

Latest Developments in the Canadian Economic Accounts

Foreign direct investment in Canada by ultimate investing country

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Foreign direct investment in Canada by ultimate investing country

Introduction

The ownership structures of multinational enterprises are becoming more and more complex. Inter-company investment or Foreign Direct Investment (FDI) can now be channelled through various entities located in different countries within an enterprise structure before reaching its final destination.

Traditionally, FDI statistics have been presented in the international accounts¹ according to the location of the immediate investor, which is the last country through which the investment transited before entering the domestic economy. This measure is appropriate to evaluate the direct investment flows and corresponding funds exchanged between countries. However, it can obscure the ultimate source of FDI in a domestic economy when foreign investors channel their investment through companies in countries that are not the same as those of the ultimate investor.

Ultimate investor

The ultimate investor is identified by proceeding up the ownership chain of the immediate investor until an enterprise is reached that is not controlled by another enterprise. The location of the ultimate investor is referred to as the ultimate investing Country (UIC).

This is best illustrated using an example. Assume a firm in the United States wants to acquire a Canadian mining company for \$100 million that is operating in Ontario. The US firm has a holding company in the Netherlands and it chooses to route the \$100 million through the holding company. The immediate investing country is the Netherlands while the ultimate investing country is the United States.

There is a growing interest in identifying the location of the ultimate investors in economies receiving direct investment from abroad in order to better understand which countries ultimately bear the risks and reap the rewards of these investments as well as to fully understand international interconnectedness and which countries are being used for the transmission of FDI.

The Organisation for Economic Co-operation and Development (OECD), which sets the international standards for measuring FDI through its Benchmark Definition of Foreign Direct Investment (BMD4), has recognized this fact by establishing new international guidelines for producing FDI statistics for the stock of inward FDI on an ultimate investor basis. The OECD recommends that countries begin producing inward FDI statistics by ultimate investing country (UIC) as a supplementary measure of FDI, while at the same time reaffirming the use of the immediate investing country (IIC) for the release of primary FDI statistics. The IIC indicates the location of the last direct investor before the investment reaches the Canadian economy.

Purpose of the study

This study was initiated to determine the feasibility of producing inward FDI estimates by UIC for Canada. In order to be able to implement this supplemental measure as recommended by BMD4, Statistics Canada has developed the methodology necessary to produce these estimates. This includes analysing the ownership structure of enterprises to identify the location of the direct investor that ultimately controls the direct investment enterprise, i.e., the Canadian enterprise in which the foreign direct investment is made.

1. International accounts includes Canada's balance of international payments and international investment position.

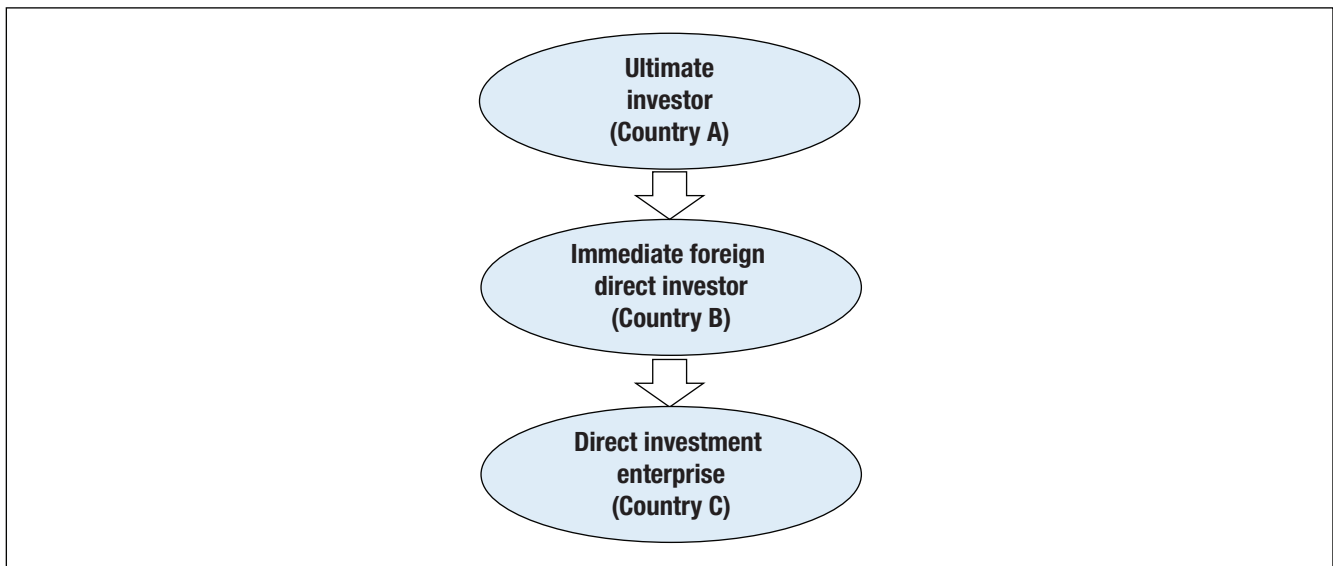
A comparative analysis was then made between inward FDI by IIC and inward FDI by UIC for the reference years 2011 to 2014. By analysing a time period of four years, it was possible to achieve consistent and coherent results and identify some patterns in the data. The Canadian results were then compared to those of countries that have already developed inward FDI statistics by UIC to identify common findings.

