



August 27, 2014

ECONOMIC GROWTH AND INNOVATION

It's Alive! Corporate Cash and Business Investment

by
Finn Poschmann

- Fears of “dead money” lying idle on corporate balance sheets have spurred some policymakers and observers to push for heavier taxation of private activity or greater public-sector investment.
- Yet such concerns seem misplaced. Business sector investment Canada-wide is growing at roughly the same pace as the economy, and the investment share of output is just above its 30-year average, as is typical of an economic recovery period. Meanwhile, the run-up in cash holdings after the last recession reflects long-term changes in business practices, and uncertainty about the future.
- Concerns over business investment, if any, would better be handled through improvements to market certainty and the investment environment through, for example, stable fiscal planning aimed at building investor confidence.

Concerns continue to arise, in Canada and elsewhere, over a perceived slow pace of business investment growth, and rising holdings of corporate cash (Isfeld 2014), and possible connections between the two phenomena.

Concern over these issues seems misplaced, and is worrisome. The “dead money” view is routinely used to build the case, as in Ontario, for heavier taxation of private activity, and for potentially unaffordable and unproductive public-sector investment (Spiteri 2014). Yet the view is mostly wrong, as I discuss in what follows.

The author thanks colleagues of the C.D. Howe Institute, Phil Cross, Andrew Sharpe, and anonymous reviewers of early drafts. The errors that remain are mine.



Business-sector investment Canada-wide since 2011 has been growing at roughly the same pace as the economy, and the investment share of output is just above its 30-year average, as is typical of an economic recovery period. Indeed, as former Bank of Canada Governor Mark Carney put it, what was previously called dead money, is “dead no longer. Resurrected.” (Carmichael 2013) In recent years, moreover, capital spending has been the strongest in the energy and mining sectors – wherein cash holdings had grown the most (IMF 2014).

So what accounts for the run-up in firms’ cash holdings? In the wake of the recession that ended in Canada five years ago, businesses shored up their balance sheets overall, so that current assets would more safely exceed current liabilities. In doing so, they continued a trend that became most evident beginning a decade ago, as I discuss below; they steadily trimmed the share of current assets held in relatively unproductive inventories, and similarly trimmed accounts receivable. They began accumulating more liquid financial assets, cash and cash-like instruments, to be deployed as investment opportunities arose.¹ This indicates prudent balance sheet management, and perhaps caution with respect to investment commitments, likely owing to market uncertainty.

As these are benign trends, not unique to Canada, and well within the range of ordinary business behaviour, my conclusion remains as stated in Poschmann (2013); in the absence of a market or business conduct failure, so called dead money is not so, and hence this argument provides no basis for calls for a rising tax burden on private activity.² Concerns over business investment, if any, would better be handled through improvements to market certainty and the investment environment through, for example, stable fiscal planning aimed at building investor confidence.

What the Data Reveal about Business Balance Sheet Choices

Business investment in machinery and equipment and nonresidential structures, as a share of national output or income, rests slightly above its long-run Canadian average of 10.3 percent (Figure 1), and some forecasters see indications that investment growth in coming quarters will significantly exceed output growth; the manufacturing outlook is correspondingly positive (Bartlett 2014, RBC 2014).³

The recent investment share for machinery and structures, 10.7 percent of output, is less than in some previous adolescent boom, or pre-bust, periods. What the data suggest, however, is that the the past several decades have shown a declining amplitude in cyclical swings of Canadian business investment activity. This is consistent with a decentralization of global production and manufacturing capacity and decision-making, technological change, and better use of information regarding demand – and therefore an improved ability to attenuate or repurpose supply capacity to suit demand conditions.

