a clearer picture of the actual portfolio flows. Despite a net divestment by Canadians from foreign portfolio securities, Canadian portfolio investment abroad increased by \$36 billion during the quarter. While foreigners were divesting from Canadian portfolio instruments during the quarter, shedding \$4.1 billion in Canadian securities, the revaluation effect nonetheless boosted their portfolio investment in Canada by \$22 billion. Again, a substantial portion of Canadian debt is issued in foreign currencies – although Bank of Canada data shows that foreign-denominated debt was being strongly reduced over the past decade.

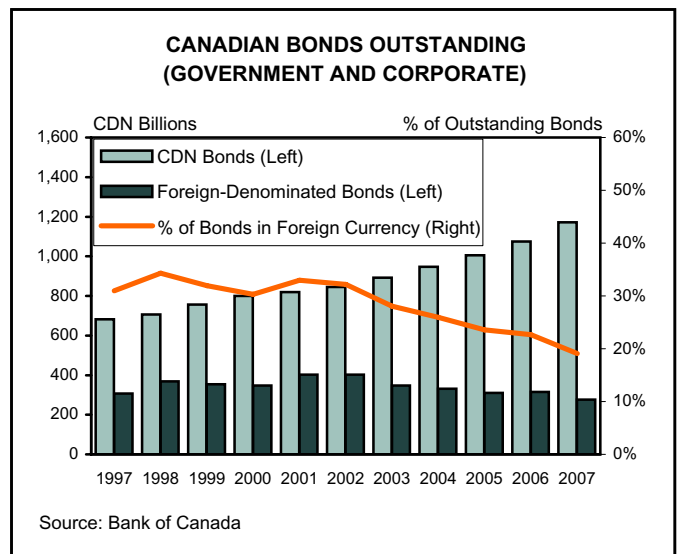
Over the quarter, foreigners' dropped \$1.5 billion of Canadian stocks and divested \$12.7 billion in Canadian bonds – \$7 billion of which were denominated in U.S. dollars. However, foreigners moved strongly into Canadian money market instruments, increasing their holdings by \$9.8

billion over the quarter – the largest recorded quarterly purchase of Canadian short-term debt by foreigners. These shifts show the flight away from long-term, high-risk instruments. Incorporating currency effects, foreign portfolio investment in Canada was up by \$26 billion in bonds, down by \$929 million in equities and up \$11.2 billion in money market instruments.

Amid credit market turmoil and a falling trade balance, Canadians' rapidly divested from foreign portfolio investments, shedding a record \$21.2 billion of these investments during the fourth quarter. The swift departure meant a \$13.8 billion divestment from foreign portfolio assets by Canadians over 2008, marking the end of 20 years of outward portfolio investment. The main divestment was from foreign bonds, of which Canadians liquidated \$11.5 billion, especially shedding U.S. government bonds (\$9.1 billion). Canadians also disposed of \$3.4 billion in foreign stocks and \$2.4 billion in foreign short-term debt. Nonetheless, given the loonie's depreciation over the quarter, Canadian portfolio investment abroad increased by \$32 billion of which only \$13 billion was in the U.S.

Canada's net financial outflows are over for the foreseeable future

The shock to Canada's trade from falling commodities and the turmoil Stateside will deepen the deficit in Canada's current account over the next year. Indeed, we do not foresee a return to a current account surplus in the next five years (see our Long-term Economic Forecast, March 12). Although Canada benefited from "twin surpluses" since 1999, the days of expanding trade are over



(see “Canadian Exports Have A Long Way To Fall,” March 13). Consequently, Canadians will no longer have a trade surplus with which to fund net acquisition of foreign assets. The appreciation of the Canadian dollar will also reverse the somewhat illusory leapt in our asset position

witnessed in the last quarter. This will be further exacerbated as Canadians shed foreign portfolio assets. Increased foreign ownership of domestic assets is the logical consequence of Canada’s reversion to a current account deficit.

Grant Bishop, Economist
416-982-8063

INTERNATIONAL PORTFOLIO FLOWS								
	Canadian Securities by Foreigners				Foreign Securities by Canadians			
	<i>(Positive numbers are inflows of funds)</i>							
	Total Flows	Bonds	Stocks	Money Market	Total Flows	Bonds	Stocks	Money Market
Quarterly Flows (CDN millions)								
Q4/2005	1,202	-1,090	-812	3,104	-12,704	-6,902	-369	418
Q4/2006	7,031	14,043	-5,264	-1,748	-17,637	-10,767	-1,769	568
Q4/2007	-27,122	5,197	-32,039	-281	-5,377	2,932	-1,829	220
Q4/2008	-4,141	-12,507	-1,532	9,897	21,243	11,597	3,405	2,483
Annual Flows (CDN Millions)								
2005	9,438	-218	9,134	520	-53,278	-29,238	-3,964	-310
2006	31,656	17,128	10,814	3,711	-78,490	-43,603	-8,478	-320
2007	-31,590	11,540	-41,995	-1,138	-48,422	-28,903	-11,632	902
2008	26,819	13,224	2,460	11,132	13,893	16,352	-1,513	227

Source: Statistics Canada (International Transactions in Securities)

CANADA'S INTERNATIONAL INVESTMENT POSITION									
End of Period, Book Values									
	Net Assets	Canadian Assets Abroad				Liabilities to Foreigners			
		Total Assets	Direct Invest	Portfolio Invest	Other Invest	Total Liab.	Direct Invest	Portfolio Invest	Other Invest
Amount Outstanding (CDN billions)									
Q4/2005	-159.5	999.8	455.2	292.6	251.9	1,159.2	395.2	498.5	265.5
Q4/2006	-77.3	1,191.9	530.0	372.2	289.7	1,269.2	437.8	529.6	301.9
Q4/2007	-125.0	1,184.4	514.5	354.3	315.6	1,309.4	500.9	486.7	321.8
Q4/2008	13.5	1,493.1	658.8	407.3	426.9	1,479.5	530.7	566.8	382.0
Quarter-to-Quarter Change (CDN Billions)									
Q4/2005	7.6	1.8	3.5	9.7	-11.4	-5.7	2.4	-3.3	-4.8
Q4/2006	45.7	61.8	45.9	34.2	-18.3	16.1	12.9	11.8	-8.5
Q4/2007	-10.9	16.8	10.7	-0.3	6.3	27.6	26.3	-5.8	7.2
Q1/2008	48.3	107.7	45.9	25.3	36.6	59.4	9.1	20.7	29.6
Q2/2008	3.1	7.1	0.0	-3.3	10.4	4.0	5.6	21.8	-23.4
Q3/2008	12.6	36.0	26.4	-1.3	10.9	23.4	9.4	1.3	12.7
Q4/2008	74.5	157.8	72.0	32.4	53.5	83.4	5.8	36.3	41.3

Source: Statistics Canada (International Investment Position)

(Endnotes)

- ¹ All reported values are book values and all figures are in Canadian dollars. Book value represents the value of an asset or liability that is recorded in the books of the enterprise in which the investment is made. Since we are particularly interested in the relationship between changes in Canada's international investment position and the current account balance, book value is the more appropriate valuation measure. Changes in book value reflect currency effects or disposal of assets or liabilities, excluding market revaluations.

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