Ultimate investor concept

In an effort to enhance their competitiveness in an increasingly globalized environment, multinational enterprises have developed more and more complex ownership structures over time, resulting in ownership chains that can have numerous levels. As a result, determining who ultimately controls a FDI enterprise has become more and more challenging.

Under the standard presentation of FDI statistics and as illustrated in Figure 1, when a direct investment enterprise in Country C, receives an indirect foreign investment from Country A, via Country B, the value of inward FDI in Country C is attributed to Country B (the immediate foreign direct investor). The Country of the ultimate investor (Country A), which represents the ultimate source of the investment is therefore obscured by standard FDI statistics.

Figure 1
Foreign direct investment relationship



Source: Statistics Canada, "Foreign direct investment in Canada by ultimate investing country", *Latest Developments in the Canadian Economic Accounts* (13-605-X), 2017.

Presenting FDI estimates on a UIC basis enables the identification of the countries around the world that ultimately control the stock of inward FDI. These data are useful because they represent the location where multinational enterprises often make decisions. Understanding the difference between the location of the ultimate and immediate investor is also important as it provides an indication of the extent to which foreign companies are channelling their investments before they reach the Canadian economy. Finally, they provide a better indicator of international risk. For example, assume a British company invests in Canada through a subsidiary in Luxembourg. The immediate investor is from Luxembourg and the ultimate investor is from the United Kingdom (UK). If there is a shock to the UK economy ultimately impacting the Canadian affiliate, the FDI statistics on an immediate basis will attribute that shock to Luxembourg while the shock originates from the UK. For example, identifying ultimate investing countries could have better revealed the geographical impact of the financial crisis on the Canadian affiliates.

The UIC method of reporting inward FDI can also offer new perspectives when examining FDI statistics, one example of which is highlighting instances of round-tripping. Round-tripping occurs when a domestic company makes a direct investment abroad into a foreign affiliate which in turn, invests back in the domestic economy in the form of direct investment. Round-tripping estimates can illustrate to what extent inward FDI is actually controlled by domestic investors. Using Figure 1, a simple example of round-tripping would be if both Country A and Country C represented Canada, with the investment originating in Canada, passing through Country B and then returning to Canada. Round-tripping is discussed in more detail later in this paper.

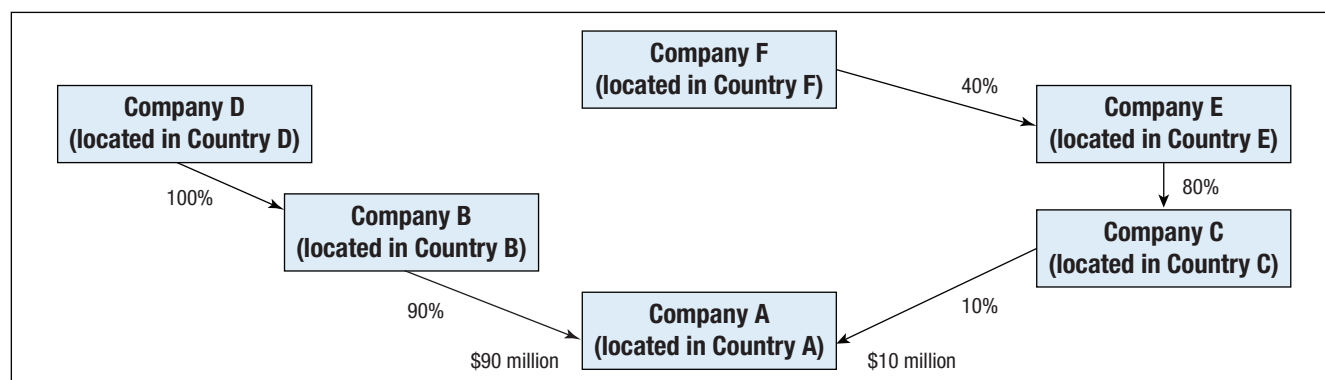
Framework used to identify the ultimate investing country

