Corporate Capital Markets: Hollowing Out?

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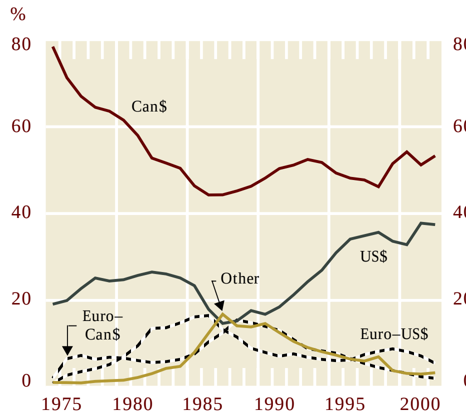
As globalization increases, some observers have questioned the future of the bond and stock markets in countries that are on the periphery of the major global financial markets. Will they continue to exist and to prosper, or will activity increasingly shift to markets in other countries? In the case of Canada, we know that Canadian corporations borrow significant amounts in U.S. bond markets and that an appreciable number of large Canadian corporations are cross-listed on U.S. stock exchanges. Is this a harbinger of a future in which Canadian financial markets become ever less important, or is it a reflection of a long-standing and viable situation in which Canadian corporations use both Canadian and U.S. financial markets to conduct their financing?

Chart 1 Distribution of Outstanding Bonds Issued by Canadian Corporations



Bond Markets

To address these questions, one can start by examining the borrowing behaviour of Canadian corporations over the past 25 years. Chart 1 shows the distribution of outstanding bonds issued by Canadian corporations, both non-financial and financial (including government enterprises).[1]

Over the first decade of the data (1975–85), a declining share, but well over half, of the issues outstanding were denominated in Canadian dollars and issued in Canada. This ratio has remained at around 50 per cent since the mid-1980s. The share of outstanding bonds denominated in U.S. dollars and issued in the U.S. market increased in the 1990s, but this has been

1. These data include issues of asset-backed securities.

* This note draws from a forthcoming study of financial developments in Canada, Freedman and Engert (2003).

at the expense of other types of issues.[2] Considering that the measurement of the foreign currency component is inflated by the depreciation of the Canadian dollar over this period, the fact that Canadian-dollar issues placed in Canada have maintained a steady share of the total over the last 15 to 20 years is impressive.

Another perspective can be gained by examining net new issues over the period (Chart 2) rather than levels outstanding. While choppy, these data show that for all corporations, the proportion of bonds issued in Canada over the last 15 years, although lower than the proportion seen before the mid-1970s, has, on balance, remained at about half the total.

It is also worth noting that corporate bond issues as a whole, across all markets, grew rapidly in the 1990s (as indicated by Chart 2). When account is taken of the low rate of inflation and, hence, the relatively low growth of nominal GDP over the period, the growth rates are striking. As a percentage of GDP, Canadian-dollar corporate bonds outstanding rose from 9.0 per cent in 1991 to 10.0 per cent in 1996 and to 16.5 per cent in 2001. Thus, virtually all of the increase came in the second half of the period (1996 to 2001), when the federal government was moving into budget surplus and reducing its demands on the Canadian bond market.

Over this period, 1996–2001, federal government debt denominated in Canadian dollars declined in absolute value, while corporate bond issues increased rapidly. At the same time, provincial governments were shifting from foreign currency debt to Canadian-dollar debt. Thus, over the five years, Canadian-dollar debt excluding federal government issues increased by 54 per cent, while total Canadian-dollar debt (i.e., including federal government debt) rose by 28 per cent, similar to the growth of nominal GDP. "Crowding in" of non-federal debt was very much at work over the period.[3]

Chart 2 Total Net New Bond Issues: All Corporations

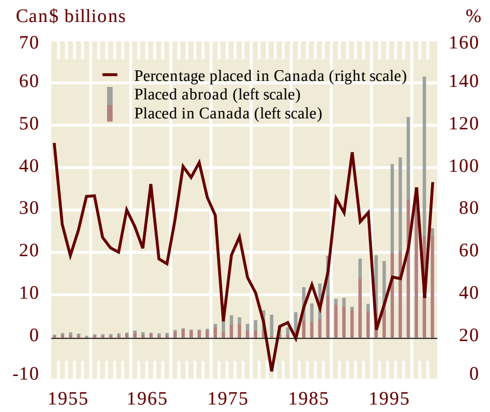
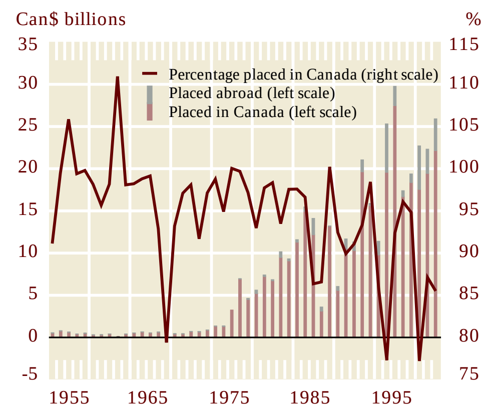


Chart 3 Total Net New Stock Issues: All Corporations



2. These issues include Euro-Canadian bonds (Canadian-dollar issues placed outside Canada), Euro-U.S. dollar bonds (U.S.-dollar bonds placed outside the United States), and bonds in other currencies.
3. For more on this, see Chouinard and Lalani (2001–2002).