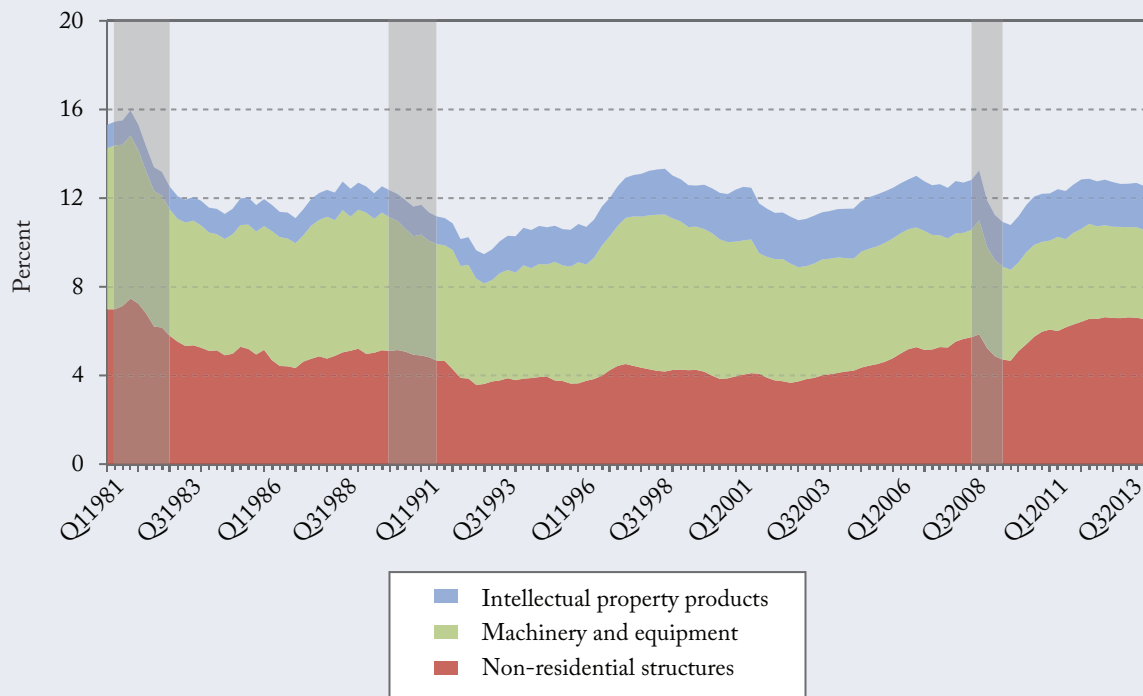
In concert with improved transportation capacity and improved inventory management, in the context of expanded regional and supra-regional trade and investment agreements, globalization seems to have smoothed the Canadian investment cycle.

1 Nonfinancial firms’ cash holdings, as a share of output, began to rise in the early 1990s, and continued to do so steadily until Q3 2010, since when the share has remained flat (CANSIM Tables 380-0064 and 187-0001).

2 Similar trends and concerns have arisen in Western Europe (including the UK) South Africa, and the US, where international tax factors play a role in corporate behavior that is less evident in Canada.

3 Within Canada, there is much regional dispersion of private investment rates with low investment levels in some parts of the country compared to other countries (Cross 2014, Dachis et al., 2014). Further, the investment share of nonresidential structures and intellectual property has risen, while that of machinery and equipment has fallen, likely reflecting strength in the resource sector relative to manufacturing.

Figure 1: Investment in Non-residential Structures, Machinery and Equipment, and Intellectual Property, Share of GDP, Canada



Note: Shaded areas indicate recession periods, as defined at <http://www.cdhowe.org/c-d-howe-institute-business-cycle-council-issues-authoritative-dates-for-the-2008-2009-recession/19382>.

Source: Statistics Canada CANSIM, Table 380-0064, accessed June 24, 2014.