BMD4 provides guidelines to compilers on how to identify the ultimate investing country of the direct investment and who bears the risk of that investment. According to BMD4, the UIC can be identified by “proceeding up the immediate direct investor’s ownership chain through the controlling links (ownership of more than 50% of the voting power) until an enterprise is reached that is not controlled by another enterprise. If there is no enterprise that controls the immediate direct investor, then the direct investor is effectively the ultimate investor in the direct investment enterprise”². In the case where there are multiple direct investors in an enterprise, BMD4 recommends that the inward FDI position of each immediate direct investor is reallocated to the country of their ultimate controlling parent.

Figure 2 illustrates the case for a company with multiple direct investors. In this example, companies in Country B and Country C are both classified as the immediate direct investors of the direct investment enterprise in Country A, with \$10 million of the investment coming from Country C and \$90 million from Country B. By following the investment up the ownership chains, Country D is identified as the UIC of the direct investor in Country B and Country E is identified as the UIC of the direct investor in Country C. Country F is not considered the ultimate parent because it does not have majority ownership.

Following the BMD4 guidelines to determine the UIC of the stock of inward FDI in Country A, \$10 million of the investment in the enterprise in Country A would be allocated to Country E and \$90 million would be allocated to Country D.

Figure 2
Example of ownership structure to identify the ultimate investing country



Source: Statistics Canada, "Foreign direct investment in Canada by ultimate investing country", *Latest Developments in the Canadian Economic Accounts* (13-605-X), 2017.

2. OECD Benchmark definition of Foreign Direct Investment, Fourth Edition, 2008, page 208

Review of the current approaches used to determine the ultimate investor

In a number of countries that already produce inward FDI on a UIC basis, separate survey programs exist that collect information on the Activities of Multi-National Enterprises (AMNE) and Foreign Affiliate Statistics (FATS)³, including information on the location of the ultimate investor in their domestic enterprises. The information from these survey programs is then linked to inward FDI statistics to produce inward FDI on a UIC basis.

Although BMD4 recommends the allowance of multiple ultimate investors, which requires the re-allocation of the entire inward FDI position to the ultimate controlling parent of each of the immediate direct investors, many countries prefer to use a unique ultimate investor because their AMNE/FATS surveys only collect information on the primary ultimate investor. Furthermore, they prefer this unique UIC approach because it maintains consistency between their FDI and FATS programs and users could be confused by the different concepts of ultimate investor between the FATS and FDI programs. In addition, in order to identify cases where there are multiple UICs, some countries would be required to redesign their surveys, which could increase both program costs and response burden.

One disadvantage of using the unique ultimate investor approach as per the AMNE/FATS framework, is that it provides less information regarding the financial and ownership structure of the multinational enterprise, mainly because minority ownership interests would not be allocated to the real UIC. Using a unique UIC also provides less information on all of the entities that ultimately bear the risks and reap the benefits of the investment as it only focuses on the country of control of the enterprise, as in Figure 2 where all of the investment on an ultimate basis is allocated to Country D even though some of the investment ultimately came from Country E.

The Canadian approach

The Canadian approach differs from the BMD4 proposed approach by allocating to a unique UIC (as noted previously several countries compiling FDI also favour this approach)⁴. A primary reason for this is that the ultimate investor information used to build the stock of direct investment in Canada by UIC is generated from the Activities of foreign majority-owned affiliates in Canada program (or inward FATS), which is based on a unique ultimate investor. In addition, the use of consistent concepts in the development of FATS and FDI statistics allows for more coherent and comparable results between the two programs.

Using the unique ultimate investor approach, in the example given in Figure 2, the full direct investment value of \$100 million would be allocated to the ultimate investor in Country D.

