

The Power of International Capital

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Now more than ever, foreign central banks and other large international investors can make or break governments. Backed by international buying, more fiscally responsible nations are capable of funding elevated borrowing programs at previously unheard of levels. Granted, as Canada has learned, being the target of large-scale foreign buying has carried its own risks, spurring currency appreciation and eroding trade fortunes. But consider the plight of other, more profligate states, where a lack of foreign investor subscription could ultimately lead to financial ruin.

Emerging Markets Won't Save Global Growth...

As we highlighted in our recent issue of *Forecast*, past policy tightening has clipped the wings of some high flying developing countries. Our feature article on pages 3-5 provides a detailed examination of growth in the BRIC countries. Importantly, there's scope for monetary policy relief, preventing an economic slowing from overshooting the mark too far. Still, tamer emerging market growth blunts export prospects for many advanced countries and dulls prospects for commodity producers and risk-correlated currencies like the CAD and AUD severely. Both currencies could shed some 5% from current levels in coming quarters (see forecast table, page 2).

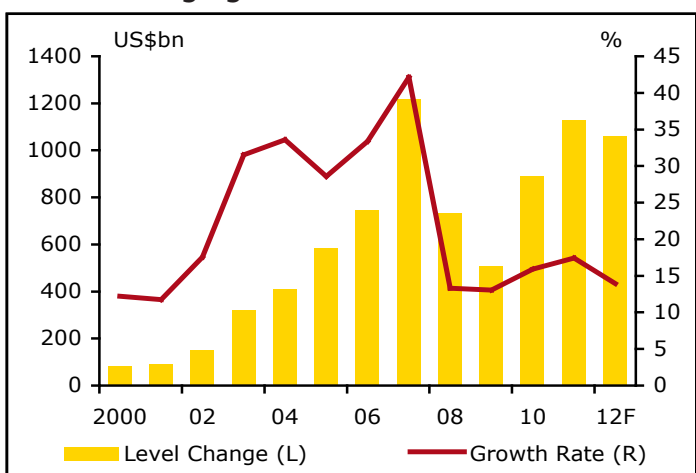
...But Central Bank/Official Reserves Offer Important Lifeline

Softer global growth has triggered a slowdown in official reserve growth, which in emerging markets is now just half the pre-crisis pace (Chart 1). All the same, official reserve accumulation remains a critical theme for global capital markets. There's likely to be an extra US\$1 trillion of emerging market reserves put to work in 2012, with China (and the other BRICs) accounting for the lion's share of that growth (Chart 2).

At US\$8½ trillion, emerging market reserves would be equivalent to roughly 15% of nominal GDP in high income countries by the end of 2012, making EM countries critical facilitators of advanced country indebtedness. Attracting reserve flows looks to be a vital funding strategy for cash strapped governments in the developed world.

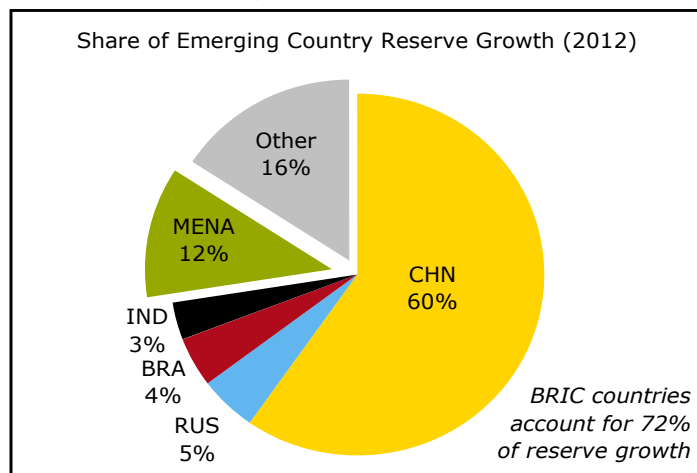
Even small adjustments to such a large reserve portfolio can have meaningful implications for smaller markets like Canada. Shifting merely 1% out of US\$ reserves could trigger a 10%-plus jump for the so-called "other" currency basket, which includes CAD, AUD and the Scandinavian currencies, amongst others.

Chart 1—Emerging Markets Official Reserve Growth



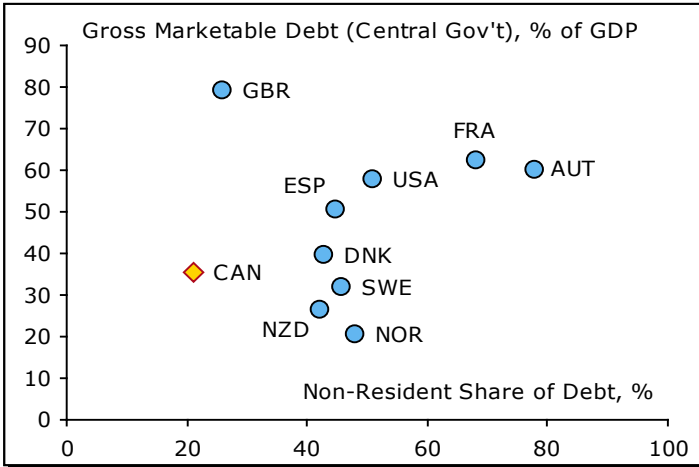
Source: CIBC, IMF

Chart 2—BRICs Key to Reserve Growth



Source: CIBC, IMF

Chart 3—Canada Less Reliant on Foreign Investors But...



