Canadian investors would be among the most vulnerable to an abrupt decline in U.S. financial markets -- more so than Japan and China which have built up vast hoards of U.S. treasuries in recent years, according to a new IMF working paper.

A 10% decline in the U.S. dollar, stocks and bonds would lead to wealth losses for Canadian investors of 6.25 percentage points of gross domestic product, estimates Francis Warnock, professor at the University of Virginia and visiting scholar at the International Monetary Fund.

That compares with an estimated loss of 4.1 percentage points for Japan and 4.3 for China.

The hit to Canadian wealth would be higher as a percentage of GDP than most of the 50 countries Mr. Warnock studied -- largely because of the substantial U.S. equity positions Canadians have built up.

Major financial centres such as Luxembourg, which would take a 255-percentage-point hit, Hong Kong, Singapore, Switzerland, Taiwan and Belgium would suffer more, along with the Netherlands, Ireland and Uruguay.

In 1994, the hit to Canada would have only amounted to two percentage points of GDP.

"It's some combination of a removal of [RRSP] barriers, greater equity participation generally ... and there always has been tight economic ties between the two countries," said Mr. Warnock in an interview.

Experts, including Bank of Canada David Dodge, have been warning for years the U.S. dollar is vulnerable to an abrupt correction because of the massive fiscal imbalances that have built up in the global economy.

The United States is borrowing to fuel consumption, running up an unprecedented current account deficit of about 6% of GDP. Other countries have funded the borrowing by buying U.S. treasuries.

Investors have raised their exposure to U.S. financial markets because the U.S. has consistently led growth and has safe, deep, liquid markets.

In all, foreigners had amassed roughly US$5-trillion in U.S. bonds and equities by mid-2004, roughly the size of the Japanese economy, according to Mr. Warnock.

The worry is investors could one day balk at high U.S. indebtedness and abruptly pull out of U.S. markets, sending the U.S. dollar tumbling. That would bring the U.S. current account deficit down but could also cause a global recession.

A 10% correction in the U.S. dollar would be considered by many to be mild. Some analysts say the greenback would have to correct 20% to 30% to put any meaningful dent in the U.S. current account deficit.

If it happened quickly, there could be turmoil on world financial markets.

Japan and China appear particularly exposed, with Japan holding US$736-billion in U.S. treasuries and China US$320-billion by mid-2004. The bulk is held as foreign exchange reserves by the central bank. Since then, China's holdings have swelled further.
But outside United Kingdom and the Caribbean financial centres, Canada had built up the biggest U.S. equity position with holdings totalling $240-billion in 2004.

In total, the 50 countries studied would lose four percentage points of foreign GDP if the U.S. U.S. dollar, equities and bonds all declined 10%, Mr. Warnock calculated.

"In the scenario we go through, it's just a 10% drop," Mr. Warnock said. "That wouldn't scare anybody but 30% might."

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Table: IMF; National Post / THE HIT TO WEALTH: Percentage point drop in GDP if U.S. dollar, stocks, bonds each fall by 10%.

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