It should be noted that in the Canadian FDI statistics around 90% of direct investment enterprises have a unique investor. Therefore, the use of the unique UIC approach as opposed to the multiple UIC approach would not, in practice, lead to very different results.

Statistics Canada methodology

Using data from the inward FATS survey program to determine the ultimate investor for the stock of inward FDI

Statistics Canada does not currently collect information on the ultimate investor as part of its FDI survey program. Consequently, an alternative data source was required to build the series for the stock of inward FDI on a UIC basis. One advantage of a centralized statistical agency is that it compiles a wealth of economic data from ongoing surveys and administrative programs. In 2015, an initiative was undertaken to develop an inward FATS survey program by linking various data sources within the Agency. The UIC of foreign majority-owned Canadian enterprises (i.e., those Canadian enterprises for which a foreign immediate investor owns more than 50% of the voting shares) was identified as part of this initiative.

3. Activities of Multi-National Enterprises (AMNE) and Foreign Affiliate Statistics (FATS) statistics are an extension of statistics on FDI. FATS provides additional insight on the effects of FDI in national economies in terms of sales, employment and trade. The broader framework of AMNE also provides information on the importance of multinationals in their economy.

4. There are currently differences in the way that countries treat multiple investors when presenting inward FDI statistics on a UIC basis. This is currently a subject that is under discussion as part of an OECD working group.

To determine the ultimate investor for majority-owned enterprises in Canada in the inward FATS frame, specific steps were followed using information from the Foreign Direct Investment in Canada survey program, various tax schedules, the Inter-Corporate Ownership (ICO)⁵ database and Statistics Canada's Centralized Business Register. The enterprises on the inward FATS program were linked to the ICO, which maintains information on the structure and ownership of larger corporations active in Canada. By proceeding up the ownership structure of these multinational enterprise units to the last enterprise with over 50% of the voting shares that is not more than 50% owned or controlled by another entity, namely the ultimate investor and country of residence were identified.

The data on the ultimate investor that was compiled as part of the inward FATS program were then linked to the frame of companies on the inward FDI program. This methodology was employed for the reference years for which the FATS ultimate investor information was available, which at the time of this study covered the years 2011 to 2014. Because the inward FATS program only looks at majority-owned enterprises, a small proportion of the inward FDI frame that is minority-owned could not be linked to the ultimate investor information.

Methodology for minority investors and sister companies

In contrast to the inward FATS universe, which only covers majority-owned enterprises (ownership of more than 50% of the voting shares), the inward FDI survey program also includes Canadian enterprises with foreign ownership between 10% and 50% of the voting shares. These enterprises account for less than 10% of the total stock of direct investment in Canada on a value basis. Because these enterprises are not part of the inward FATS frame there is no information available on their UIC.

For the purposes of this study the immediate investing country has been used as a proxy for the ultimate investing country when foreign ownership of Canadian enterprises is between 10% and 50% of the voting shares. As there can be more than one foreign minority investor in a Canadian enterprise and these investors may be from different countries, in some cases this can result in attributing multiple UICs to an enterprise. Given that this group of enterprises accounts for a small proportion of inward FDI applying such a methodology does not materially affect the overall picture of the estimates on a UIC basis. This method represents a temporary solution as it deviates from Canada's proposed approach, which is to allocate the investment to a unique ultimate investor. Moving forward, in cases where there is more than one immediate investor in foreign minority-owned Canadian enterprises the methodology will be developed to allocate the total investment of these units to the country with the largest value of FDI.

The inward FDI frame also includes foreign sister companies (sometimes referred to as fellow enterprises) that normally do not have any direct equity investment in the foreign-controlled Canadian enterprise, but which have issued debt to the Canadian enterprise. Because they are controlled by the same foreign parent as the Canadian enterprise these companies are considered part of the FDI framework. As with the cases of minority ownership, these enterprises are not included in the inward FATS frame and therefore there is no information on the UIC. Once again, for the purposes of this study the IIC has been used as a proxy for the ultimate investor. Again, this approach contradicts Canada's preference for a unique ultimate investor and in the future the total value of debt will be allocated to the country of the ultimate investor.