Equity Markets

In the last 15 years, there has been an increase in reliance on foreign placements of net new equity issues. Nevertheless, the share of foreign placements of new issues continues to be relatively small—although volatile—averaging 12 per cent in the last 5 years (Chart 3).[4] Thus, while the share of net new equity issues placed abroad has tended to increase in recent years, the vast majority of net new equity issues are still placed in Canada.

In the 1990s, there was a sharp increase in the number of Canadian-based stock issues listed on both Canadian and U.S. exchanges, which peaked in 1998. But scaling these data by the number of stocks listed on the Toronto Stock Exchange shows that the percentage of such interlisted firms rose in the last 15 years or so from about 12 per cent in the mid-1980s to about 15 per cent more recently, a modest increase.[5]

There was also an increase in the absolute volume and value of trading of interlisted stocks on U.S. exchanges over the last decade. However, there has been little change since the mid-1980s in the proportion of the value of interlisted stocks traded on U.S. exchanges. About 40 to 50 per cent of total trading in interlisted stocks is on U.S. exchanges, which has been the case for about 20 years.

Finally, the number of Canadian-based firms listing exclusively on U.S. exchanges declined consistently from the levels seen in the mid-1990s through 2002.

Why Borrow in Foreign Markets?

Canadian firms have long been active in foreign capital markets, especially fixed-income markets. What encourages Canadian firms to use foreign markets, particularly U.S. markets?

First, U.S. capital markets are deeper and more liquid, which might allow easier access to cheaper capital for some Canadian firms (and also attract Canadian investors). Thus, for example, corporations trying to raise very large amounts of funds are more likely to issue securities in the U.S. market than in the Canadian market. Similarly, Canadian firms are more likely to turn to U.S. markets when domestic markets face heavy borrowing programs.

Second, major U.S. financial centres appear to be more skilled and sophisticated in the structuring, pricing, and placement of transactions. As a result, more complex and more risky instruments (such as high-yield securities) are likely to be concentrated in U.S. markets.

A third factor may be the protection from adverse exchange rate movements (i.e., a "natural hedge") that Canadian exporters have when borrowing in U.S. dollars. With the increase in Canada-U.S. trade in recent years, this factor may have increased in importance. Similarly, Canadian corporations that are considering direct investments in the United States will take into account the natural hedge from denominating their borrowing in U.S. dollars.

Fourth, it is possible that regulation of Canadian financial markets is less efficient than it could be, which effectively taxes capital market activity in Canada.[6] While, broadly speaking, easy access by Canadian firms to foreign sources of fixed-income and equity capital is positive, the possible inefficiency of capital market regulation in Canada remains a policy concern. As a result, the authorities, both federal and provincial, and market participants are working to improve the efficiency and effectiveness of capital market regulation and thereby facilitate the financing of corporations in Canada.

A fifth key factor until the mid-1990s, was the degree of "crowding out" of corporate securities by large issues of government bonds in Canada.

Conclusions

The main findings from the data are as follows.

- The Canadian corporate sector has had a large appetite for foreign sources of fixed-income financing since the early 1980s.
- However, the share of total corporate bonds that are issued in Canadian dollars (and placed in Canada) has remained fairly

4. These data include income trusts.
5. If this were measured by market capitalization, the result would likely indicate a somewhat larger interlisted presence.
6. For an overview of issues and possible approaches, see Harris (2002) and MacKay (2002).

steady at about half over the past 15 years or so.

- While Canadian equity issuers are turning more to foreign markets, the extent of that reliance is currently small.
- The percentage of Canadian-based firms interlisting on U.S. exchanges has increased only modestly in the last decade, to about 15 per cent. And there has been little change since the mid-1980s in the percentage of trading of interlisted stocks on U.S. exchanges.
- There has been a downward trend in the number of firms listing exclusively on U.S. exchanges.

Thus, while there has been somewhat increased reliance on foreign sources of funds over the last decade, the data reviewed here do not provide much support for the view that domestic capital markets have been abandoned by Canadian firms or have been "hollowed out" in recent years. But other observers have reached more pessimistic conclusions and remain concerned about future developments.

Furthermore, as long as Canadian residents wish to hold Canadian-dollar assets—and there is little reason to suppose that they would not for the foreseeable future—then there will be a demand for such assets. Accordingly, there will be incentives for governments and domestic firms to supply Canadian-dollar securities, including corporate bonds and equities.

What would help domestic corporate capital markets to flourish?

- Continuing efforts on the part of the financial industry to develop the skills needed for corporate capital markets, including the ability to evaluate and price the risks associated with corporate instruments and to place these securities with investors
- A readiness by Canadian investors to make corporate securities a larger part of their portfolios
- An efficient regulatory system
- Continuing fiscal discipline on the part of Canadian governments

References

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