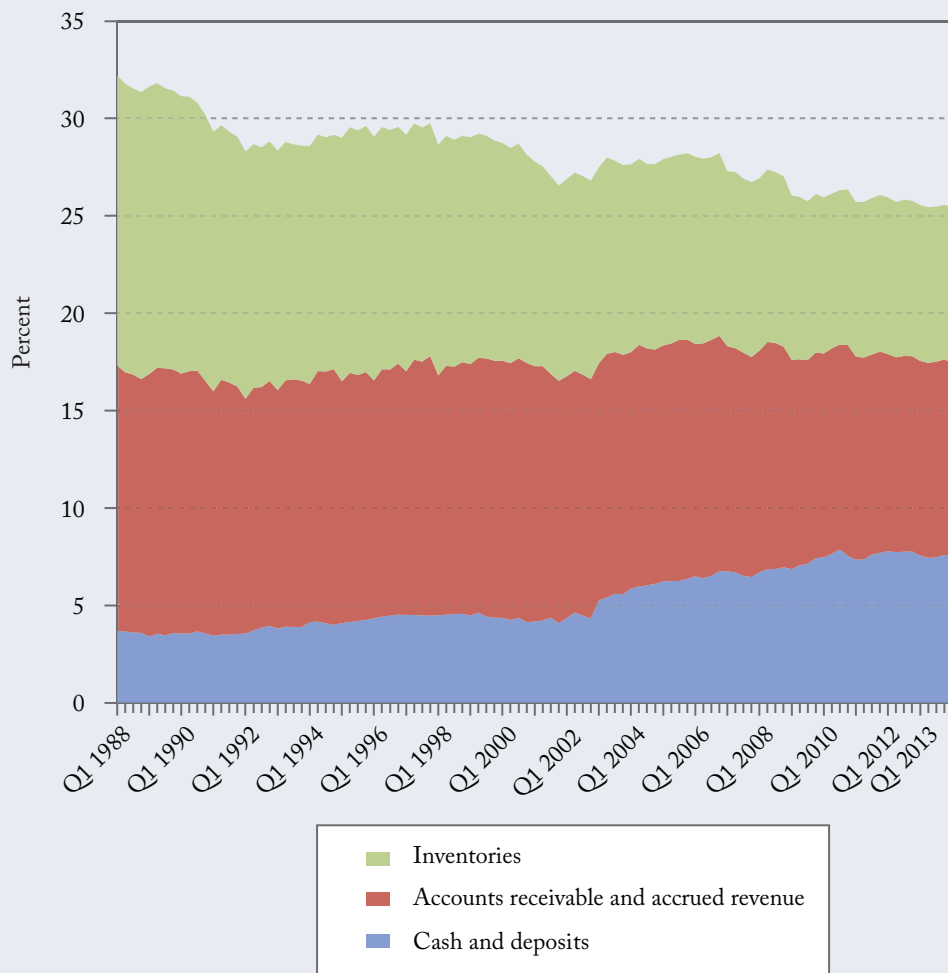
Poschmann (2013) noted that businesses generally had been shoring up their ratios of current assets to liabilities. The pattern suggests a learning process – after the sharp shocks of the early 1990s, early 2000s, and 2008-09, the importance of maintaining liquidity for ordinary operating reasons, and for precautionary reasons, seems to have led typical ratios of current assets to current liabilities – the current ratio – to rest above past levels. The general rise in the current ratio ceased in the second half of 2012.⁴

The Composition of Current Assets

Since the early part of this century, businesses have been holding more of their current assets, as a share of total assets, in liquid forms such as deposits, cash, and cash-like instruments (Figure 2, panel A). In part this represents the precautionary motive discussed above, and one increasingly recognized as prudent business investment behavior (Shufelt 2014).

⁴ Statistics Canada CANSIM, Table 187-0001, accessed June 20, 2014. I estimate the current ratio as current assets, the sum of cash and deposits, inventories, accounts receivable, portfolio investments, as a percentage of current liabilities, the sum of accounts payable, bankers' acceptances and paper, and other current loans and borrowings.

Figure 2 – Panel A: Major Asset Categories, Percent of Total Assets, All Nonfinancial Industries