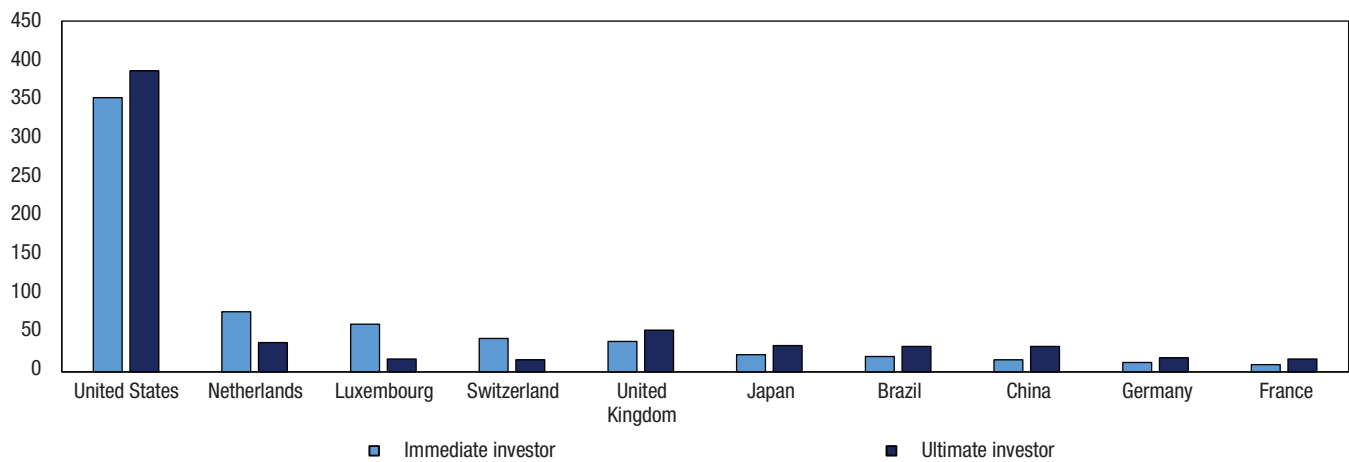
Analysis – Provisional estimates for reference year 2014

This section presents some of the preliminary results of the stock of inward FDI by UIC for reference year 2014. As can be seen in Chart 1, one of the main conclusions that can be drawn is that the United States, which is already the dominant direct investor in Canada on an immediate investor basis, further increases its share of overall investment when the data is presented on an ultimate investor basis. The stock of direct investment in Canada held by US investors went from \$352 billion on an immediate basis to \$386 billion on an ultimate basis, an increase of 10%. Other countries with notable increases in investment when measured on an ultimate investor basis include the UK, Brazil, China and Japan. On the other hand, moving to FDI on an ultimate investor basis results in a substantial reallocation of direct investment out of countries such as Luxembourg, the Netherlands and Switzerland. These results were similar for all four of the reference years that formed part of this study, making it possible to identify consistent patterns in the data over time.

5. The Inter-Corporate Ownership (ICO) database is an index of who owns and/or controls whom in Canada. The ownership (voting equity) information in the database is primarily based upon non-confidential returns filed by Canadian corporations under the *Corporations Returns Act*. This information is supplemented from a broad range of national and international data sources for major changes in corporate ownership and also uses international publications such as Moody's and Who Owns Whom.

Chart 1
Inward foreign direct investment by immediate and ultimate investor by major country, 2014