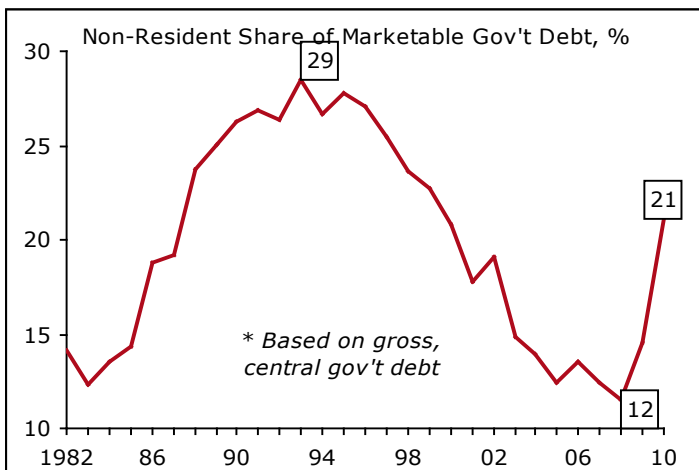
Source: CIBC, OECD

Reliance on Foreign Capital Varies Widely

In Canada’s case, past debt repayments have meant less reliance on foreign investors than other advanced nations (Chart 3). That’s been a nice place to be. After all, it’s countries with a heavy debt burden and an outsized reliance on foreign capital that typically spark the most concern.

But don’t be fooled into thinking foreign capital flows aren’t an important feature of today’s Canadian market. Non-resident holdings of Canadian government debt have been marching higher (Chart 4). And in the Government of Canada market alone, the net \$73 billion of bonds gobbled up by foreign investors during the past two and a half years took down 60% of net issuance. Provincial

Chart 4—...Foreign Exposure Has Increased Notably



Source: CIBC, OECD

governments too, have courted international capital heavily, given unprecedented funding needs.

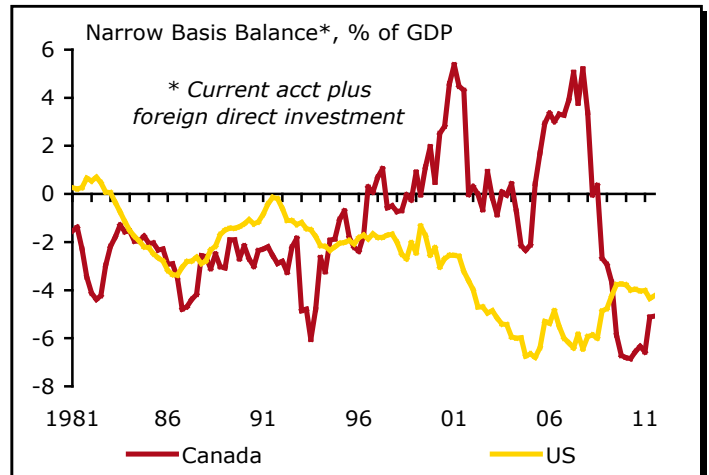
As fiscally sound and risk-correlated Canada became the target of foreign official buying, the resulting appreciation in the C\$ exacerbated provincial imbalances, eroded fortunes in the country’s still-sizeable factory sector, erased the country’s trade surplus and pushed the current account deep into the red—where it remains. Call this the ugly side of foreign investor buying. Where are we today? In proportionate terms, Canada’s narrow basic balance (that is, the current account *plus* foreign direct investment) shows a larger net portfolio requirement than in the US (Chart 5).

Flight to Safety Bid Could Be Slow to Fade

Where do we go from here? Markets have seized on some healthier US economic data and the odd sign of life from Europe. Downgrades to 2012 forecasts have seemingly run their course. Meanwhile, work towards a European debt solution (while far from complete) has contributed to lower volatility, setting the stage for a partial unwind of a flight to safety (or more appropriately, a flight to liquidity) trade that so gripped markets this Fall.

As we continue to caution, however, global economic growth will be lukewarm at best next year. Whether in America or Europe, there remain plenty of triggers for a renewed risk-off environment, be it political dysfunction, prospective credit rating downgrades or other tape bombs. Worse, risks to 2013 growth are as yet underappreciated, keeping challenging market conditions in place for longer, delaying a more complete unwind of the FTQ trade and constraining flows into more risk-correlated currencies like CAD.