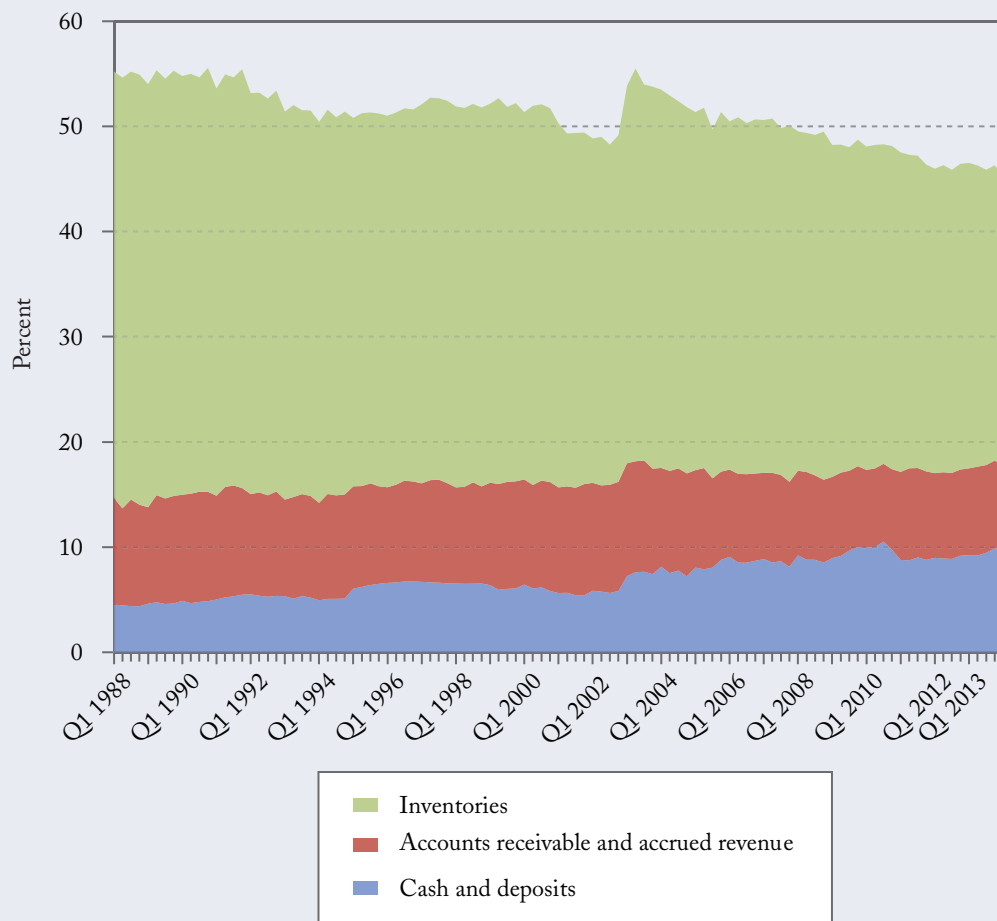


Source: Statistics Canada CANSIM, Table 380-0064, accessed June 24, 2014.

There are other reasons for the cash increases, tied to the need for any business to ensure that current assets are in tune with current liabilities, or to achieve a desired current ratio. The availability of liquid assets to meet near-term spending needs is of keen interest to investors and analysts (Deveau 2014).

The first and largest reason is the decline in inventories as a share of current assets. This long-term, secular decline may be attributed to improved transport and trade flows, containerization, cross-border integration of production, and the spread of just-in-time delivery systems (Poschmann 2013). Also, innovations in inventory management systems have grown to more tightly link supply adjustments to demand conditions. Further, inventories lack liquidity, relative to cash, and liquidity is valuable in itself, especially in times of stress.

Figure 2 – Panel B: Major Asset Categories, Percent of Total Assets, Retail Industries



Source: Statistics Canada CANSIM, Table 380-0064, accessed June 24, 2014.

Whatever the economic weight of these factors, the net impact is remarkable. Inventories relative to current assets, for all nonfinancial firms, have fallen from 14 percent at the end of the 1980s to 8 percent in recent quarters (Figure 2, panel A).⁵

The other major current asset category is accounts receivable – payments due for goods and services that have been sold – which also has shown a major trend decline over the past three decades. Accounts receivable are an especially unproductive asset, and information technology has helped firms squeeze them, through

5 Removing cash holdings from the total assets denominator produces an almost identical pattern, meaning that the fall in inventories – and accounts receivable – as a share of total assets is not a byproduct of an independent rise in cash holdings (author's calculations).

automated invoicing and electronic billing systems, which also may facilitate speedy collection when purchasers fall delinquent. Where receivables cannot easily be squeezed, firms may always have the possibility of factoring or selling them. What has changed since the 1990s, however, is the capacity of nonfinancial firms to securitize receivables, converting for example leases and other streams of payments to cash. Since the asset-backed securities market had been insignificant prior to the 1990s, this capacity did not previously exist.

The features described above apply to some sectors more acutely than others. With respect to declining inventories, retailers stand out (Figure 2, panel B), and the likely drivers are those mentioned above. In addition, integrated retailers, such as Benetton Group SpA, adopted point-of-sale technology to guide production decisions, reducing their inventory costs.⁶ Further, firms such as Wal-Mart Stores, Inc. introduced agreements with suppliers that would see the latter take on responsibility for distribution directly to retail establishments.⁷ The result is that the sector's inventory to current asset ratio has declined, from over 40 percent at the end of the 1980s to less than 28 percent recently.⁸

The pattern in manufacturing, over the past decade, is remarkably similar and apparently driven by the same factors (Table 2, panel C). One difference is that the trend shift appears to have moderated, with little change among the major components of current assets since late 2011.