billions of dollars

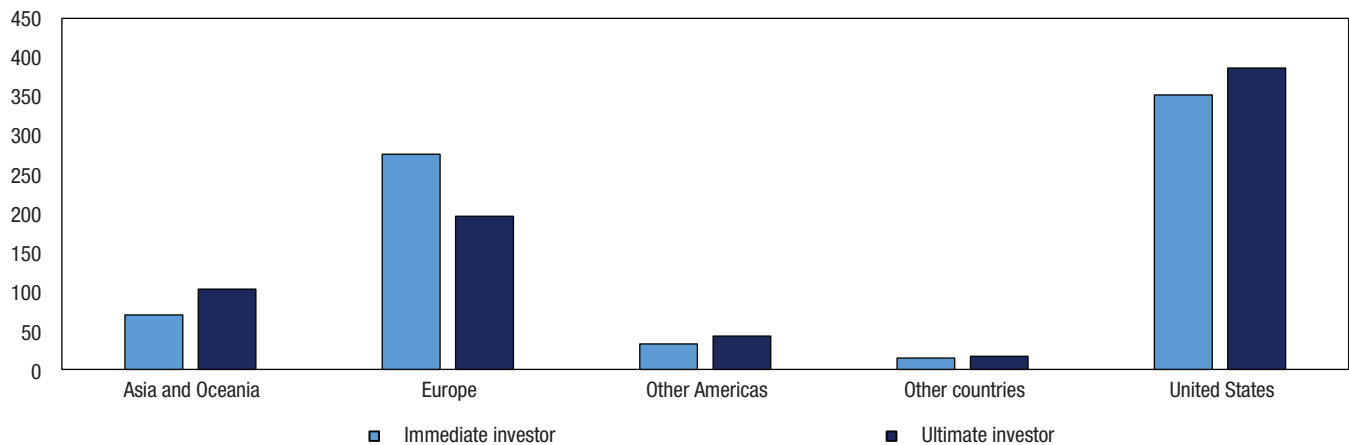


Source: Statistics Canada, "Foreign direct investment in Canada by ultimate investing country", *Latest Developments in the Canadian Economic Accounts* (13-605-X), 2017.

When measured on an ultimate investor basis, there is a significant decrease in the stock of direct investment held by investors in Europe, which indicates that investors in other parts of the world will often channel their investment into Canada through European countries (Chart 2).

Chart 2
Inward foreign direct investment by immediate and ultimate investor by major country, 2014

billions of dollars

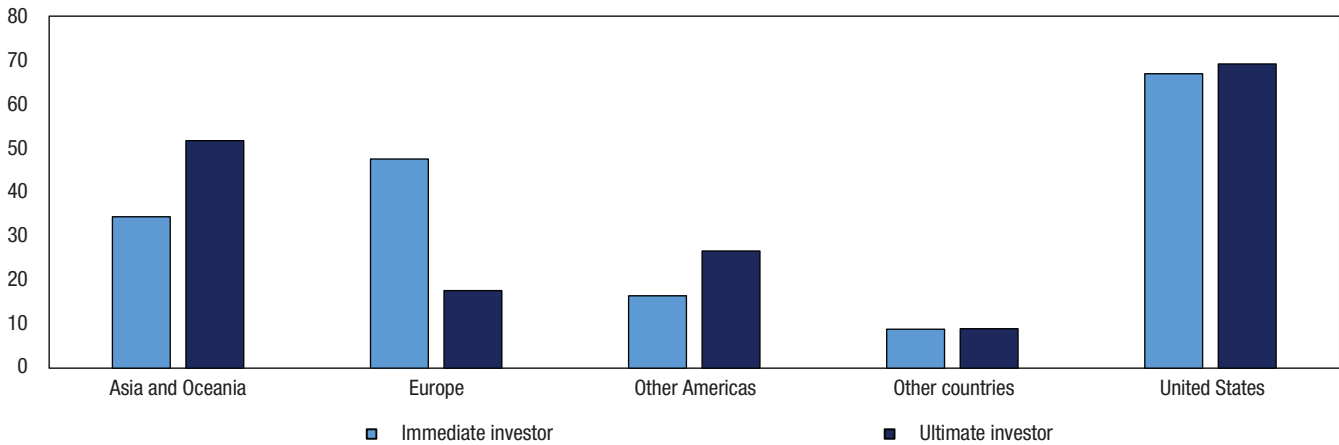


Source: Statistics Canada, "Foreign direct investment in Canada by ultimate investing country", *Latest Developments in the Canadian Economic Accounts* (13-605-X), 2017.

Presenting inward FDI on an ultimate investor basis can also result in significant changes to the geographical distribution of FDI by sector. An example of this is the mining and oil and gas extraction sector. When presented on an immediate investor basis, European countries are the second-largest investors in this sector after the United States (chart 3). However, when measured on an ultimate investor basis, most of the investment in this sector that is coming from Europe is ultimately controlled by companies located in other parts of the world, most notably in Asia and Oceania and the Other Americas regions.