Chart 5—Required Portfolio Inflows Canada/US



Source: CIBC, StatCan, US BEA

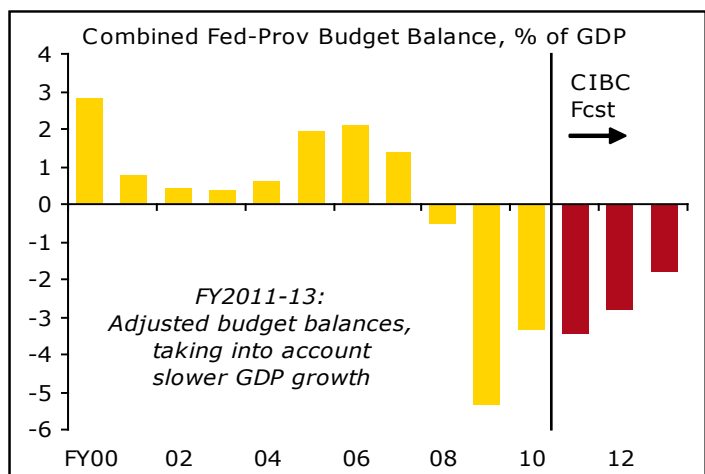
Smaller Deficits Won't Mean Less Supply

Slower growth is bad news for governments struggling to get back to balance. In many cases, earlier fiscal targets could prove unattainable. While deficit progress won't be as significant as earlier hoped, fiscal consolidation efforts will nonetheless see primary budget shortfalls worked down in many advanced economies in the coming year. Notwithstanding a longer timeline for deficit elimination in Ottawa, Canada's combined federal-provincial budget shortfall should fall to 2.8% of GDP in 2012/13, about half the peak level registered in the wake of the 2008-09 recession, with further progress due in FY2013 (Chart 6).

Smaller deficits and the end of fiscal stimulus efforts mean lighter net funding needs, but that won't translate into reduced gross issuance. Government debt is coming due in ever larger waves. For large developed countries, maturing debt is equivalent to more than 20% of GDP in 2012 (on average), accounting for nearly 80% of the coming year's gross borrowing requirement (Chart 7).

Government issuers that enjoy the market's confidence will be in a position to lock in rates at exceptionally low levels. We've already seen this in Canada, with interest savings compensating for fewer revenue dollars at the federal and provincial levels alike. In less fiscally secure regions, however, there's a substantial risk to rolling over so much debt. A loss of market confidence combined with heavy refinancing requirements can accelerate the path to fiscal ruin. The current environment puts a premium on liquidity and that's the catalyst for the meaningful provincial government pre-funding that we expect to see over the final quarter of fiscal 2011/12. It's also spurring Ottawa's efforts to build up prudential liquidity facilities.

Chart 6—Cdn Governments Making Progress on Deficits



Source: CIBC, Federal/Provincial Governments

Supply Fundamentals Only Part of the Picture

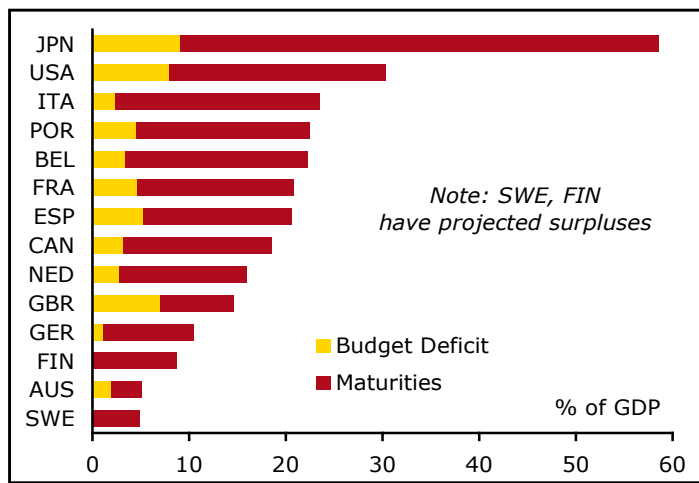
All else equal, stronger fiscal credentials and relatively lighter sovereign bond supply support Canadas vs. Treasuries. That should be particularly true in the long end where supply dynamics exert greater influence and GoC supply is more constrained. Of course, in the near term, all else is not equal, with longer-dated Treasuries supported by the Fed's Twist program and Canadas vulnerable due to an expected weakening in the currency on a softer growth backdrop.

Finally, it's important to understand how the composition of Canadian government bond supply is changing. With net GoC supply slowing more quickly, and limited net new product from the federally-guaranteed CMB program, provincials will comprise a growing share of net Canadian government bond supply going forward.

Canada's provinces are high investment grade credits. However, as Moody's recent decision on Ontario reminded us, some provincial issuers run the risk of further credit ratings pressure. While any negative rating actions are likely to be limited and relatively isolated, eroding provincial credit quality could give the most cautious investors pause, requiring wider spreads to clear the necessary funding at home and abroad.

All in all, net foreign buying of Canadian portfolio assets will remain an important theme in 2012, forestalling a more serious depreciation in the C\$. While continuing to create challenges for Canadian manufacturers and exporters, foreign investor demand will provide cost effective and varied funding options for federal and provincial governments that continue to run sizeable budget deficits.

Chart 7—Gross Funding Needs Elevated, Despite Smaller Deficits



Source: CIBC, IMF