Current Assets in Context

The past rise in cash holdings, and their rise as a share of current assets, is not unique to Canada (IMF 2014). It reflects in significant part a conversion of current assets from less liquid to more liquid forms. In turn, liquid assets represent precautionary holdings not only against market downturns, but as prepositioning for business investment choices (IMF 2014), which grants them option value that less liquid options do not possess.⁹

The recently prevailing low interest rate environment, coupled with uncertainty over global and regional growth prospects, amplifies the precautionary factors. When borrowed funding is cheap and the supply extensive, and risk and uncertainty over returns make capital investment expensive in the financial economics sense, firms will face an incentive to structure more liquid balance sheets.

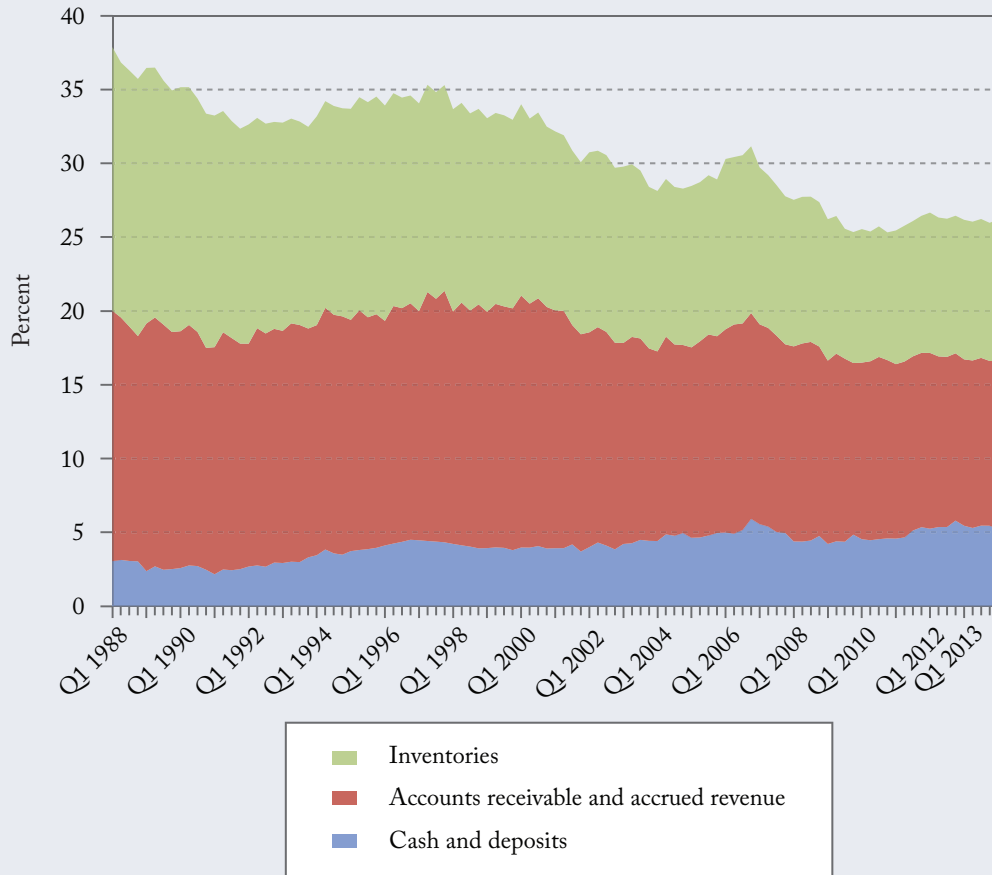
6 Benetton introduced electronic networks that linked internationally distributed points of sale and regional Italian production decisions in the 1980s, and revised the system in 1989 to include freight-forwarding and customs data (<http://www.referenceforbusiness.com/history2/92/Benetton-Group-S-p-A.html>).

7 Wal-Mart's annual inventory turnover ratio, for example, is generally high as compared with the department and discount retail sector average (analyst reports, various). Among the firm's US stores, about one-fifth of inventory is delivered directly by suppliers rather than routed through distribution centres and, for example, the Sam's Club division makes extensive use of cross-docking at distribution facilities, so that inventory moves to sales points as speedily as possible, and spends less time counted among the firm's assets (SEC filings, various).

8 There was one upward shock to an otherwise downward trend, in 2003, likely owing to fallout from the then recent and sharp US recession (Figure 2, panel B). Further, not shown here, the cash share of assets has fallen in recent quarters in the oil and gas and mining and quarrying sectors (CANSIM Table 187-0001).