Chart 3
Inward foreign direct investment by immediate and ultimate investor for the mining and oil and gas extraction sector, 2014

billions of dollars

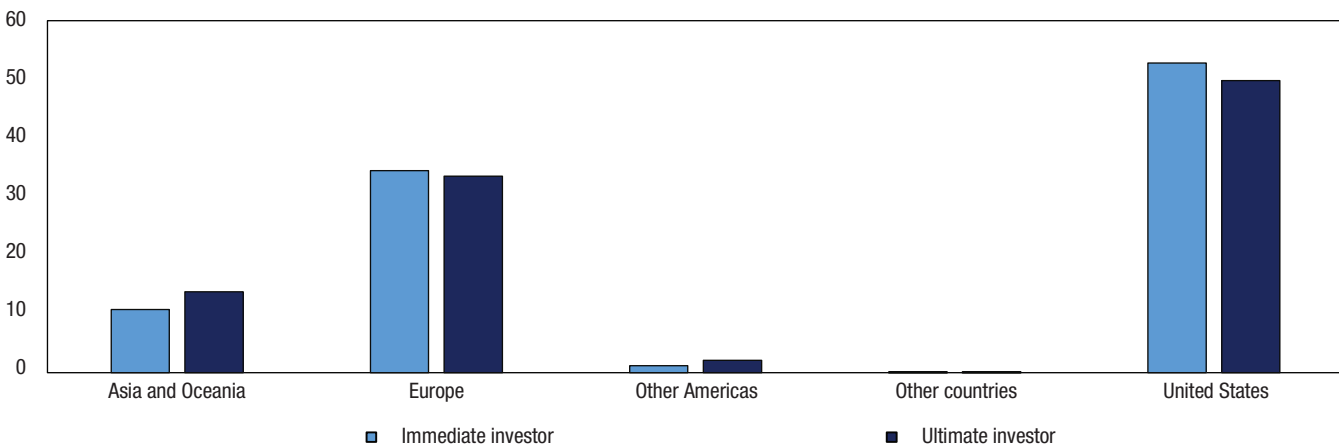


Source: Statistics Canada, "Foreign direct investment in Canada by ultimate investing country", *Latest Developments in the Canadian Economic Accounts (13-605-X)*, 2017.

For other sectors such as finance and insurance, the change in regional distribution between the immediate and ultimate investor presentations is not as pronounced (chart 4).

Chart 4
Inward foreign direct investment by immediate and ultimate investor for the finance and insurance sector, 2014

billions of dollars



Source: Statistics Canada, "Foreign direct investment in Canada by ultimate investing country", *Latest Developments in the Canadian Economic Accounts (13-605-X)*, 2017.

A number of countries currently publish inward FDI by ultimate investing country⁶. Among these countries, similar trends were observed when presenting FDI on an ultimate investor basis, including a large reallocation to the United States and significant declines for countries such as Luxembourg and the Netherlands. This type of information is useful to policy analysts to better understand and assess investment strategies used by multinational organisations.

6. Information about other countries that publish inward FDI by UIC can be found on the OECD (<http://stats.oecd.org>) website.

Round-tripping

Another common finding among countries publishing inward FDI by ultimate investing country is the presence of round-tripping investment, which refers to the process whereby funds from a domestic economy are channelled abroad and then returned to the same economy in the form of direct investment. In the cases analysed by the OECD, round-tripping was significant enough to push investors from the domestic economy into the top ten sources of FDI when the data was reported on an ultimate investor basis⁷.

Results from this study indicate that this is not the case for Canada as the value of round-tripping is not significant in comparison to other countries producing inward FDI estimates on a UIC basis. Throughout the four reference years studied, the value of round-tripping was below 1% of the total stock of FDI in Canada, suggesting that Canadian companies are rarely channelling funds through intermediate countries before investing back into Canada in the form of direct investment.

Conclusions

This study was done to determine the feasibility of producing the stock of inward FDI estimates by UIC for Canada. By making use of the information already produced from the inward FATS, provisional estimates were generated and analysed on this new basis of measurement. The study suggests it is feasible to begin producing FDI by ultimate investing country in upcoming years. In addition, Canadian results were coherent with common international findings among countries that have explored the topic.

Following this initial study and provisional estimates, Statistics Canada will work toward finalizing the methodology, for example refining the approach to allocate the ultimate investing country for enterprises with foreign ownership between 10% and 50% as well as sister companies. The objective is to publish a new series for the stock of inward FDI by UIC, as a supplement to the already existing series by IIC.

The new data will provide users with better information on who ultimately controls investment entering Canada. The ultimate investor typically makes decisions for multinational enterprises and possesses significant control of the direct investment. Currently, as per traditional FDI measures, the standard method of reporting inward FDI is by immediate investing country, the last country the investment passes through before reaching the destination. Due to the increasingly complex ownership structures of enterprises, it is useful to provide users with both the ultimate and immediate investing country information.

7. Based on the OECD review note 'FDI Statistics by the Ultimate Investing Country', 2015.