9 IMF (2014), p27.: "With imperfect capital market and information asymmetries that make external financing costly, firms may decide to keep their cash holdings at a level that equates its marginal costs and benefits... Firms may thus increase their holdings of cash if they face a higher level of uncertainty and greater potential future investment needs as the opportunity costs from having to forgo spending due to a of lack of adequate external funding is higher in these cases."

Figure 2 – Panel C: Major Asset Categories, Percent of Total Assets, Manufacturing Industries



Source: Statistics Canada CANSIM, Table 380-0064, accessed June 24, 2014.

Conclusion

Notwithstanding concerns over rising cash on corporate balance sheets, and impatience over the pace of business investment, cash in the Canadian economy remains conspicuously alive.

Jurisdictions within Canada, should they be concerned that the pace of business investment growth is lower than it might be, or that money is resting when it might or should not, should attend to factors that encourage business investment, such as a stable fiscal environment, stable investment policy, and committing to reduce rather than increase taxes bearing on business investment. These policy issues address directly the reasons firms may hold significant liquidity.

Otherwise, the accumulation of cash in firms is best explained as an expression of caution on the part of firms, and of prudent or efficient asset reallocation. To the extent that slack business investment poses a challenge for policymakers, cash holdings should be seen not as a cause, but at most as a symptom.

References

- Bartlett, Randall. 2014. "Despite Recent Setbacks, Business Investment Is Still Poised To Revv Up In Canada." *TD Economics Observation*. June 24. <http://www.td.com/document/PDF/economics/special/BusinessInvestmentInCanada.pdf>
- Carmichael, Kevin. 2013. "Corporate Canada's 'dead money' is back to life, Carney says." *The Globe and Mail*. April 19. <http://www.theglobeandmail.com/report-on-business/economy/economy-lab/corporate-canadas-dead-money-is-back-to-life-carney-says/article11379141/>
- Cross, Philip. 2014. "The Public Purse versus Private Wallets: Comparing Provincial Approaches to Investing in Economic Growth." E-Brief 178. Toronto: C.D. Howe Institute. June 25. http://www.cdhowe.org/pdf/e-brief_178.pdf
- Dachis, Benjamin, Nicholas Chesterley, and William B.P. Robson. 2014. "Capital Needed: Canada Needs More Robust Business Investment." E-Brief 179. Toronto: C.D. Howe Institute. July 17. http://www.cdhowe.org/pdf/e-brief_179.pdf
- Deveau, Scott. 2014. "Bombardier meets expectations, but climbing cash burn raises concern." *National Post*. May 1. <http://business.financialpost.com/2014/05/01/bombardier-meets-expectations-but-climbing-cash-burn-raises-concern/>
- International Monetary Fund (IMF). 2014. "Canada: Selected Issues." *IMF Country Report No. 14/28*. February. <http://www.imf.org/external/pubs/ft/scr/2014/cr1428.pdf>
- Isfeld, Gordon. 2014. "Canadian corporate cash hoard rises to \$630-billion in first quarter." *National Post*. June 20. <http://business.financialpost.com/2014/06/19/canadian-corporate-cash-hoard-rises-to-630-billion-in-first-quarter/>
- Poschmann, Finn. 2013. "Not Dead Yet: The Changing Role of Cash on Corporate Balance Sheets." E-Brief 143. Toronto: C.D. Howe Institute. January 16. http://www.cdhowe.org/pdf/e-brief_143.pdf
- RBC. 2014. "RBC Canadian Manufacturing PMI™ hits six-month high in June." July 2. <http://www.rbc.com/newsroom/news/2014/20140702-pmi.html>
- Shufelt, Tim. 2014. "Forget 'dead money' – cash is king." *The Globe and Mail*. June 22. <http://www.theglobeandmail.com/globe-investor/investment-ideas/forget-dead-money-cash-is-king/article19284391/>
- Spiteri, Ray. 2014. "Feds need to do more for municipalities: May." *St. Catherines Standard*. <http://www.stcatharinesstandard.ca/2014/06/02/feds-needs-to-do-more-for-municipalities-may>

This E-Brief is a publication of the C.D. Howe Institute.

Finn Poschmann is Vice President, Policy Analysis, at the C.D. Howe Institute.

This E-Brief is available at www.cdhowe.org.

Permission is granted to reprint this text if the content is not altered and proper attribution is provided.